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TREND WATCHING

Correlating gold, bonds and the USD with the S&P

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A bear market can be identified by the break in certain technical parameters, as I have discussed in my book *Sideways*. Basically, a bear market is one that displays a series of lower lows, and lower highs on a weekly stock chart, along with a break of the 200-day Simple Moving Average. When these conditions are present, this is called a "down trend". If that trend takes the market down by less than 20 per cent, it can be considered a corrective move within a bull market. If the market sells off by 20 per cent or more, it's a bear market in my books.

If you see a break in trend using the parameters discussed above, your analysis may also be aided by observing the stock market's correlation, or relationship to, other asset classes. Some assets go up when stock markets decline. We can study these asset classes to help us determine the likely severity of a pullback.

Let's say that an asset class that is normally "negatively correlated" to stocks during major bear markets begin to rise during a stock market pullback. This may offer evidence that the stock market decline may accelerate to a greater degree than a standard correction. Further, that asset class may also be a place to hide some capital as a hedge against a bear market.

In this article, I'd like to have a look at three markets that may, or may not, have provided bear market warnings and safe havens in the past. By observing the charts of almost 30 years of history on the S&P 500, we might gather some clues as to where we might hide our money should a bear ensue. Note that on each chart, the S&P 500 is in grey while the opposing index is black.

The U.S. dollar: The U.S. dollar, or USD, as seen on the correlation chart below, is often negatively correlated to stock market corrections and bear markets. On the left side of the chart are two minor corrections (1990, 1998) when the USD moved in tandem with the S&P 500. However, the much larger bear market moves on the S&P 500 of 2001-02, and 2008-09 and even the bear of 2011 as well as the correction of 2015-16 showed a rising greenback.

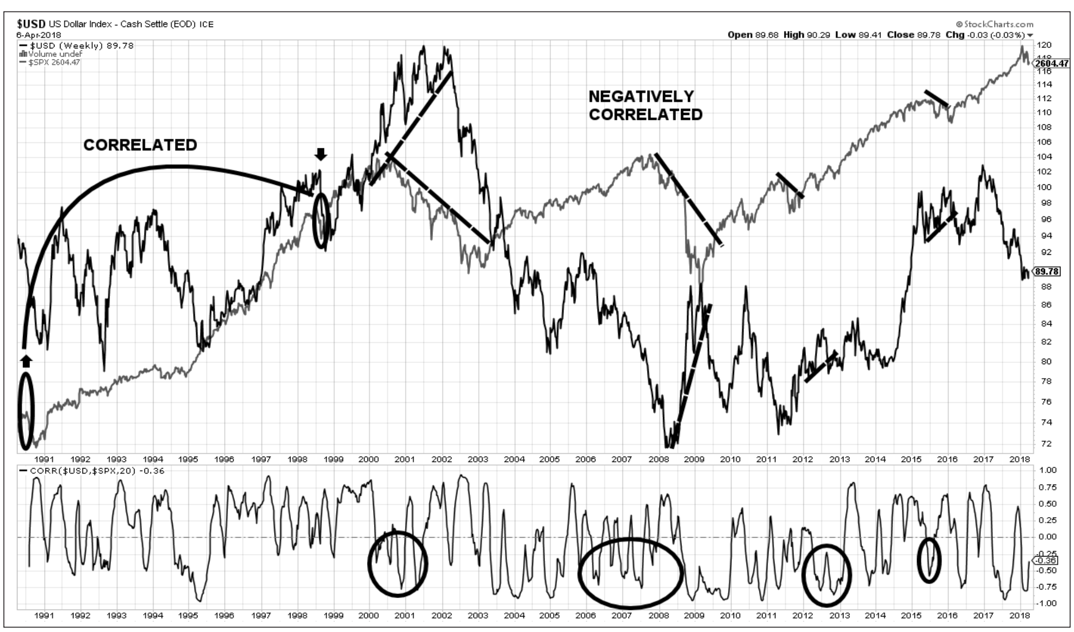
The minor corrective activity earlier this year has not yet inspired a flight into the USD. But we should keep an eye on the dollar to see if it might begin to rally.

As you may know, the USD – against a basket of world currencies – has been trending down over the past year or so. In fact, Sentimentrader.com's "USD Optix", a compilation of sentiment indicators pertaining to the USD, suggests that the USD has overly bearish sentiment.

When "everyone" hates the dollar, it is considered a contrarian "buy" signal. Should the USD begin to move up when this negative sentiment reverses, this may coincide with a downturn on the stock market. At the very least, a rising USD can be a good asset to hold for Canadian investors wishing to hedge stock market risk during bear market conditions.

30-year T-bonds: There is a definite relationship between the long bond and the S&P 500 during significant bear markets.

Note the extreme movement into bonds during the 2001-02 and 2008-09 market crashes. There



was also ample evidence of rotation into safety during the bear of 2011 and the significant correction of 2015-16. Even 1998 saw some minor rotation into bonds.

As with the USD, we are not observing this rotation in the current correction at this time. However, a significant bear market might inspire an upward move on the long bond. Keep an eye on the movement of the long bond.

Gold: I post this chart to dispel a myth. Let me get right to the point. There is no reliable negative correlation between gold and the stock market during bear markets– at least there has not been a consistent negative correlation during the past 30 years. The chart above illustrates this fact. Gold and the S&P 500 have moved in tandem during most bear market periods with one exception. It was only in the 2001-02 bear that we saw gold rise.

Further, the correlation line (bottom pane) illustrates a random relationship most of the time (2001-02 aside). They deviate in relative performance randomly, not specifically during bear markets.

Conclusion: Gold is not a reliable asset to move into during most bear markets. Gold is not a reliable indicator of an upcoming bear market. Gold should only be bought on its technical merit, not as a bear market indicator, or as a hedge against falling stock prices.

Strategy: Stock market corrective action in the first quarter of this year did not occur in tandem with bullish moves by the USD or the long bond. Therefore, it is safe to suggest that we have not moved into a broad-based bear market…yet. The current correction is largely technical – removing the irrational exuberance from the markets.

Keep an eye on the dollar and the long T-bond. If they see substantial bullish trend changes while stocks correct, that will add a strong piece of evidence to the probability of the onslaught of a new bear market. Purchasing those assets via an ETF or otherwise might be warranted as a hedge if, as, and when that potential occurs.

Keith on BNN

Keith appears regularly on BNN's Market Call to answer viewer questions. His next appearances on the show will be on Wednesday, June 6 at 6 p.m. and Monday, July 9 at noon. If you have questions about the technical analysis of stock trends for individual stocks, be sure to phone in with your questions for Keith during these shows.

Call Toll-Free 1-855-326-6266 or email your questions ahead of time (specify they are for Keith) to marketcall@bnn.ca.

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