schaeffer's investment research
Smart Options for Today's Investor

How to Trade the Market in 2014

Introduction

As we kick off 2014, the market looks anything but dull. The years-long bull run continued in 2013, ushering the major equity indexes to a string of new record highs -- despite jitters prompted by the seemingly endless political brinksmanship on Capitol Hill, and the prospect of an eventual end to the central bank's unprecedented stimulus efforts.

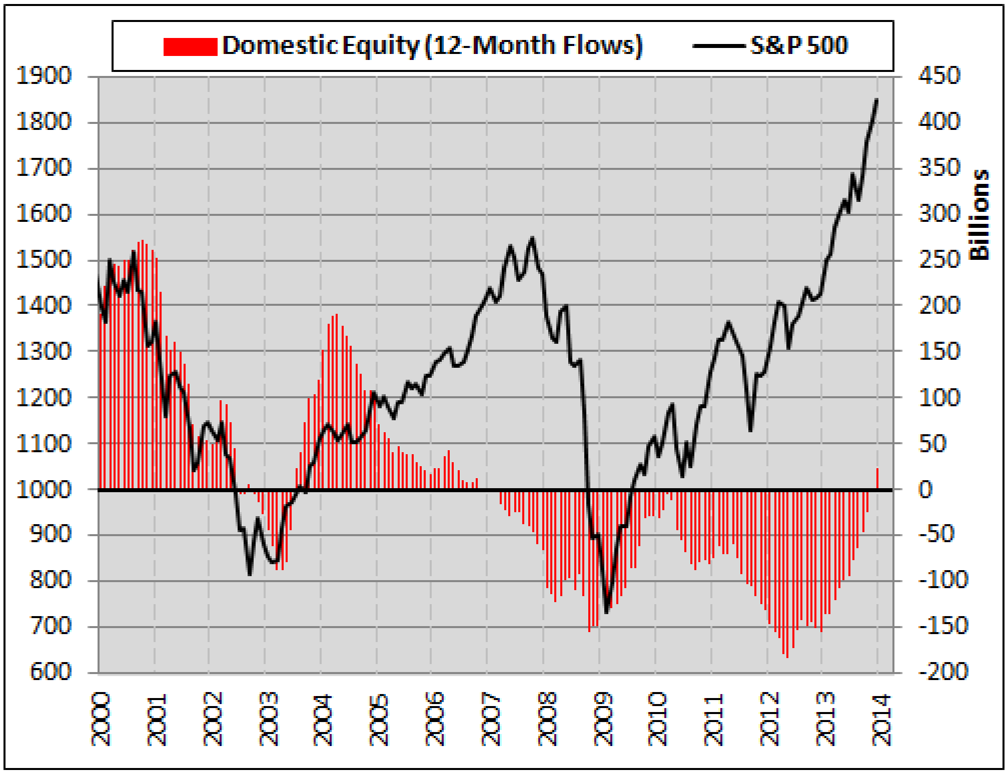
If you're one of the investors who has missed out on the uptrend in recent years, you may be wondering if it's too late to buy into the rally. Or, if you've been along for the ride as stocks have charted new highs, perhaps you're starting to debate whether it's time to take profits and get out of the market. Here, we'll explain the key technical levels and sentiment indicators we'll be watching in the months ahead, and what each one is telling us about the prospects for the market in 2014.

Following the Money with Mutual Fund Flows

Tracking mutual fund flows can offer valuable clues as to how investors feel toward stocks and the market in general. Are traders favoring equities (viewed as a "riskier" approach) or bonds (a more conservative angle)? Or are they feeling so negative that they're pulling out of the market altogether and shifting toward cash?

In the 12-month period from December 2012 through November 2013, we were net negative on inflows into U.S. domestic funds, with $27.8 million in outflows from equity funds and $7.8 billion in outflows from bond funds over this time frame. It would seem we are still in the middle of an unwind from extreme pessimism on the market, when 12-month outflows reached about $175 billion in mid-2012.

To put this in historical perspective, extremely high net inflows preceded the tech bubble and ensuing bear market of 2000-2003, while roughly three years of inflows followed by outflows were the ingredients for the bear market from 2007-2009.



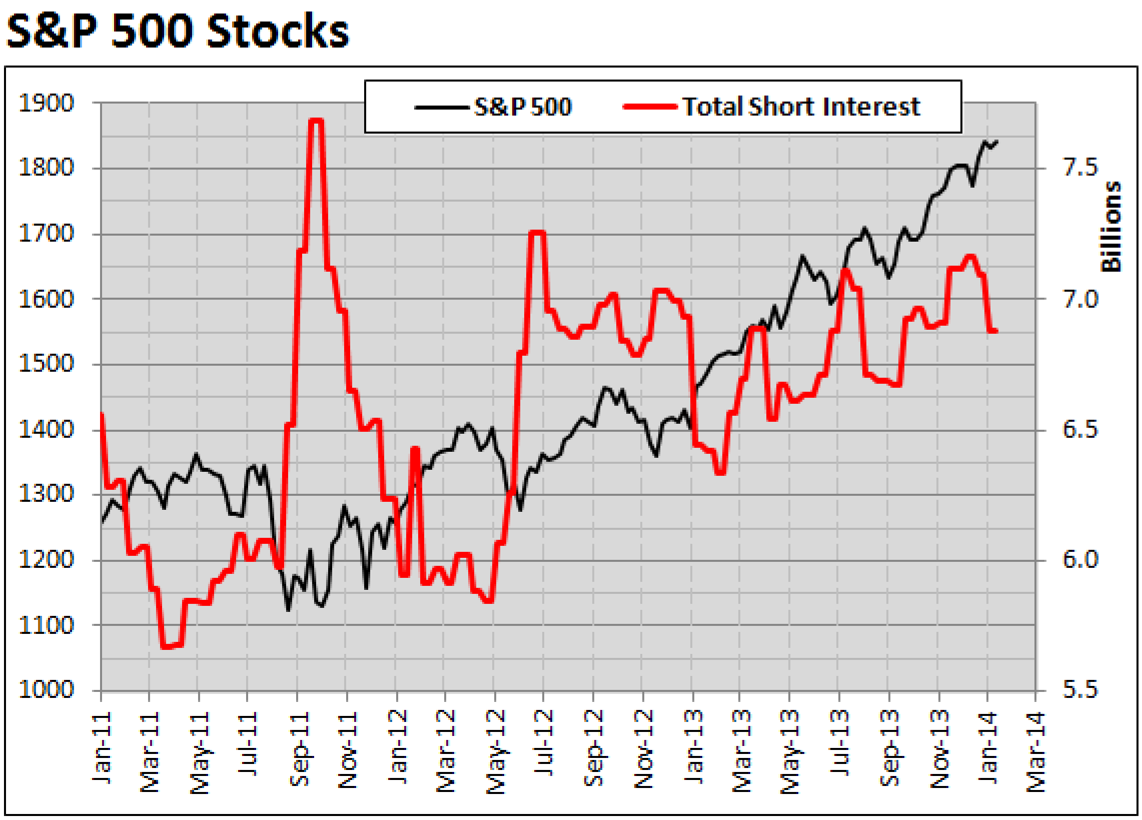
Taking a closer look at the current situation, both of these facts are worth noting:

- From 2007 through 2012, there were about $611 billion in outflows from domestic equities. In 2013, there were $24.1 billion of inflows. Inflows were about 3.95% of outflows.
- From 2007 through 2012, there were about $1.19 trillion in inflows to bond funds. In 2013, there were about $82.3 billion of outflows. Outflows in 2013 were about 6.94% of inflows.

This rotation out of bonds and into stocks could continue into 2014, which would be supportive of the market as new money flows in.

Why Short Interest Could Fuel Another Round of First-Quarter Gains

Despite the market's strong price action in 2013, short interest remains elevated relative to a year ago. This could be linked to the fact that negative headlines have dominated the financial media, even as the charts look appealing to bulls.



A short-covering rally in the first three months of 2013 propelled a solid first-quarter advance, but European concerns resurfaced when Cyprus, the third-smallest economy in Europe, required a bailout. Short interest on S&P 500 Index (SPX) stocks moved higher, generating a pullback as fears built. Since then, short interest has remained relatively high amid the rise of stimulus "tapering" concerns and uneven economic data.

With these macro uncertainties still at the forefront, market participants are acting with caution, anticipating one or both of these factors could lead to a slowdown in economic growth. As a result, there's a healthy amount of short interest out there right now, which could unwind to support another first-quarter advance if these bears are pleasantly surprised by positive developments.

A Surprisingly Skeptical Stance from Analysts

The first chart below shows the percentage of analyst "buy" ratings for all equities, alongside the performance of the SPX. The second chart shows the percentage of "sell" ratings. The percentage of "buys" has been decreasing since late 2011, despite the market gaining ground over this time. Meanwhile, during this same period, the percentage of "sells" has ramped up.

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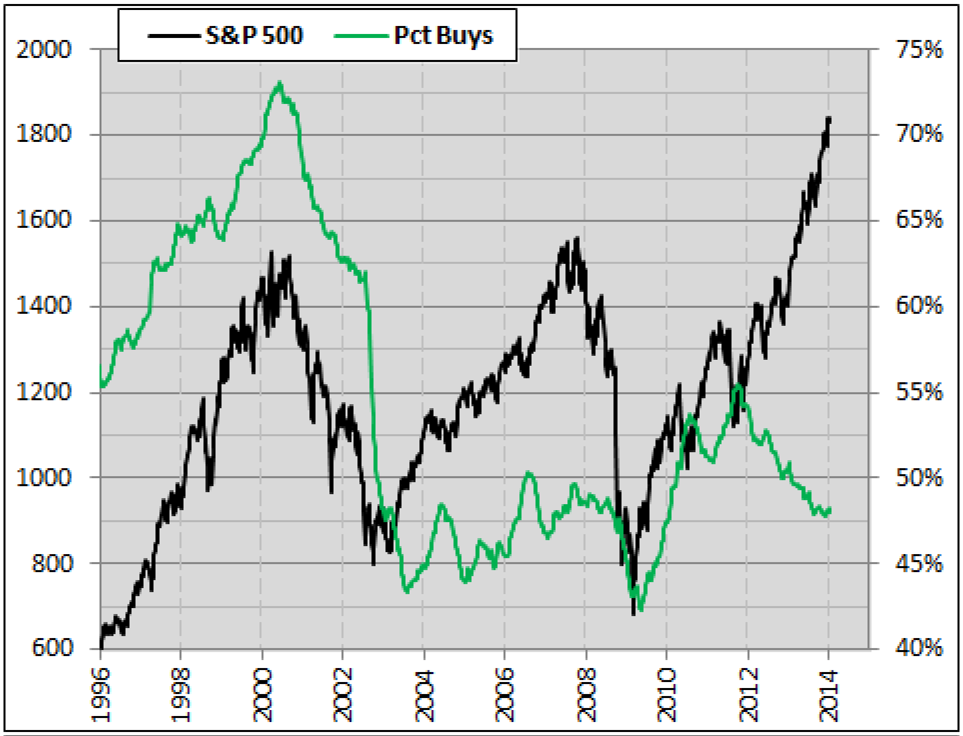

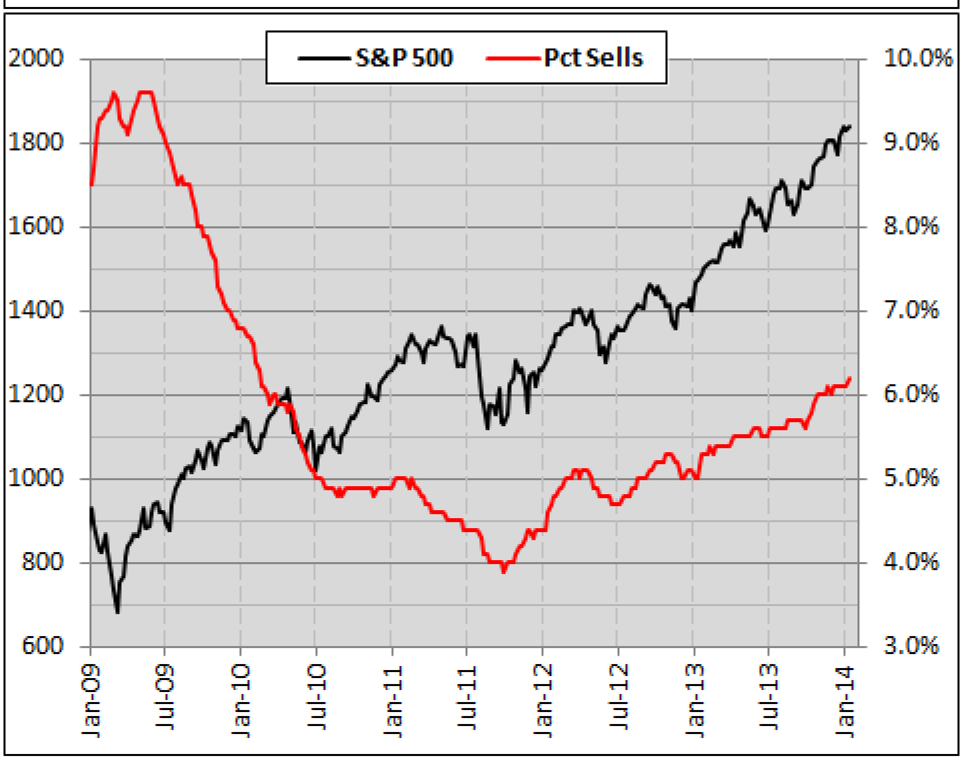

Many people may find it hard to believe that there is more upgrade potential on SPX component names now, with the index around 1,800, than there was when it was trading down at 1,100-1,200. However, that's certainly the case as we head deeper into 2014.

While it's not a given that the market will continue higher, the possibility of a shift in analyst ratings back toward the bullish end of the spectrum could be a positive catalyst for stocks going forward.

Will History "Rhyme" in 2014?

A quote frequently attributed to Mark Twain declares, "History doesn't repeat itself, but it does rhyme." With this in mind, our Quantitative Analysis team considered a few factors that make 2014 unique -- including the market's current winning streak and the appointment of a new Federal Reserve chair -- to determine whether these elements might affect stocks in the year ahead.

First, what happens when the Dow is positive five years in a row? The market ended solidly higher in 2013 -- only the third time stocks have finished higher for five straight years. Looking back at previous such occurrences, the sixth year has resulted in two negative annual returns for the Dow Jones Industrial Average (DJIA), and one strongly positive year.

This isn't enough data to draw any likely conclusions for 2014, but the lesson here is that winning streaks *can* last longer than many expect. What's more, a recent survey suggests that most investors do not realize 2009 was a positive year, as they think back to this year as being the height of the financial crisis -- when, in reality, stocks actually finished higher that year after bottoming in March.

Dow Performance After 5 Straight Positive Years

Year	Year-End Close	Return
1929	248.48	-17.17%
1990	2,633.66	-4.34%
1996	6,448.27	26.01%

Next, what should we expect during the second year of President Obama's second term? Below are two tables summarizing the returns for the Dow during the second year of each presidential cycle since 1949. Compared to the first year, it's generally a modest improvement. The second year of the cycle is positive 63% of the time, up from 53% positive for the first year. What's more, the average return rises to 6.64% from 5.25%.

Three of the last four years resulted in double-digit percentage gains for the Dow, and the one notable exception coincided with the bear-market bottom of 2002.

Dow 2nd Year Presidential Cycle

Year	Year Close	Year Return
1950	235.4	17.41%
1954	404.4	43.96%
1958	583.7	33.96%
1962	652.1	-10.81%
1966	785.7	-18.94%
1970	838.9	4.82%
1974	616.2	-27.57%
1978	805.0	-3.15%
1982	1046.5	19.61%
1986	1895.1	22.53%
1990	2633.7	-4.34%
1994	3834.4	2.14%
1998	9181.4	16.10%
2002	8341.6	-16.76%
2006	12463.1	16.29%
2010	11577.5	11.02%

Dow Returns Since 1949

Cycle Year	No. of Returns	Average Return	Median Return	Percent Positive
1	17	5.25%	10.88%	53%
2	**16**	**6.64%**	**7.92%**	**63%**
3	16	16.95%	16.70%	100%
4	16	4.77%	5.76%	75%

Finally, will the new Fed boss sway stocks? Current Fed Chairman Ben Bernanke is set to step down from his post at the end of January, which means a new top central banker (namely, Janet Yellen) will take the reins for the first time in eight years.

The table below shows the starting date of the tenures for each of the last 14 Fed chairs, along with the market's return during the one-year period immediately following. The modern market seems to respond well to a new Fed chief, as four of the last five years resulted in double-digit returns for the Dow. The notable exception here is Alan Greenspan, who had the misfortune of taking the Fed helm shortly before the Black Monday crash of October 1987.

Dow Returns

Date	New Chairman	1-Year Return
8/10/1914	Charles Hamlin	9.02%
8/10/1916	William P.G. Harding	1.82%
5/1/1923	Daniel Crissinger	-6.36%
10/4/1927	Roy Young	20.13%
9/16/1930	Eugene Meyer	-49.60%
5/19/1933	Eugene Black	15.26%
11/15/1934	Marriner Eccles	47.17%
4/15/1948	Thomas McCabe	-1.40%
4/2/1951	William Marting, Jr.	7.44%
2/1/1970	Arthur Burns	17.98%
3/8/1978	G. William Miller	13.13%
8/6/1979	Paul Volcker	10.88%
8/11/1987	Alan Greenspan	-22.61%
2/1/2006	Ben Bernanke	16.65%

Breakout Sector to Watch: Steel/Iron

Some of the stocks in the steel/iron space right now look a little bit like the solar names of 2012-2013. These solar stocks exhibited terrible price action for most of 2012, but experienced huge rallies in the fourth quarter and continued that momentum into 2013. During that key fourth quarter of 2012, the positive price action in the solar sector was confirmed by the Guggenheim Solar ETF (TAN) rallying above its 200-day moving average for the first time since May 2011.

Likewise, the Market Vectors Steel ETF (SLX) was weak for most of 2013, hitting multi-year lows in June. However, in the second half of the year, SLX rallied above its 200-day moving average and retested it successfully. Other rallies above this trendline in the past couple of years have been false breakouts, but the successful retest of this long-term moving average may signal that this current rally is for real.

Daily Chart of SLX since January 2013 with 200-Day Moving Average

Chart courtesy of Thomson Reuters

From a sentiment standpoint, analysts have been downgrading the group during the past year -- even though SLX ended 2013 in positive territory, with the index rebounding approximately 36% from its June low. The percentage of "buy" ratings on stocks in the group is 37%, down from 41% at this time last year. Short interest on components of the SLX is up over this same time frame, with an average of nearly 9% of each stock's float dedicated to short interest -- resulting in a mean short interest ratio of 6.7 days to cover.

Fundamentally speaking, many steel and iron companies have successfully passed along price increases in recent months. As a result, margins and earnings could improve, helping to turn some of these bears into buyers in 2014.

Two Stocks to Buy for 2014

Within the steel/iron group, **United States Steel (X)** is compelling as a potential speculative turnaround play for 2014. The shares did not participate in the broader market's rally off the 2009 lows -- and, in fact, hit new multi-year lows in April 2013.

Since hitting that bottom, however, X has bounced about 70%, and is now trading within range of its annual high. The shares benefited from a positive earnings reaction in late October, gaining nearly 9% in one day after U.S. Steel's third-quarter loss came in slimmer than expected.

The stock's breakout has pushed X above many of the longer-term moving averages we follow. This includes the 80-week trendline that previously marked a top in late 2012, right after the shorts had left the building.

Weekly Chart of X since November 2010 with 80-Week Moving Average

Chart courtesy of Thomson Reuters

With the shares now trading above this key moving average, short interest on X is high, representing about 23% of the stock's available float. And, for the first time in many years, there is evidence that these shorts are in the red, which was not the case during most of X's decline. If these bears take steps to cover their losses, it could provide the shares with a steady influx of buying pressure.

Meanwhile, analysts seem to have given up on X. The stock has garnered only four "buy" ratings, compared to seven "holds" and three "sells." In light of the technical breakout and improving fundamental backdrop for U.S. Steel, a round of upgrades could draw more buyers to the table.

All bets are off if the shares decline back below $21, but $40 looks like a reasonable upside target for X as the heavy skepticism begins to unwind.

Turning to our next pick, **Charles Schwab (SCHW)** was a momentum name in 2013, and the stock's persistently skeptical sentiment backdrop supports the argument for continued momentum into 2014. The shares are up roughly 70% year-over-year, having continued an impressive uptrend that dates back to June 2012.

Weekly Chart of SCHW since June 2012

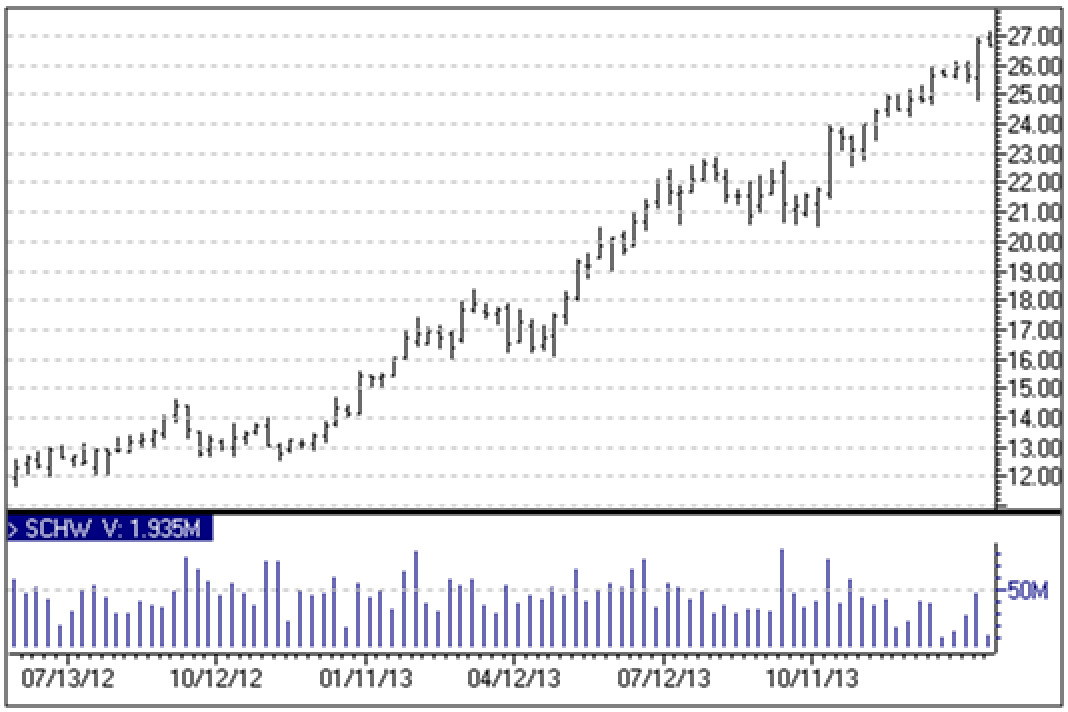

Chart courtesy of Thomson Reuters

The fundamental backdrop also looks solid. In mid-October, Schwab broke a streak of three consecutive negative earnings reactions by rising 4.6% in the session after its third-quarter release. This marked the first time in a year the company had surpassed analysts' earnings expectations -- a feat SCHW easily repeated with its fourth-quarter results.

Checking out the sentiment landscape, there's still plenty of room for the stock to benefit from fresh bullish attention. With seven "holds" and three "sells" out of 13 analyst ratings, SCHW could potentially attract some upgrades during the near term.

Meanwhile, short interest on Charles Schwab is near multi-year highs, with 38.1 million shares sold short. A drop in this metric during the month of December might suggest these bears are beginning to throw in the towel. If so, a continuation of this short-covering activity would be supportive of additional gains in SCHW going forward.

Three Crucial Technical Levels to Watch on the S&P 500 Index (SPX)

1. The 120-day moving average. This trendline contained major SPX pullbacks in 2013, so the 120-day is a moving average we'll continue to focus on as a potential layer of support. However, if a pullback occurs and this trendline is broken, the market could experience more selling (perhaps a 10% decline from closing high to closing low). The biggest correction in 2013 was the 5.8% decline in early summer.

Daily Chart of SPX since January 2013 with 120-Day Moving Average

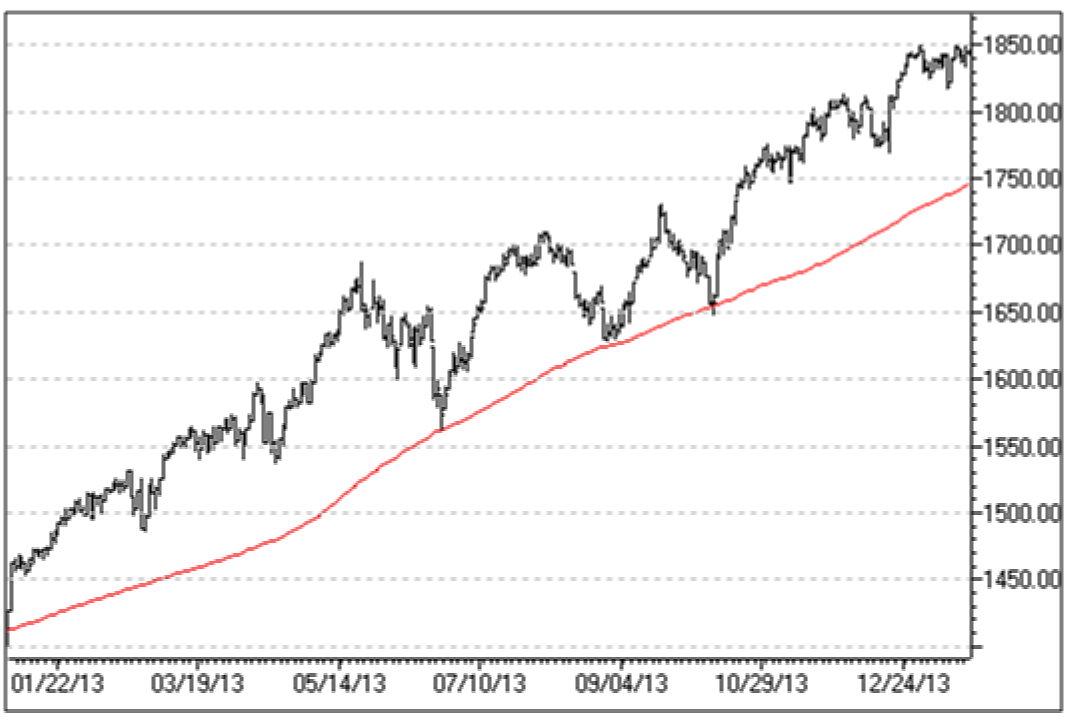

Chart courtesy of Thomson Reuters

2. Year-to-date (YTD) percentage returns. If we remain in rally mode, keep an eye on the SPX's year-to-date percentage returns in increments of five (5%, 10%, 15%, and so on) as potential hesitation points along the way -- or even areas of potential support on pullbacks. The index's activity in 2013, pictured below, is a perfect example of how the SPX and its companion exchange-traded fund (ETF), the SPDR S&P 500 ETF Trust (SPY), respected these areas as they moved higher throughout the year.

S&P 500 Index (SPX) and SPDR S&P 500 ETF Trust (SPY) with YTD Returns

Chart courtesy of Google Finance

3. The 2,000 millennium level. Should the SPX's momentum continue -- which is possible if hedge funds move into an overweight position and out of other assets (such as gold and muni bonds), and the retail player finally returns to the market and makes a positive impact -- the index could easily make a run at 2,000. This area, however, is one to watch carefully.

First, it's a millennium mark, and these should never be ignored. This is evidenced by the S&P MidCap 400 Index's (MID) 22-month battle, from April 2011 through January 2013, to finally clear 1,000. Equally instructive is the Russell 2000 Index's (RUT) rejection at 1,000 in May 2013, which preceded a short, but notable, period of weakness. While the 1,000 level on the SPX was taken out rather easily on the first and second attempts (in February 1998 and again in September 2009), it should also be noted that in both cases, the SPX revisited this millennium level six months and 10 months later, during significant pullbacks. In both cases, the SPX peaked 20% above 1,000 before returning to this psychologically significant area.

What's more, 2,000 on the SPX represents a triple of its March 2009 lows. Looking back, the SPX peaked in the 1,330-1,340 zone -- a double of those 2009 lows -- ahead of a significant pullback in 2011.

Conclusion

As we head into 2014, the SPX is positioned above key support at its 120-day moving average, and a continued uptrend could eventually force a capitulation among the remaining bearish analysts and short sellers. This potential unwinding of pent-up negativity could provide the boost needed to push the benchmark index further into all-time high territory. In fact, we're targeting an SPX move up to **2,100** by the end of 2014.

Overall, the combination of intact chart support, positive momentum, and lingering skepticism among traders and analysts has powerfully bullish implications, from a contrarian perspective -- not only for the broader equities market, but for a number of select outperforming stocks, as well. Going forward, we'll be keeping an eye on all of these technical and sentiment indicators to guide our trading decisions in the year ahead.