The Market in Review

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This week's articles and insights

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"Fashion is not something that exists in dresses only. Fashion exists in the sky, in the street, Fashion has to do with ideas, the way we live, what is happening."

- *Coco Chanel*

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	20,094	+1.34%	+ 1.68%
S&P 500	2,295	+1.03%	+ 2.50% (+0.16% in $CDN)
TSX	15,576	+0.18%	+ 1.89%

The New Sheriff

This is the first week of the new Trump administration. It is also the first time in history that the Dow Jones Industrial Average has surpassed the 20,000 mark. Investors are excited about the prospect of lower tax rates, more jobs, and a stronger economy. Most developed nations, especially the US, have neglected their highways and infrastructure. Just upgrading those in the US will require tens of thousands of man-years of employment.

Compared to 1999, when the Dow Jones first surpassed 10,000, the market today is actually in better health. Breadth – how many stocks are rising – is far better, for example. You want all your horses pulling the wagon, not just a few. Valuations are also lower than in 1999.

Our chief strategist, Jeff Saut, feels we should get some sort of mild correction soon. The market has risen 9% just since the election, which is a good year in just three months. Optimism towards stocks is high, as is pessimism towards bonds. Both need to cool off. Oil prices have levelled out around US $52-53, which is good for Canada. We feel oil can rise in price this year, but not by a great deal. With every $1 increase in the price, more drilling comes back on-line, making a rebound in oil somewhat self-limiting. That's actually good for the overall economy.

In terms of adding new money to portfolios, we are dragging our feet a little, waiting for better prices (i.e. some down days). In terms of individual stocks, we are investigating the US homebuilders, which appear as cheap as any sector we follow.

Trust the Dress

In case you have not listened to the news, there are a tremendous number of stories telling completely opposite things.

For example:

\+ We know the first months of a new Presidential term are generally positive as new projects are enacted and campaign promises kept. Markets are usually up in the first few months of a new presidential administration.

\- **But** (say the naysayers), the first year often develops into the worst of the four-year term. If you are going to deliver bad news, get it out of the way in the first year.

+ President Trump's policies promise to grow American exports and defend the country better. He is already reducing regulations to allow companies to expand.

- **But**, his threats of protectionism loom like a dark cloud on the horizon. Remember the 1930s? A recession became a depression when trade came to a halt with the Smoot-Hawley tariff bill.

+ The Dow Jones Industrial Average just broke through the 20,000 mark for the first time in history. This positive momentum often carries on for up to a year.

- **But**, valuations are getting stretched. Price/Book values are in the top 98% of historic measures for the S&P 500 – nosebleed territory. The Investors Intelligence survey indicates 60% of investors are bullish, a level that has been reached only 1.8% of the time in the past (source: Dynamic Mutual Funds).

With all this confusion, we are forced to look elsewhere for divine guidance. Let's consider a time-tested barometer: women's skirt lengths. What do they say about the economy's future?

In 1926, Wharton economist George Taylor established a link between women's skirt lengths and the economy. His reasoning then was that when women could not afford stockings, they wore longer dresses. Hence, a poor economy led to longer skirts. Further research pointed to skirt lengths as a general attitude towards the future. The more optimistic a society is, the shorter the skirt. The more pessimistic, the more conservative the fashion. The 1920's saw the high "flapper" dress, for example, and the dour 1970s saw the introduction of the first midi-skirt. Skirt lengths went up in the 1980s, and back down after 2008. They reached their longest lengths since the 1930s, according to some watchers, in 2012. This was just after the Greek bailouts and worries that Europe was collapsing.

Researching this phenomenon even further, two economists from the Erasmus School of Economics in the Netherlands in 2010 showed a three-year lag time after skirt lengths moved up or down. They predicted that the 2009 recession would result in long skirts by 2011-2012, which is exactly what happened.

Another aspect of this is the fashion of the First Lady when her husband is elected. In this case, what did Melania Trump wear when "The Donald" was elected? Both long and short dresses made an appearance on the runways of Paris and Milan last year, which confused the Hemline Index (an economic measure a few people follow). Melania Trump's dress was something called a swag cut, a skirt that is long on one side and short on the other. If the fashion industry is signaling a mood about the future, it seems to be saying women are highly uncertain about what is about to come.

And perhaps that is the message we should take from the disparate news reports and mixed skirt lengths. Neither the press nor the fashion designers have any idea what the mood of the population truly is. Markets have been very calm for years, with volatility measures at 10-year lows. The period ahead may be just the opposite, with more volatility than we are expecting.

Fears for Sears

The world is changing faster than we think. More on that below, but one dramatic trend is on-line shopping. Once a curiosity of a few brave shoppers, it is now commonplace to order a digital book on your tablet or buy clothes through Amazon (**NASDAQ AMZN**), which will then ship them to you free in just a few days. Kids don't hang out at malls as much anymore, and mom is increasingly ordering the household necessities through the computer. My sister-in-law even orders dog food through Amazon (**NASDAQ AMZN**). The delivery courier dutifully lugs the 50-lb. bag to her door every month. Retail stocks are very cheap right now, because of this threat.

Traditional retail stores are not standing still. They will adapt and survive, of course, because some things like washing machines and hot coffee are hard to order and deliver on-line. But who would have expected jewelry to go digital, or sporting goods? Or auto parts?

One retailer that should have thrived in the on-line era was Sears (**NYSE SHLD**). Especially Sears Canada (**TSX SCC**), which kept the venerable catalogue after the US parent phased it out. Catalogue shopping could have easily become a productive on-line division, but they muffed the execution. Sears had strong brands in Kenmore, Die-Hard, and Craftsman. Then the company made the mistake of buying K-Mart years ago, a dying chain. Newer department stores like Target (**NYSE TGT**) and Wal-Mart (**NYSE WMT**) pecked away at Sears' sales and the chairman bled the company dry through asset sales and big dividends. Sears just sold its Craftsman division for $900MM to Black and Decker, after listing it for a reported $2 billion a year ago. This leaves Kenmore and Die-Hard, but both have been on the block since 2015 with no takers. The debt of Sears was just downgraded.

Today, Doug Kass at RealMoney thinks we could see Sears go bankrupt and its 100,000 employees let go. Sears Canada could probably survive for a few more years, but retail is struggling up here, as well.

As we said, the retail industry will adapt and survive. Not all retailers will, however, and there will be bargains once the dust settles. We are standing back from the entire sector, for now.

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(Self) Driven to Distraction

In the *short term*, the investing world is focused on earnings and the Dow Jones Industrial Average breaking above 20,000 for the first time. The Dow serves as a sort of barometer of the mood of American business. Right now, the barometer is displaying a warming trend. Home sales, employment, and manufacturing are all improving.

In the *medium term*, investors – and workers in factories from Shanghai to Oshawa – are watching the blizzard of executive orders coming out of the White House. President Trump has wasted no time in approving pipelines, constricting immigration, and threatening global trade. Every move cuts both ways. They can be good for US business today but they could also have negative ramifications tomorrow. The Trans Pacific Pact, for example, was meant to extend American interests into the Far East, making sure the US had economic power as well as military strength in the region. Cancelling it is a short-term win, but it also forces countries like Australia and New Zealand into China's embrace if they want to increase trade.

The end result may be exactly the opposite of what President Trump wants.

For now, markets remain in a buoyant mood. They are cheering the proposed lowering of personal and corporate taxes, as well as the dismantling of numerous regulatory burdens. Money goes where it is best treated, goes the old saying. Money likes what it is hearing from the new administration. Today, anyway.

In the *long-term*, science and engineering are moving much faster than most people think. Peter Diamandis, a venture investor and noted futurist, lists ten areas where substantial progress was made in 2016. Here is the link if you want to read the full article:

https://www.linkedin.com/pulse/top-10-tech-trends-transforming-humanity-peter-diamandis

I want to focus on just one of these today – the driverless car. I remember a contest called the DARPA challenge back in 2004. The US government offered $1MM to the inventors of any vehicle that could navigate 150 miles on its own through the desert. The car that made it furthest crashed into a rock after just 7 miles and no money was awarded. By 2005, five vehicles completed the entire course.

As of late 2016, Tesla now has over 1 billion miles of driving data they are feeding into their autonomous driving algorithms. Self-driving trucks are now being tested even as autonomous forklifts already operate in closed spaces such as dockyards and factory floors. While it may seem fanciful to imagine streets full of cars with no drivers, it is closer than we think. A company called NuTonomy is already testing automated taxis in Singapore and plans to unveil the service in 10 other cities by 2020. Most forecasts project the driverless age will officially begin in that same year.

That is just three years away.

I raise this because my brother and I were just at a car show in Phoenix, where collector cars from the 1950s through today were auctioned off to anxious (and wealthy) collectors. What will this auction look like in ten years? Will it even exist? Young people today view cars more as pure transport rather than projects. Twenty and thirty year-olds did not grow up fixing cars like we did because today's engines have become so complex, even professional mechanics scratch their heads when a hood is opened. The autonomous car will move car ownership even further from many people's minds. Why own a car when you can simply summon one to take you to work and pick you up? It can park or drive itself around during the day, doing the work that ten cars do today, cars which spend 90% of their time in a garage or parking stall.

Autonomous vehicles will farm for us. They will take over taxi, trucking, and even ocean shipping tasks. For seniors who have lost their driver's licenses, autonomous vehicles will be a huge boon. For the auto companies, it is not so clear cut. If one car running on its own for eight hours a day can do the work of eight cars running for one hour per day, what will that do to automobile sales?

Once a new trend starts, it expands exponentially until a market is saturated. In Britain in the year 1900, there were approximately one million working horses. By 1914, thanks to automobiles and other petrol transport, the population had shrunk to about 25,000 (source: International Museum of the Horse). Cellphones were a novelty in 1994. They passed traditional wireline phones by 2004 and today, 66% of people under the age of 25 use them exclusively. This suggests the majority of cars on the road could be driverless by 2030. That is not that far away.

This has enormous ramifications for everything from automobile production and oil use to a decline in taxi and municipal parking revenues. Today, shares in automobile companies trade at low multiples, even as their sales and profits have been strong for several years. Is the market sensing a dramatic change coming? Markets tend to overdo things, and many industries have been written off far too soon. The disk drive business comes to mind. Even though there are just two large competitors left making disk drives, they have both expanded into memory chips and are highly profitable. The industry consolidated and adapted, in other words. Which is likely what will happen to the automobile companies.

It is interesting to see politicians from Ottawa to Washington to Mexico City bribing and threatening car companies to set up shop in their countries. Fast-forward five years, and we may well see massive mergers and shrinkage as these companies switch from making luxury cars with cruise control to stamping out utilitarian pods with no steering wheels.

One thing is sure: a giant wave is washing toward the car business. The trick is, how do investors surf it?

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