

The Market in Review

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This week's articles and insights

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“I’m not better than the next trader, just quicker at admitting my mistakes and moving on to the next opportunity.”

- George Soros

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	25,381	+ 1.59%	+ 2.68%
S&P 500	2,740	+ 1.29%	+ 2.50% (+6.66% in \$CDN)
TSX	15,150	+ 1.51%	- 6.53%

The Changing Patient

I had a doctor as a client who got angry when the market went down.

“I am a better surgeon today than I was a decade ago because of how hard I practice and what I have learned. Why can we not apply this to stocks? Why can’t we avoid stocks that go down??”

What he meant was “why can’t you avoid stocks that go down”, but I digress.

“We also practice and learn,” I replied. “We apply what worked in the past, then adapt our methods with the most modern tools. We focus on larger companies now, ones that have larger “moats” to protect them against competitors. Unfortunately, the stock market changes. Your patients don’t.”

“What?” was his exasperated reply.

“Look,” I continued. “When you cut into a patient’s chest, his heart is always in the same place, right? In my ‘stock market’ patient, it changes. Yesterday, rising earnings made stocks go higher. Today, it might be a big dividend that entices people to buy. Tomorrow? It might be how many new subscribers the company signed up, even if they lose money on every one. In my world, the heart might be in the left side of the chest on Monday, on the right side on Tuesday, and in the left foot by Friday. The stock market ‘patient’ evolves to confound the majority of investors.”

“In other words,” I said, “if it was easy, everyone would be rich.”

He’s still learning. So are we.

We avoid small companies and the latest fads (marijuana, anyone?). We’ve seen excessive debt sink too many companies, so we shy away from big borrowers. Our portfolios generally rise less in good markets, but fall less in bad ones, and we are fine with that.

Good Riddance, October

And so ends the weakest half of the year.

The Stock Trader’s Almanac describes the May 1st through October 31st period as the weakest six months of the year, which is then followed by the November 1st through April 30th period, the stronger of the two halves.

So long, October. Don't let the door hit you on the way out.

October is often weak. This year, it was one of the weakest in years, for a number of reasons:

- In even-numbered years, there is a U.S. election cycle for senate and congressional seats. As we can see and hear this year, the 2018 mid-term elections are exploding with sound and fury.
- Most mutual funds have October 31st as their year-end. Because they often dump stocks to crystallize losses and lock in gains, there can be higher-than-normal trading and volatility in October.
- This is the month when Q3 earnings are reported. Many companies are active buyers of their own shares, but must stop during the earnings "blackout" period. For the first half of October, only about \$10 billion in authorized buyback programs were active. Today, about \$80 billion of buying is now in effect, rising to almost \$160 billion by mid-November (source: FactSet, Deutschebank). Help is on the way.

In September, we said we expected a "wobble" in stocks during October. Nothing to worry about! By October 12th, the US market had fallen about 7% from its peak, and a week later, both it and Canada's index were down almost 10%. A decline of 10% is official "correction" territory, and much more severe than we expected.

How severe? The S&P 500 did not fall more than 2% on any day during 2017, yet has now done so seven times this year. This perfect storm caught most strategists and timing services off-guard.

What has changed to make this the worst October decline since 2008?

Well, central banks around the world want growth to moderate. They slow things down by hiking interest rates, and may have gone too far. Morgan Stanley analysts had this to say:

"We have been suggesting the Fed and other central banks are tightening much more than most market participants and commentators. More importantly, the markets seem to agree and have been quietly revolting all year. Now that these revolts have reached the shores of the US and the large cap tech stocks, more people are paying attention. We don't think the revolts will stop until central banks pause or at least signal they are concerned."

Job gains in U.S. small businesses are slowing (source: ADP report) and more companies are reporting rising expenses. So, markets are now reflecting slower growth.

Is this the end of the world? Not if growth is just pausing. It is the equivalent of the market taking a breather. However, if “slower growth” means recession, then stocks could get weaker.

We don't see this happening yet. If a recession was imminent, we would see problems in credit spreads – corporate bonds yielding far more than government bonds. Yet, spreads are still near their 20-year lows, implying a very healthy lending market. See how spreads rose in 2000 and 2007? No sign of that now:



Second, earnings have been good this quarter, but not quite as good as expected. Approximately 75% of U.S. companies reporting have exceeded their estimates for earnings. That's above average. However, only about 45% have exceeded their revenue, or sales, estimates. In other words, they are making more money per widget sold, but selling fewer widgets. That is not what we want to see.

Finally, one of the bigger changes is the rise of computer trading. Somewhere between **60% and 90%** of all trades are now done by computer programs on any given day (source: JPMorgan). Many of these algorithms listen for phrases like “*increase Chinese tariffs*” or “*more rate hikes*” then sell millions of shares instantly. September's rate increase in the U.S. (and Canada's in October), combined with the U.S. mid-term election and all its rhetoric has given these algorithmic predators a lot to act upon.

Market declines are never easy. Many of our individual company holdings, such as Microsoft (**NASDAQ MSFT**), Disney (**NYSE DIS**), and Merck (**NYSE MRK**) have reported strong earnings. They still declined. Even sad old Westjet (**TSX WJA**) surprised everyone with a better-than-expected quarter, and its shares were flat. Because of the underlying profitability of most companies, we believe the worst of this seasonal decline is behind us.

But...the rest of the world is not as healthy as Canada and the U.S. are. China has slowed sharply. Blame Trump and the trade wars, if you will, but many agree that China needs to behave like a developed world economy and not like a tiny emerging market that can do what it likes. China's stock market is down close to 25% this year, which definitely casts a shadow on stocks over here. Rather than pull the world up with its strong economies, North America could instead be dragged down by a weaker world. The next few months will be telling.

We know we are in the late stages of the economic cycle. Parts of the world have already started slowing down. However, stocks here could still see new highs through early next year.

Our Man Jeff

Jeff Saut is Raymond James' strategist. He is never without an opinion, and his has remained resolutely positive throughout all this.

Why?

He thinks the recent market decline is not due to earnings falling off. It is due to China weakness, the Fed tightening, and mid-term election tension.

He maintains the bull market did not begin in 2009, but in 2013 when the S&P 500 broke to new highs. Therefore, it is much younger than most people think. We are in Leg 2 of 3 of this bull market, Jeff maintains. One which began in early 2016. The 3rd leg is the speculative stage, like 1994-2000. In Leg 3, investors will not be terrified as they are now – they will be eager to invest. We have years to go yet.

He also points to the shortage of stocks today. The market had 7,000 stocks in 1995, which has been cut in half today to just 3,700 publicly-traded companies. Few companies go public now, and hundreds are bought out every year.

More demand + fewer stocks = higher prices.

Other parts of the economy are not as bad as feared, either. Housing, for example. Despite the decline in housing stocks, he says many Millennials still need to buy a home and so we are years from another U.S. housing collapse.

In terms of the trade wars, he believes China will blink first and will offer a deal.

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Remembering the Mania of 2000

While much has been written about the FAANG stocks (**Facebook FB, Amazon AMZN, Apple AAPL, Netflix NFLX, Alphabet GOOG**) and their high valuations today, we cannot forget how crazy things were back in the year 2000. The recent buyout of a company called Red Hat (**NYSE RHT**) by IBM (**NYSE IBM**) demonstrates this.

After almost 20 years, Red Hat shareholders (if they held), are finally positive. Those that bought at the peak in 2000 will have realized about a 1% annual return since 1999.



Source: StockCharts

Red Hat first came public at \$20 in 1999. It rocketed up 100% immediately, then ended the year +350%. At its peak, it traded at about 1400x sales.

How high is that? Most companies trade at 1x – 10x sales. Some marijuana stocks recently traded at 100x sales. So, yes, 1400x sales is high. The “dotcom” era truly was the Mother of all Manias.

This suggests that today’s “tech bubble 2.0” doesn’t really ring true. Is there some froth? Sure. But sky-high valuations? Not even close to the bubble of 1999.

There will always be manias and areas of excitement. 2017 featured Bitcoin and its ilk, which have now collapsed. If marijuana stocks follow past “tulip bubble” declines, they could eventually fall about 80% from their peak. Then, they will be in a reasonable place. As the chart above shows, this is what happened to Red Hat. It eventually became a real company, with real sales, and then an even bigger real company bought it.

It just took two decades.

<http://www.dividendvaluepartners.com>

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