The Market in Review

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This week's articles and insights

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"He thought the lion was dead and the lion thought it wasn't."

- Obituary column for a big game hunter

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	33,504	+ 1.06%	+ 9.47%
S&P 500	4,097	+ 1.92%	+ 9.08%
TSX	19,229	+ 1.26%	+10.30%

The Spring Haircut

In the fall of 1980, I attended the University of Washington to finish my electrical engineering degree. At my previous school, the University of British Columbia, I met a rower on the UBC crew and became intrigued with the idea of rowing. So, at the age of 21, I joined the UW freshman crew - a group of 18 year-olds with far more time and energy than I had.

Little did I know that UW had a long tradition with rowing, going back to 1936 when the Husky crew won gold at the Berlin Olympics. Training was daily, often in the dark and in just about every condition of wind and wave. By March, we had thick calluses and bulging arms, just in time for racing season to begin. By then I was the fittest I have ever been. Rowing is a tough sport.

The one wrinkle I had not counted on was a unique Spring Break tradition. At the end of March, when every other student went home, the UW freshman crew stayed on campus to train intensely for a further two weeks on their own.

In a secret ceremony on the first night, every freshman had their heads shaved. By the time the two weeks were over, these young men sported a short stubble haircut that was known as the “crew cut.” This fashion apparently started at Yale and spread across the nation to every rowing crew that didn’t want hair in their eyes when the wind came up. The crew cut became widely popular in the 1950s for all men, but fell out of favour in the 1960s when those who still sported the hairstyle became known as “squares” because of the fashion’s angular style.

The demands of engineering, and the prospect of going bald at 21, led me to exit the freshman crew just before the haircut. It did leave me with a permanent admiration for those in the sport, however.

The fear of a “spring haircut” has never left markets, however. Stocks are often strong from January through March, and this year has been no different. Stocks have had an almost uninterrupted run since October for the Dow Jones and Toronto exchanges, although the tech-heavy NASDAQ stumbled badly in February. We have extremes in bullish sentiment (too many are bullish), record levels of margin debt (too much borrowing to buy stocks), and low levels of cash in portfolios (too little dry powder).

Should we be panicking?

The Ned Davis Research company tracks all of these indicators and puts them into one big one called the Fab Five. It displays everything together to measure weakness and strength in the markets, like a barometer does with weather.

Without getting into why there are only four indicators for something called the Fab Five, its primary components look like this:

Model Component	Chart	Model Reading (As of 2021-04-06)
Tape	DAVIS501	BULLISH
Sentiment	DAVIS502	NEUTRAL
Monetary	DAVIS503	NEUTRAL
Combo	DAVIS504	NEUTRAL

Sentiment: This measure says while there are elevated levels of enthusiasm, we are not in a frothy market yet.

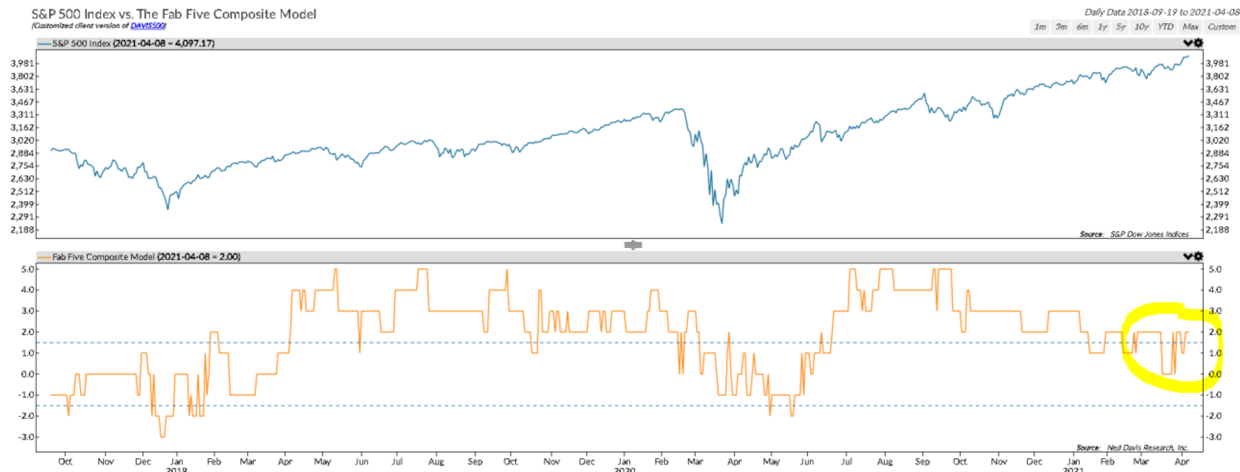
Monetary: Lots of money continues to flow into the economy from stimulus and low interest rates. This remains a big support to stocks.

Combo: This measures bonds, interest rates and new highs and lows of stocks. It is neutral at the moment.

Tape: This measures the underlying strength of the market. Are more stocks rising, or just a few big ones? Today, lots of stocks are rising, which suggests a healthy market.

Valuations remain a concern, as stocks in the U.S. are historically expensive. However, we know that profits will improve with a re-opening of the economy. And, interest rates remain low, cash continues to be supplied by governments, and politics are relatively calm.

For now, the Fab Five indicator remains in the “safe” zone, which is above 1.5 on the chart below.



These conditions won't last forever, or course. Over the summer months, markets are as likely to go sideways as they are to go up, but there is little lurking under the surface to suggest big declines are ahead.

We remain invested.

Race to the Finish

Like the lion above, we thought the virus was dead but the virus thought it wasn't.

It is a race worldwide. In one lane is a virus that has mutated to spread more easily, and in the other lane are the vaccines invented to stop it in its tracks. Here in Canada, it feels like the virus is winning, as we have just 2% of the population fully vaccinated versus 20% in the U.S. (source: Our World in Data).

This has led to uncertainty in commodities like crude oil. Supplies of gasoline have swelled because lockdowns have tightened the screws on driving trips once again.

Central banks are watching closely. Most have confirmed they will stay as accommodative as necessary, with no interest rate hikes for several years. Gold jumped on the news.

If you look at global economies, however, they are not signaling worse news ahead. In fact, quite the opposite. They are already on the mend and anticipating a victory over the virus.

For example, manufacturing output is rising in 86% of countries surveyed and is accelerating at the fastest pace seen in a decade.

Services output (travel, dining, haircuts) have lagged behind, but are also now improving rapidly. The service sector is rising in 62% of countries surveyed. The U.S. is one of the leading countries now, thanks to almost a third of the population (100 million) receiving at least one dose of the vaccine. Herd immunity is in sight in the biggest economy in the world.

The markets are saying the rest of us aren't far behind.

CPI – Confusing Price Index?

One question we get asked about the most concerns inflation. Why does everything seem more expensive when "official" inflation shows nothing to worry about?

The Consumer Price Index, or CPI, was never intended as a basket of goods to be measured for price increases, even though that is exactly what it measures. Instead, it is intended to be a measure of the economy's strength, which the central bank watches so it can twiddle with interest rates.

That basket seems to be getting more expensive, though. Just try buying lumber, food, or computers these days. The things that <u>should</u> be cheaper, such as clothing, and gasoline, aren't because of Covid-19 supply shortages.

CPI's calculation aims to balance the rising cost of some items with the improved value of others. Items such as cars with navigation units and heated seats, and faster computers for the same price are assigned lower prices because you get more features for the same money.

In other words, what we are buying may not be cheaper at all, but they work to lower CPI.

Conspiracy theorists say this is intentional. Governments don't have to raise pension payouts much when inflation is low. Pension payments are one of the fastest growing programs of western governments.

Indeed, the CPI underweights and even excludes a few things that impact our lives meaningfully. It can fail to measure what people <u>really</u> have to pay.

For example, house prices. This is the largest item most people will purchase in their lifetimes, and prices have been rising at a shocking pace. And yet "house replacement cost" is just 5% of Canada's CPI calculation and **0% in the U.S. measurement**! Rent and mortgage costs are weighted twice what the price of a house is in the calculation. Rents have not moved as dramatically, thanks to Covid restrictions and rent controls, and mortgage rates have actually dropped. These hide the inflationary impact of real estate prices.

Second, taxes. Although income tax is the largest expense for many people each year, it is not part of the CPI at all. In fact, it may even cause CPI to decline because people have less money to spend on other things!

When people say "inflation", what they feel is the erosion in the purchasing power of their dollars. One dollar in 1913 buys about $0.04 today. A single loaf of bread in Ontario in 1998 cost about $1.30. Today, a national brand costs about $2.65 (Walmart.ca). Official inflation, which has measured an increase of about 3% per year since 1998, says bread should cost about $1.90 today. And yet the actual cost is quite a bit higher.

Just to confuse things, premium bread, like the whole wheat bread we buy in our household, is $3.65 per loaf. Bread with seeds, like "Chipmunk" specialty bread, is $4.50 a loaf.

For the record, I don't envy those who calculate CPI, because real people substitute bulk brands to save money, or buy for reasons unrelated to price. Like paying more for gluten-free bread.

So should we be worried about inflation running away on us, or should we trust the government statistics that everything is just fine?

The classic definition of inflation is "more money chasing fewer goods." As of December of 2020, Canada had injected about $300 billion in stimulus payments into the economy and the U.S. about $3.1 trillion. Since then, Canada has added more and the U.S. has added at least an additional $2 trillion as of March.

This is the "more money" part of the equation. We have never seen "more money" than this created in our lifetimes.

The "fewer goods" part of the inflation definition can be seen in the supply crunches in lumber, computer chips, bicycles, running shoes – just to name a few. So, we could see a burst of inflation this year.

Longer-term, inflation is unlikely to reach the 10%+ levels we saw in the 1970s. The global population is getting older by the day and older people spend less. Technological innovations, like on-line shopping, have also lowered costs in many areas.

Then again, conspiracy theorists say governments now want *higher* inflation so the trillions they owe in debt will be paid back in much smaller dollars down the road. And what governments want, governments usually get.

Expect at least a burst of inflation in the next year or two, as a result.

The better question is this: what has kept pace with the falling value of the dollar? Where could you park your money so that you at least kept pace with bread prices since 1998, even if cash didn't?

2.8x Bread
2.5x Canadian stocks
2.6x Real estate (national home prices, inflation-adjusted, FRED database)
5.6x Gold

Inflation – as seen in the CPI calculation or hidden in the things CPI omits – erodes the value of the dollar. This will continue because it always has. Keeping everything in cash guarantees you will slip behind over time.

Certainly, "food" for thought.

The Young and the Restless

Once the world starts growing again, it is important to understand where this growth is going to occur fastest.

For a start, it isn't over here.

Why? Well, we have rapidly aging populations in Canada, the U.S. and Europe. Mexico's average age of 29 helps lower the median age in North America, but Mexico has its own problems.

If someone were to ask you what region had had a population of close to a billion people with an average age of 27.7 years, what would you answer?

Some would say China, but that would be incorrect. China has a median age of 38.4 years (Worldometers) and is aging at a faster pace than almost any country in the world.

India? Closer – India has a median age of 29 (Wikipedia).

The answer to this question is "*the rest of Asia*", or RoA. These five countries have over 850 million people with a median age of 27.7 years (source: United Nations):

Indonesia: 217 million
Pakistan: 217 million
Bangladesh: 163 million
Philippines: 198 million
Vietnam: 96 million

Moreover, the two top regions of the world for growth through 2024 are India and the Rest of Asia. Investors often marvel at the growth of emerging markets around the world, but in reality, Emerging Asia has seen double the growth of the overall emerging market index. Latin America and the Middle East have seen much slower and more volatile progress than what we see in Asia.

The type of industry also drives growth.

The emerging markets in Europe, Africa, and the Middle East (called the EAME countries) have just 2.7% of their companies in technology. The Asian region? When you include China, Thailand, Malaysia, Taiwan, and Korea, emerging Asia has over 33% of its companies in technology. Emerging Asia is growing fastest because it has far more of the most modern companies, in other words.

All emerging markets are not created equal. Expect to hear more about emerging Asia – and more specifically, the countries that make up the Rest of Asia outside of China, Japan, and India – in the years ahead.

We are already seeing our global fund managers migrating more and more money towards Asia in portfolios.

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Prices shown as of April 8th, 2021

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