TD Wealth

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Market Update

Important Topic: Checklist for a Market Top

February 2018 Fidelity put together a list of nine factors that historically have coincided with a periodic "Top" in the markets.

- Panic buying and speculative excess by the public
- Heavy inflows of funds into equity markets
- Big pick up in Mergers and Acquisitions
- Increased IPO activity
- Rising Real (after inflation) Interest Rates
- Weakening upward earnings revisions
- Decrease in the number of stocks making new highs
- Shift toward defensive stocks
- Widening credit spreads (Companies having to pay more – relative to the government bond rates - to borrow)

Interestingly, one could argue that none of these factors exist at present.

There is some speculative excess (#1) in cryptocurrencies and marijuana stocks but the overall market is not experiencing that level of excess. And one could argue that in the short term, not as many stocks are going to make new highs (#7). And soon, we may likely see rising real interest rates (#5)… But today, overall, it is difficult to claim we are at a market top … not yet.

Important Topic: Market Top vs Expensive

While related, a market top is when many variables coincide to produce a rush to exuberance and an overheated environment. An expensive market, in contrast, is much more frequent and is eventually followed by a "correction" to more rational levels. Expensive markets do not by themselves normally lead to recessions. One needs several more characteristics, such as a market top, to trigger the longer term large downturn.

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Remember that the market is always pricing in the future. Therefore, when described as "expensive", one is referring to market prices that are difficult to justify based on current earnings but are based on optimistic, expected, future earnings. If earnings are expected to rise 10% in the near term, the stock price will rise today in anticipation. Then as the future plays out, the earnings either justifies the price or not. Earnings in the U.S. grew 12% in 2017 and are expected to grow 18% in 2018 (Thompson Reuters). It is this expectation that causes prices to rise before the earnings become factual. We now wait and see. If expectations prove accurate, and better yet, if expectations remain high, these higher prices will be justified. But since the future is unknown, such a pricing mechanism will be proven wrong and overly optimistic … eventually.

Market Update: The Return of Volatility

After 18 months of record low volatility, volatility returns with a vengeance. After a long period of time having only a handful of one day movements (up or down) greater than 1%, we have just experienced several days of 4% swings.

What does this mean? Very little. We are now back to market norms. It is not enjoyable, and can be a source of stress for those who are not convinced of the long-term benefits of equity investments, but consider the following historical data on the S&P 500 index:

This year, so far, the U.S. market actually fell more than 10% while the Canadian market never reached the 10% mark but did fall back to where it was in 2008 (before the great recession).

Downturn	Frequency	Average Length
5%	About 3x a year	46 days
10%	About once a year	115 days
15%	About once every 2 years	216 days
20%	About once every 3-4 years	338 days

(statistics provided by Capital Group)

So volatility is back and I expect it to stay.

However, always remember two important points:

- Markets have, historically, made up its downturns and continued to move upward providing attractive long-term returns, and
- Our financial plans expect the volatility shown in the chart above. Plans are based on these downturns occurring as they have in the past. None of the recent movements cause us any concern with regard to meeting any long-term goals.

Most importantly, the economy remains healthy - which is the only reason why interest rates will be increased – and we are not expecting a recession. As such we remain invested, and looking forward, we remain optimistic for the medium and long term but always cautious for the short term as valuations are above fair value (expecting rosy earnings). Due to valuation levels, we prefer to avoid the Indices (inexpensive exposure to an entire market) and prefer investing with active managers who are very selective. This is a time to carefully distinguish between under and overvalued investments.For the month: the bond market was down 0.2%, the Canadian market was down 3.7%, the US market was down 3.9%, International markets were down 0.1%, the Emerging markets were down 1.2% and the Global Real Estate market was down 6.7% (Reuters).

Have a great month and let us know if there is anything we can do for you,

Meir

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