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# “By The Way”

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*“exponential rising or falling markets usually go further than you think, but they do not correct by going sideways.” – Bob Farrell*

It's 2018 and everyone wants to own stocks. We have had a real “melt up” on our hands so far this year. The S&P 500 had been on the rise for close to nine years, but was for the most part ignored by the general public and grudgingly participated in by professional investors. But now we are seeing new highs in bullishness on the part of both parties. The AAI (American Association of Individual Investors) survey is at historic highs in the mid 90% range and the Investors Intelligence Survey, which measures sentiment among professionals is at 66.7%, it's highest level since April 1986. If you have a contrarian bone in your body, and are concerned when everyone is thinking alike, you have to be worried about the potential for it at least a correction. That does not mean we are on the verge of a full-blown bear market, but does suggest meaningful downside risk. Bob Farrell was the Dean of Technical Analysts working for Merrill Lynch in the 70's and 80's, and famously wrote his “10 Market Rules” that are still quoted and useful. Number 4 on that list seems relevant in today's market; “exponential rising or falling markets usually go further than you think, but they do not correct by going sideways.” If he is right, and I sympathize with his view, we don't know how much more upside there is in this market, but you can count on significant pain when it does end. So what is the definition of “significant pain”? Well, a 5% correction would get our attention, but only take the S&P back to where it was at the beginning of December, and something closer to 10% would be even more unpleasant, yet support would be at levels seen just last September. A correction of those magnitudes would be worthy of a trade, but not necessarily call into question the integrity of this bull market. So, the challenge is to foresee and prepare for any larger issues and events that would take markets much lower and break the back of this bull.

In the meantime, as Mr. Farrell suggested, markets will go further than we think, and that is where I believe we are currently. We can cite many instances, like high-tech stocks in 1998, where markets continued higher for years despite concerns about valuations and stocks that appear overbought. In fact, “overbought” is often a bullish sign that can prevail for a long time, and there are many good and valid fundamental reasons to like the S&P 500 at this level. First of all is momentum. As Newton wrote in his first law of motion an object, or in this case a market, will continue in motion unless acted upon by an opposing force, and we see no such force in the immediate future. (For the time being we will ignore his third law about equal and opposite reactions 😊) Secondly, we are witnessing growth in almost all the major global

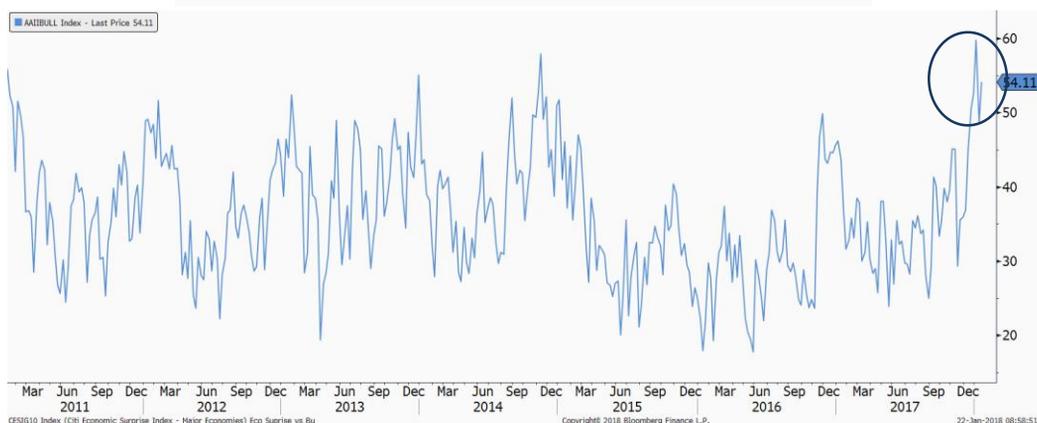
economies, and as a corollary improving corporate earnings. After three years of flat S&P reported earnings, 2017 is expected to have shown double-digit growth, and 2018 estimates are of a similar magnitude, which will help to bring valuations down to more palatable levels. With tax reform now a reality, and regulations being reduced for many businesses, there is even reason to be optimistic that those estimates may be exceeded.

Nevertheless, there are many dark clouds out there that could derail this market, so we must tread carefully. Most obvious is the unpredictability of the government in Washington. There is no future in trying to imagine what President Trump might do or say next, and the bitterly divided Congress is not far behind. Of particular interest to Canadian companies and markets is the outcome of NAFTA negotiations. It is concerning that, at heart, Trump is a protectionist, and has broad powers when it comes to trade regulations. Despite that, I believe at the end of the day, NAFTA will survive without substantive changes (if only because it is in everyone's best interest) but it will not be without turmoil in the interim. As someone wrote, the negotiations will be a "political soap opera".

The U.S. mid-term elections taking place next November, also present serious risks to the market. With Trump's approval ratings at historic lows, there is more than a possibility of a democratic sweep that would give the party a majority in Congress. Forecasting what legislation would result is impossible, but there is no doubt it would be markedly less business friendly. There are lots of other areas of concern, such as interest rates, the Chinese economy, and discord in North Korea and the Middle East, but we will have to deal with them at a later date.

So where does that leave us today? We remain bullish, expecting continuing growth in fundamentals to justify higher markets, but very aware of possible dangers that would require a change in that outlook.

### A&I US Investor Sentiment Bullish Readings



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