



Rolling from Fear of Missing Out, to Fear Itself

There are two types of fear when it comes to the stock market: fear of missing out, and fear of losses. We've seen the same dynamic in the Vancouver and Toronto housing markets. The stock market correction in October has brought to surface a number of concerns, some valid, but many unfounded. Short term sentiment driven moves in the market, particularly on the downside, can be quite quick and forceful, and lead to investor fear of what more could be around the corner. When stock prices are dropping, the short term money is running for the exits, indiscriminately selling stocks regardless of pricing. During market bubbles, the opposite holds true, with market participants buying the fastest mover, the quickest horse (cannabis stocks anyone?), as fear of missing out takes over. Investors bid up stocks, once again regardless of pricing.

The latter stage of a bull market is typically a battle of these two emotions. Often the fundamental story is still very strong, but at the same time offset by worries about the "end of cycle" or bear market. Despite these worries, the late stage of bull markets is typically a very rewarding period, with returns stronger than at any other stage in bull markets other than at the very beginning when the bull market begins. This is referred to as "climbing the wall of worry".

Many worries in this stage are replayed, over and over, as bull markets age. As the saying goes however, "bull markets don't die of old age". Similar concerns arise each time, about whether interest rates are moving at a rate that would usher in the next recession, volatile politics, or concerns about future corporate profit. In this current episode we add to this list, concerns about protectionism and the ongoing trade dispute between the U.S. and China.

The U.S. economy is running hot. Talk about recession is completely misguided at this point. As counterintuitive as it may be, it's more a matter of, is too much good news about the economy a bad thing? Employment, economic activity, and consumer spending all point to the continuation of this very strong period. We see it lasting for at least another year. Even in Canada, despite challenges in the Alberta oil-patch, the rest of the country continues to hum along. Canada will benefit from ongoing strength in the U.S.

Good economic news brings on higher interest rates, and higher bond and money market yields, eventually attracting investor funds at the expense of stocks. Yet the yields, though having risen, still remain far from a level which would hinder returns on stocks. Currently, stocks remain a much better option than bonds, on a reward to risk perspective. From a household debt point of view, borrowing costs have been going up alongside bond yields, but on an absolute level, are still very low.

Canadian and global stocks are cheap for a number of reasons. Canada for example, has been marred by a less than competitive tax structure, and a less than competitive energy sector. Global stocks have been under pressure as the U.S.

administration seeks to impose its will on its trading partners. Europe also has to contend with Italian debt issues and Brexit. Indeed there is a myriad of concerns, but stock markets are already discounting a much larger economic deceleration in the coming year than is likely. On the flip side, the U.S. S&P 500 isn't cheap, nor is it expensive. U.S. corporations are seeing "best in the world" earnings growth, about 25% increase in profits in the latest quarter. As per macro strategist Bank Credit Analyst, "investors can have cheap stocks or good news, but they can't have both."

We've endured two market corrections in 2018. We've seen similar corrections in 2010, 2011, 2012, 2015 and 2016 with the U.S. stock market punching through to new highs after each instance. Except for 2010, all the other corrections coincided with significant economic downturns (European crisis, commodity collapse, US dollar surge).

Market sentiment has undoubtedly been negative in 2018, but has gotten significantly worse in the past few months. Much of this may be because of the seemingly endless barrage of tit-for-tat tariffs between the U.S. and China. Whereas the U.S. was able to bully Mexico and Canada into a new trade deal, China proves to be a much more formidable opponent. This has clearly weighed on investors' minds. During this period of political showmanship, it's easy to forget that a trade deal is what both countries eventually want and need.

As the fear subsides, we see a good possibility of the "fear of missing out" taking hold once again. This would be consistent with the history of bull market cycles, with a strong period of returns possibly leading to an end of cycle type increase in valuations. At that point in time, it will be prudent to become much more defensive. Market corrections (10+% downside) are a bit like the boiling pot of water bouncing the lid, but not boiling over. This lets out some of the steam in overheated markets.

It's worth noting that the typical return in the year following a U.S. mid-term election is about 15%! Given that history often repeats itself, and more importantly the strength of the underlying economy, the potential for meaningful upside in this late stage bull market keeps us invested.

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