Infomail
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What Do the Markets See?

"Smart investing doesn't consist of buying good assets, but of buying assets well. This is a very, very important distinction that very, very few people understand."

Howard Marks, Legendary Chairman of Oaktree Capital

The Dow Jones has made 38 new highs this year, while the S&P 500 has made 53, yet still, the market in general is not overbought. Sure, some may argue that Fed policy, in part, is designed to help the equity markets to create a wealth effect, but there is more to play out in my opinion. Still, bears, hedge shorts, and booksellers will whine into the New Year about this being a Fed induced rally, telling investors that an ugly end is coming.

They've missed 13,000 points on the Dow Jones and they've cost would-be investors to miss 13,000 points as well.

Once again, many investors, including the hedge fund industry got 2014 wrong. Traders were positioned for a "sell in May," a big summer rout, and a chance to load up in the fall. While the strategy would have played out on Canada's TSX, it was not so good on the US side, where indices rallied right into year end.

The US Federal Reserve, while led by former Chair Ben Bernanke, and picked up by current Chair Yellen, are so fearful of seeing a replay of 1937, when premature tightening tipped the US economy into the second leg of the Great Depression, that they are willing to err on the side of over stimulation. With many commodity prices and precious metals down 30 to 50% year to date, they certainly have a free pass on the inflation front to do so.

But perhaps the equity markets are trying to tell us more than what is appearing in the daily headlines. There might be some deeper trends going on which go beyond the daily noise, and everyone but the equity markets are missing them?

China is supposed to be a mess, yet it's been one of the best equity markets in 2014, up approximately 45% year to date. Is it also possible with the pounding Russian wealth has taken, that the markets believe there will be some sort of peace dividend, much like when the Berlin Wall fell in 1989?

Maybe the markets see the incredible technology breakthroughs going on in 3-D printing, communications, and even fracking, despite the recent drop in energy prices. What if there really are (finally) advances in cancer research that dramatically drops the costs of treating it and raises the success rate? Even "disruptive" technologies like Uber and their impact?

How about what the markets sees on the energy front, an energy independent USA (and maybe even an exporter), and that the real cost of energy which has collapsed being a huge positive? What if Elon Musk's Tesla is able to deliver a $40,000 electric car with a 300 mile range (as he has promised within 5 years). Would that be a game changer? Already 80% of Middle East's oil goes to China, what if it goes to 100%, then who's problem will the constant turmoil and production disruptions be?

What if the markets have come to the realization that interest rates might stay low for a long, long time? With inflation down, commodity prices down, and if labour prices stay in check (and with this jobless recovery so far that's been the case), then there's absolutely no reason to raise rates for some time.

Sure interest rates could go from the current "zero" to 2%, but on a historical basis that is still pretty low. Borrowing costs would remain low for any borrowers – individual, corporate or government. In fact, the main cause of recessions over the last 50 years has been either a sudden spike in interest rates or a sudden reduction of oil supplies.

What if the equity markets are starting to realize that PM Abe's plan in the world's third largest economy in Japan is actually working, bringing them out of a 30 year deflationary spiral, and bounces back from a 1% growth rate to 3% or even 4%?

What if markets see Europe actually starting to get it together? All we hear about is the debt crisis, austerity, stagnation and a messed up political system. What if the new leadership combined with ECB head Draghi's efforts finally get it going in the right direction? The measures are on the table to create growth, all that is needed is the political will to implement them.

With US market P/E trading at about 16X, they are nowhere near valuations seen in prior cycle highs in 1999 (30X) and 2007 (25X), while fundamentals are much better across the board today than then as well.

In my opinion, we are half way through this cycle. Sure we can get violent corrections on the journey, but by the time this is over we could get a Dow Jones of 30,000 and an S&P 500 with a “4” handle. May seem like fantasy, but it makes today’s prices still cheap. It could take years to play out, but I think the writing is on the wall for higher equity prices, not just in the USA but globally.

We will see.

Last, but certainly not least, we want to wish all the best to our readers for a Happy New Year and a great 2015.

Stay tuned,

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