Infomail

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The Great Rotation is Coming
(Plus: Phases of a Bull Market)

"There are two kinds of forecasters: those who don't know, and those who don't know they don't know."

Economist John Kennett Galbraith
Wall Street Journal Jan 22, 1993

Investors and market analysts alike are obsessed with the idea of a correction. The words "correction," "tapering" and "volatility" seem to appear in the majority of headlines and in all the articles in my nightly reading.

It's now been two years since U.S. markets experienced a 10% decline and in my thirty years in finance, I've learned that those efforts to predict those moves are simply in vain.

Wall Street legendary strategist Bob Farrell summed it up best in 1989:

> *"Money managers are unhappy because 70% of them are lagging the S&P 500 and see the end of another quarter approaching. Economists are unhappy because they do not know what to believe: this month's forecast of a strong economy or last month's forecast of a weak economy. Technicians are unhappy because the market refuses to correct and gets more and more extended. Foreigners are unhappy because due to their underinvested status in the U.S., they have missed the biggest double-play (a big currency move plus a big stock market move) in decades. The public is unhappy because they just plain missed out on the party after being scarred into cash after the crash. It almost seems ungrateful for so many to be unhappy about a market that has done so well……Unhappy people would prefer the market to correct to allow them to buy and feel happy, which is just the reason for a further rise. Frustrating the majority is the market's primary goal."*
>
> Bob Farrell, Merrill Lynch 1989

The conventional parameter for a "correction" is 10%. In 2013, we experienced 4-5 "pullbacks" in the 4-6% range, but those small moves simply brought more buyers in and markets went higher.

Here is data for the S&P 500 going back to the early 1980's:

S&P 500 Corrections

Correction				Bull Market			
Begin	End	Change	Days	Begin	End	Change	Days
10/10/83	7/24/84	-14.4%	288	8/12/82	8/25/87	228.81%	1,839
9/4/86	9/29/86	-9.42%	25				
10/9/89	1/30/90	-10.2%	113	12/4/87	7/16/90	64.77%	955
2/18/97	4/11/97	-9.64%	52				
10/7/97	10/27/97	-10.8%	20	10/11/90	7/17/98	301.66%	2,836
9/23/98	10/8/98	-10%	15				
7/16/99	10/15/99	-12.1%	91	8/31/98	3/24/00	59.52%	571
12/31/99	2/25/00	-9.25%	56				
11/27/02	3/11/03	-14.7%	104	10/9/02	10/9/07	101.50%	1,826
7/19/07	8/15/07	-9.43%	27				
4/23/10	7/2/10	-15.9%	70	3/9/09	6/20/14	190.14%	1,929
4/29/11	10/3/11	-19.4%	157				
10/28/11	11/25/11	-9.84%	28				
4/2/12	6/1/12	-9.94%	60				

The conclusions from the above are easy:

- Corrections are seldom brief (but so is the recovery)
- One day usually accounts for 25% of the entire decline
- That one day usually occurs <u>near the end</u> of the correction period

(Source: Birinyi Associates: June 2014)

While it can be argued using several benchmarks, that markets are overbought in the short and intermediate term, we all know they can remain that way for a prolonged period. Just like in bear markets where markets can remain oversold for some time.

Our friends at Fidelity Investments recently published a report that covers three paradoxes that are currently confusing market watchers:

- Despite what seems to be a US economic recovery, bond yields have fallen from approximately 3% to 2.50% since the start of 2014
- Despite the Dow Jones hitting new highs, the small cap Russell 2000 is at its low of the year, and eight of ten US stocks are down by an average of 14%
- The USA and European economies seem to be accelerating, but China seems vulnerable

Their conclusion was that bond yields may remain lower than generally expected, and stocks may go in a sideways range for some time still, but will set up for a launching pad for higher prices.

There is no doubt US growth is sluggish at best, and Fed Chairman's most recent comments seemed to indicate inflation is not a worry at this time. Europe seems to be doing everything in its power to fight off deflation.

So far in 2014 the TSX has outperformed the S&P 500 with a return of 10.99% for the TSX and 7.04% for the S&P. The broader Russell 2000 is down approximately 9%. Many high flying momentum names were hit in a rotation out of momentum into value oriented names.

The year 2014 for equities seems to be playing out similarly to 1994, the last time the Fed shifted into a tightening phase. The S&P 500 traded sideways for 9 months and never fell by more than 8.9%, but during those nine months, 94% of the names in the index performed worse than the index itself, by an average of almost 27%.

Some pundits will argue that when momentum and small cap names start failing it is a sign of an aging bull market. However, similar action in 1994 led to a powerful rally in 1995 which went on for almost three years.

And the catalyst for that next big move upwards might be a rotation from bonds to equities as global managers rebalance their asset allocations. There is no doubt actions by central banks have had a positive effect on equities, but according to many reports, equities are at the lowest portion of investments compared to any other time in history (going back to 1959), and the Great Bond rotation, which seemed like it was starting last June, has never occurred.

Bond rotation is beginning to happen, but given the vast amounts which poured into them the past few years, it barely scratched the surface.

Mutual Fund Inflows: June to December 2013
Equities: +$58.8 Billion
Bonds: -$178.1 Billion

First Four Months of 2014
Equities: +$58.8 Billion
Bonds: +$25.3 Billion

(Source: Wall Street Strategies: June 6, 2014)

Since April, $8.6 Billion came out of equities and $14.0 Billion went into bonds.

This may be the most hated bull market in the history of markets, but real bull markets tend to go through several phases.

The first phase comes out of the bottom after investors have been crushed. No one believes things will ever get better and do no believe the rally is real. They use the rally to raise more cash and sell into it. Ironically, the fastest appreciation happens during the first (and third) stages of a bull market.

The second stage is usually acceptance as investors warm up to the idea markets have indeed bottomed. Overall psychology remains cautious, and all short term pull backs have investors believing the bull market is over. They continue to underweight equities and remain in cash or very defensive positions. During this phase, stocks continue to climb and market corrections are short lived. It is here in this phase (between phase 2 and phase 3) that a deeper market pullback occurs. This pullback tests the resilience of the bull (and investors!), shakes stocks out of weak hands and the deeper pullback is used by institutions (usually who missed phase 1) to get in or increase exposure.

Phase two is also where investors start to turn bullish simply because prices have been rising for some time. Analysts and strategists turn bullish to protect and manage their careers.

In stage three, and the final stage of the bull market, market participants become ecstatic. Euphoria is driven by continually rising prices and caution is thrown to the wind. "This time is different" comes up a lot. The media talking heads trash any one who contradicts the bullish view, bad news is ignored, and everything seems easy. During this phase, there is nearly a complete rotation out of "safety" and into "risk."

In my humble opinion talking day to day to clients, there remains a high level of caution and nervousness still. The bond rotation hasn't even begun, let alone that pile of cash still on the sidelines. There is a lot of pessimism and doubt surrounding the market rally.

My gut is we are in phase two, will get some sort of pullback (my guess is 7-10%) at some point, only for that to be the springboard to much higher prices. Euphoria? Don't see it.

Readers know we were bullish in early 2009 when things were so dark, we remained so through the Euro mess in 2011, and remain so today. Yes, there are many reasons that in the end, this could end ugly (global debt being the main one) but that is many years off still.

If we get that bond rotation one day, we can get a "melt-up" in prices. Regardless, we are in a new secular bull market which has a long way to go.

Stay tuned,

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