Infomail

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Breakout or Fakeout?

Although Canada's TSX index is still 20% below 2007 highs, the USA's Dow Jones and S&P 500 have quietly made all time highs. While the volume has been suspect, the market's moves don't seem justified by the economic data which remains mixed, there is no doubt this had been a liquidity driven rally driven by concerted efforts by central banks all over the world.

So the big question now being debated and facing investors is whether this is a breakout (i.e. a new bull market) or a fakeout? (i.e. the continued range bound bear market we've been in since 2000).

Since 1950, there have been 12 instances where the Dow Jones average has been up 8% or more in the first quarter, and in all of those 12 instances, the Dow Jones ended the year higher. And in 10 of those instances, the Dow was higher at year end than where it was at the end of the first quarter.

In recent months, several factors have converged which have created this sweet spot for equities:

1) Improving economic momentum
2) Abundant monetary stimulus
3) A strong technical tape
4) A positive shift in sentiment

The global markets are driven by the economies of the USA, Europe, and China. The US economy has picked up some steam in recent months as the housing and employment pictures have improved.

Europe remains in recession, but has stabilized and in some countries even displayed some characteristics of recovery. Bad news is less common and quite simply, things are "less bad" than two years ago.

China has rebounded from last year's growth recession which was an intentional result of policy tightening in 2011. The data has been mixed so far in 2013 so time will tell if they sustain a "soft landing."

At this time every year, the “sell in May and go away” mantra raises its head and questions arise of a “spring swoon” as we get the seasonal effect that has kicked in each of the past 3 years:

2010 April 19 - June 28 - 10 weeks – down 15.7%
2011 April 25 - Sept 19 - 25 weeks – down 15.9%
2012 April 23 - May 28 - 5 weeks - down 8.4%

Perhaps this year may be different, but I suspect we are due for some sort of pause/pullback after the recent run. The only thing I will add is that now too many people are looking for it so odds are we get more upside first.

The US Federal Reserve has kept the monetary spigot open, and has confirmed it will do so for some time, but now the Bank of Japan has joined the fray and this past week Europe’s Central Bank implied it may start its own Quantitative Easing (QE).

So the monetary spigot remains open for the most part, and that tends to be bullish for equities and other risk assets. <u>But for the first time in the modern era, massive monetary expansion and plunging yields have failed to ignite an economic recovery that would drive investors from bonds to stocks.</u>

The long term performance of bonds (since the early 1980’s) is a unique trend in modern economic history. Long-term, non-callable bonds have, on a cumulative basis, outperformed equities over 31 years.

Under free market economic theory, that is supposedly impossible. The basic math of capitalism states that Risk Assets, such as stocks and real estate, must deliver higher returns than risk free assets, over the longer term. That has <u>not</u> been the case but I do believe that relationship is in the process of changing.

The fundamentals remain positive and improving, and the monetary spigot remains open, but it wouldn’t take much for something to go wrong in Europe or China, especially given that time of the year, when in each of the past three years the markets have put in a seasonal high. Recent sentiment has reached a point where in the past it has produced some short term market tops. This rally has been a strong one and any weakness has been greeted by more buying.

Any correction would create a buying opportunity in my opinion. I expect the S&P 500 to trade to new highs by year end and remain very positive for several reasons:

- Economic reports from around the globe continue to improve
- Corporate earnings in the USA are still showing solid growth trends and moving higher
- Domestic economic reports have been improving, led by the important US housing market

- Still lots of cash on the sidelines

I believe we are near the end of the Secular Bear Market which started in 2000 and in the early stages of the next Bull Market. The US market in particular, looks a lot more attractive and compelling than it did in 2007 or 2000 (where valuations were way out of whack).

Stay tuned,

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