RBC Wealth Management
Dominion Securities

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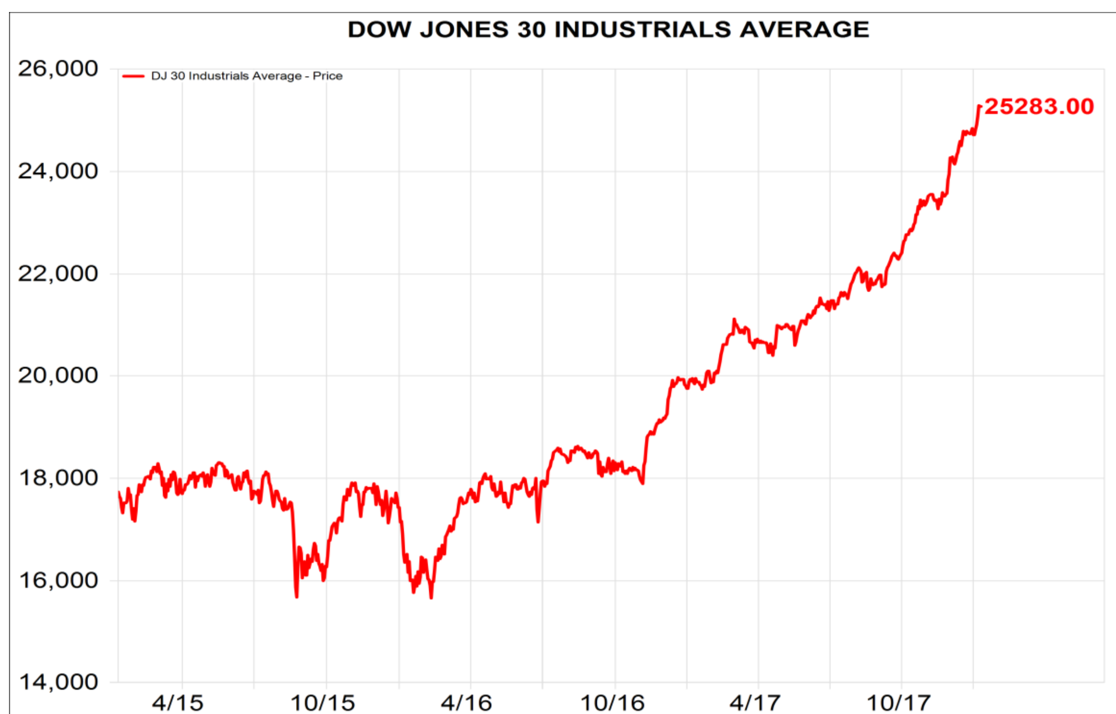
New Year 2018

A year or two ago I liked to describe the rise in stocks as the most unloved of bull markets. The emotional repercussions of the financial crisis of 2008-2009 lingered on for years. Investors seemed uneasy with rising stock prices and unable to enjoy them. It felt as if investors were, even seven years after the lows of 2009, as much concerned about not losing money as with making it.

My sense is that the mood has changed over the last six months or so. The sharp recent gains in stock prices have brought on signs of speculative fervor.



DOW 30 Industrials Average over a period of 3 years (Graph from FactSet)

People are starting to worry about missing out. This is borne out in a variety of ways:

1) High valuations – the Shiller Cyclically Adjusted Price-Earnings Ratio, as I unfortunately pointed out a year ago, has only been higher once, at the peak of the technology stock craze in 1999.
2) Sentiment indicators – *Barron's* (January 6) quotes *Leuthold Group*'s note "that bulls dominated the *Investors Intelligence Survey* in 2017, averaging 77% over the course of the year. That's the second highest 12-month average on record and only the 10th above 70%. But readings that high haven't been great for future returns, with the S&P 500 averaging a decline of 0.2% in the following year."
3) Speculative ardor – here at the office we've noticed that, among our generally rather reserved clientele, in the last six months there has been an unusual amount of interest in speculations of various kinds. Prominently among them have been enquiries about cryptocurrencies.

I'm reminded of Charlie Munger's description from a couple of decades ago of how he and Warren Buffett ran Berkshire Hathaway: "Our job is to find a few intelligent things to do, not to keep up with every [bleep] thing in the world." Munger has always been known for his bluntness. Last month CNBC reported his views about cryptocurrencies, Bitcoins and the like: "I think it is perfectly asinine to even pause to think about them. … Its bad people, crazy bubble, bad idea, luring people into the concept of easy wealth without much insight or work… It is total insanity. You know it is one thing to think gold has some marvelous store of value because man has no way of inventing more gold or getting it very easily, so it has the advantage of rarity. Believe me man is capable of creating more Bitcoin. …They tell you there are rules and they can't do it. Don't believe them. When there is enough incentive, bad things will happen." By the way *The Globe and Mail*'s Ian McGuan (January 5) reports that Bitcoin mining, mostly in China where coal is cheap, now consumes roughly as much energy as Ireland.

Jeremy Grantham, in his January 3 essay titled "Bracing Yourself for a Possible Near-Term Melt-Up", had this priceless opening; "I find myself in an interesting position for an investor from the value school. I recognize on one hand that this is one of the highest priced markets in U.S. history. On the other hand, as a historian of the great equity bubbles, I also recognize that we are currently showing signs of entering the blow-off or melt-up phase of this very long bull market. The data on the high price of the market is clean and factual. …In contrast, my judgement on the melt-up is based on a mish-mash of statistical and psychological factors based on previous eras…"

Imagine Grantham is correct and stocks are going to shoot way up in the next 12 months, give or take six months, and then the bubble will collapse. That would put investors in a quandary. Does one ride the wave and try to time an exit before the crash or, does one take a pass on all the excitement and simply wait for the bust that follows a boom? This is a particularly hard choice for a professional investor who has to worry about career risk. How long can someone who looks after other people's money afford to sit on the sidelines during a boom before the money is taken away from him?

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At the moment lower U.S. corporate tax rates are sucking all the oxygen out of the room. Stocks that are not part of the major U.S. indices are relatively less affected.

We will try to maintain our investing discipline. We require all our clients to tell us how much of their savings they can risk in stocks. We establish in your Investment Policy Statement a maximum, a minimum, and a target for the percentage in stocks. We insist on always having something in reserve. We rebalance towards the target. In this way we will try to cope with both booms and busts.

Happy New Year.

Sincerely,

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Portfolio Manager, Vice-President
Please visit us at www.georgestedman.com