

4 Weeks Ending March 9, 2018

	High	Low	Last	
Federal Funds	1.45%	1.42%	1.42%	
30yr T-Bonds	3.21%	3.09%	3.16%	
Gold (London PM)	\$1352.45	\$1307.75	\$1320.60	
	High	Low	Last	200D M.A.
DJIA	25709.27	24538.06	25335.74	23181.08
DJUA	685.76	662.25	672.28	723.36
NASDAQ	7560.81	6981.96	7560.81	6668.88
S&P 500	2786.57	2656.00	2786.57	2570.50
S&P 500 P/E	Current: 26.0		90 yr Avg: 17.2	

## Technical and Monetary Investment Analysis

### *Rationalizing Irrationality* *The Emotional Traps of a Mature Bull Market*

**Investing is always an extraordinary emotional challenge!** For a new subscriber who is not familiar with InvesTech's long-term track record, or not seasoned by Wall Street's historical "school of hard knocks" from past bear markets, our proactive move to increase portfolio defenses might seem prematurely bearish or out of step with reality. In most economic reports today –from leading indicators, to consumer confidence, to the latest employment data– the news has become so positive and so euphoric that it is difficult to find any clouds on the horizon. And the recent sudden, steep correction in stocks has only amplified the emotional intensity of this market, and the pressure to be onboard:

**Fear of missing out keeps investors in stocks despite risks** – Reuters, 12/1/17

**Investor 'fear of missing out' runs wild as record amount of money flows into stocks the last four weeks** – CNBC, 1/19/18

**'FOMO' stock market sees a week of record inflows** – MarketWatch, 1/26/18

**If You Didn't Sell Stocks This Month, You've Probably Got FOMO** – Wall Street Journal, 2/28/18

**Investors' Overriding Fear: Missing Out on Stock Rally** – Wall Street Journal, 3/1/18

Therein lies the problem or dilemma for investors. How does one justify implementing portfolio defenses when it seems that none are required? The only way to answer this question is to venture backward in time and examine stock market history.

So inside this issue, we step into the psychological aspect of investing. We take the seemingly mundane academic topic of behavioral finance, which is required in the curriculum for the Chartered Financial Analyst (CFA) Program, and reveal its critical significance today – when anything other than a bold bullish outlook is considered to be heresy.

Last week marked the 9<sup>th</sup> anniversary of this second longest bull market in Wall Street history. Surprisingly few remember the depth of gloom that existed near the bottom of the bear market in 2009 at DJIA 6547, or the fearful headlines that followed as we rapidly increased our InvesTech Model Portfolio allocation from 56% to over 97% in the first few months of the new bull market. We guarantee the long forgotten "Wall of Worry" headline collage on pages 4-5 that existed for years after that generational buying opportunity will be a real eye-opener. It also serves as a reminder of the importance of swimming against the emotional tide of investor sentiment – both during the most profitable years of developing bull markets, as well as the high-risk period of a mature bull market... which is where we find ourselves today.

# From Oh-No! to FOMO\*

## Behavioral Finance and the Market Cycle

(\*Fear of Missing Out)

Behavioral finance attempts to understand and explain stock market movements by incorporating investor psychology. This differs from traditional finance, which is grounded in economic theory and assumptions. At its core, traditional finance is based on three key premises:

- Investors are **risk-averse**. This means that when faced with two investments with a similar expected return, investors will consistently prefer the one with lower risk.
- Investors are **rational**. This means that individuals will always try to obtain the highest possible personal economic well-being without regard for anything else.
- Markets are fully **efficient**. This assumes that stock prices continuously incorporate all available and relevant information.

The reality is that as human beings, investors are genetically predisposed to behave irrationally. Rather than make assumptions, behavioral finance focuses on market observations (e.g., bubbles and crashes) and draws conclusions from the data. To better clarify behavioral biases and how they play into the picture, we have broken down the market cycle into four distinct phases: Early-Stage Bull Market, Late-Stage Bull Market, Early-Stage Bear Market, and Late-Stage Bear Market.

### Early-Stage Bull Market

As stocks begin to emerge from a bear market, investors feel battered and bruised by the long severe carnage. Those paying any attention to the media will invariably be scared and skeptical after reading headlines like these... coming from economists and “experts” alike:

#### Jan - Feb 2009: The Widespread Gloom of the 2009 Market Bottom

**Economists predict continuing economic gloom for U.S. during next 4 years**  
*Chicago Tribune – 1/20/09*

**Economy’s new plunge is worst in quarter-century**  
*Associated Press – 1/30/09*

**Economists React: Worst Conditions for Construction Since 1930s**  
*Wall Street Journal – 1/22/09*

**Auto Sales are worst in 26 years**  
*CNNMoney – 2/3/09*

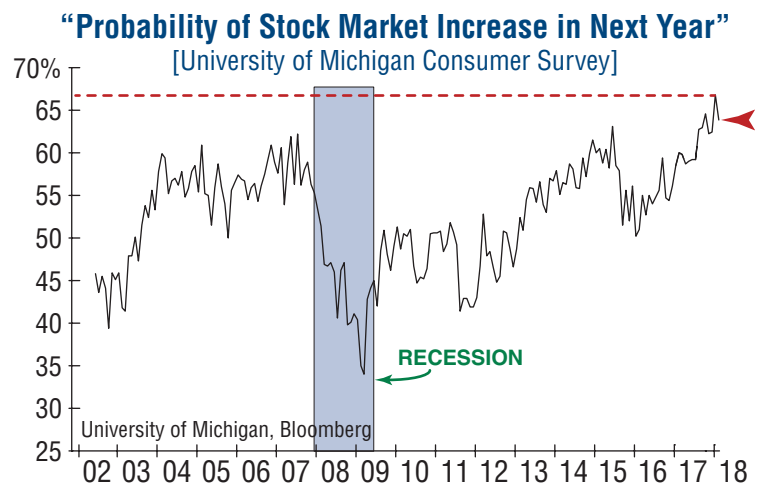
While investors should view such a period as the investment opportunity of a lifetime, they instead suffer from two key behavioral biases:

- **Loss-Aversion Bias (Oh-No!):** At this point, fear of further loss is far more powerful than the desire for gain. Unfortunately, this behavioral bias is most detrimental to investors at the best buying opportunities. As stated by Warren Buffett, “**Be fearful when others are greedy and greedy when others are fearful.**” Easier said than done...
- **Status Quo Bias:** People find it easier to do nothing (maintain the “status quo”) with their portfolio rather than make changes. After bear market crashes, people prefer to keep things the same and tend to avoid looking for opportunities. As bear market bottoms tend to be rather abrupt and v-shaped in their reversals, this behavioral bias can cause investors to miss the most profitable portion of a new bull market.

### Late-Stage Bull Market

Contrary to early-stage bull markets, late-stage bull markets are feverish affairs. Surveys that analyze consumer confidence tend to reach meteoric levels as highlighted by the chart on the right from the University of Michigan Consumer Survey. Market valuations become stretched and headlines reflect excessive optimism. The current bull market is exhibiting many of these typical late-stage phenomena. Below are two behavioral biases that are apparent at this stage of the market:

- **Overconfidence Bias:** Investors become overconfident and demonstrate unwarranted faith in their own reasoning, judgement, and abilities. Risks are significantly **underestimated** and expected returns are significantly **overestimated**.
- **Self-Control Bias (FOMO):** At this point in the bull market, people fail to act in pursuit of their long-term investment goals due to a lack of self-discipline. Instead, greed takes over and long-term risk management strategies are exchanged for short-term satisfaction. As market historians, we’ve seen this behavioral bias rear its ugly head time and time again. The loss of self-control at a market top can be devastating to an investor’s portfolio.

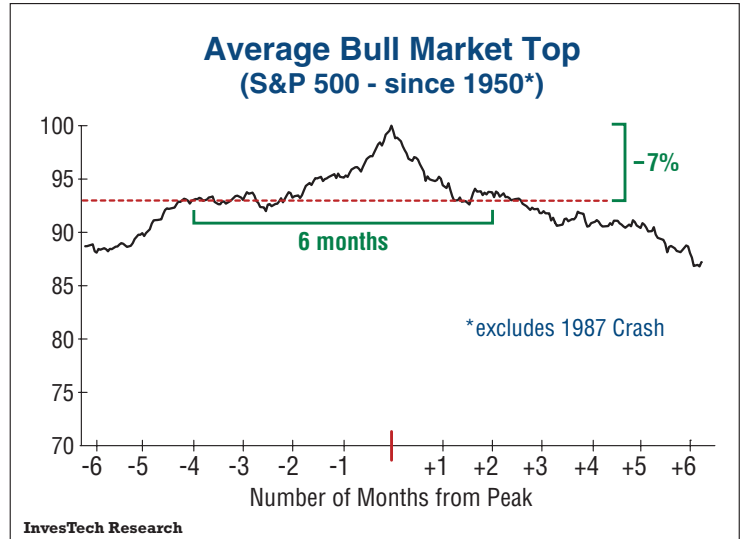


Just as investor behavior can be irrational during bull markets, bear market cycles may also exemplify unique cognitive biases. Additionally, the elongated time frame of bull market tops creates distinct challenges –and opportunities– for investors as many bull markets tend to end with a whimper rather than with a bang.

### Early-Stage Bear Market

The beginning of a bear market is generally a drawn-out process. In fact, as highlighted by the chart at right, the average bull market top since 1950 has taken approximately six months to evolve and fully confirm we are entering a bear market. This slow and painful process brings with it these key behavioral biases:

- **Illusion of Control Bias:** Individuals believe that they can control or influence outcomes, when in fact, they cannot. During the lengthy topping process, many investors trade excessively under the false impression that they can control the outcome of their investments. Needless to say, this is ultimately a futile effort.
- **Anchoring Bias:** Investors unconsciously establish a price level –an “anchor”– which becomes the baseline on which all decisions are based. For example, as the bull market begins to fade, the most recent market top becomes the target investors believe they need to reach in order to sell their shares. This idea of getting back to an upside target can lead to large portfolio losses and an inability to properly assess the weight of the evidence in the bear market downturn.



While drawn-out market tops create the above biases that trap investors into holding on, they also offer an opportunity for the few who are actively watching for warning flags to proactively implement bear market defenses.

### Late-Stage Bear Market

Rather than the uncertainty experienced at the beginning of a bear market cycle, late-stage bear markets are often extremely volatile. The table to the right highlights this fact, as it breaks the bear market period down into thirds.

**Since 1960, the final third experiences approximately 60% of total bear market declines as investors panic into the bottom.** This brings us to our last behavioral bias:

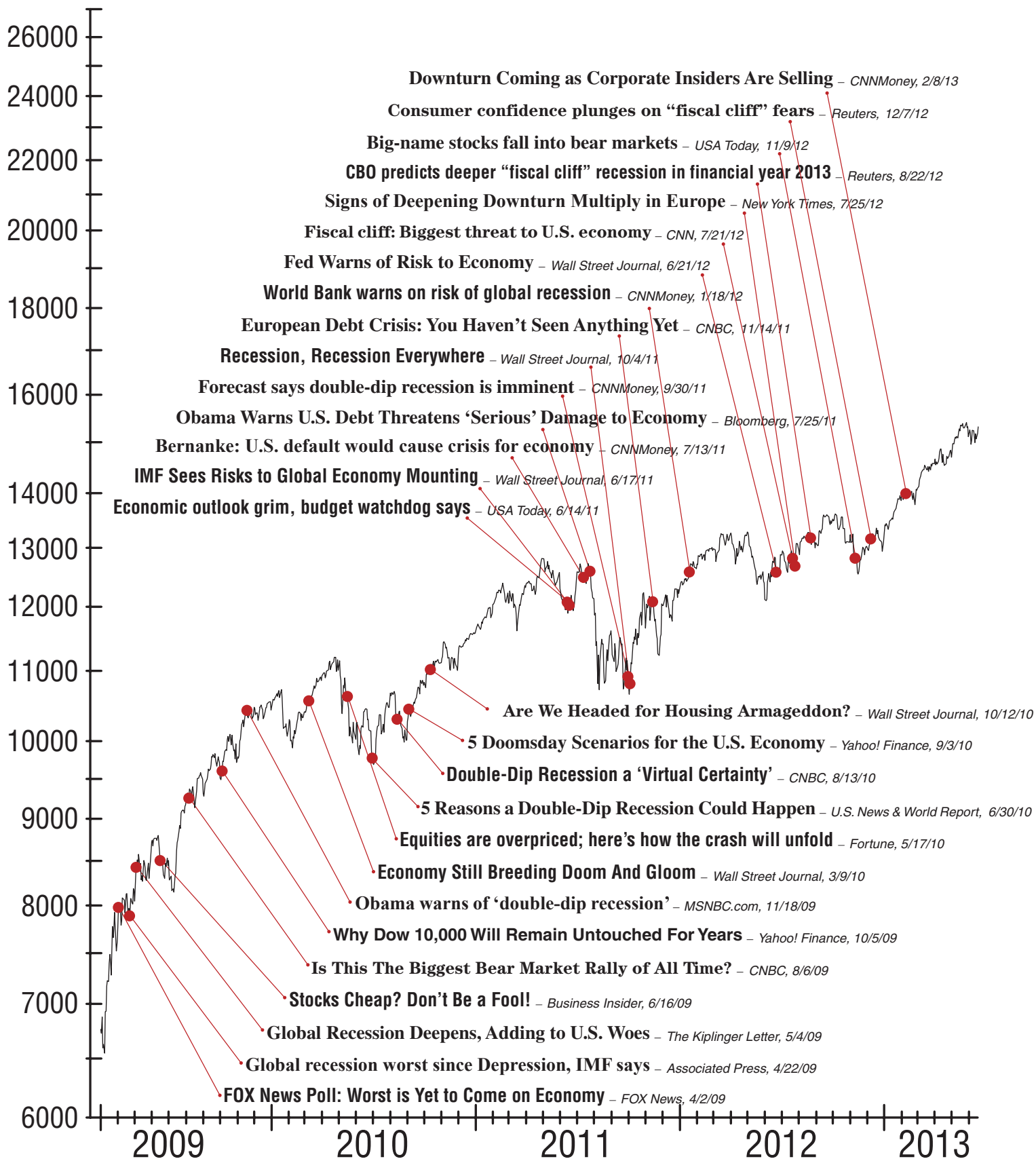
- **Herd Behavior:** Herding is the common tendency for individuals to copy the actions of the larger group, regardless of whether it’s rational or not. These types of actions result in large market downdrafts which many times carry stocks far below what would be considered fair market value. Investors finally decide to bite the bullet, which often leads to capitulation selling at the bottom.

Bear Market Losses S&P 500						
Bear Markets			Portion of Loss During			
Date	# of Days	Total Loss	1st Third	2nd Third	Final Third	
09/07/1929 – 06/01/1932	998	-86.2%	39.0%	21.5%	39.5%	
07/18/1933 – 03/14/1935	604	-33.9	15.0	49.3	35.7	
03/06/1937 – 03/31/1938	390	-54.5	22.6	54.5	22.9	
11/09/1938 – 04/28/1942	1266	-45.8	17.9	43.7	38.4	
05/29/1946 – 05/17/1947	353	-28.8	81.8	-5.4	23.6	
06/15/1948 – 06/13/1949	363	-20.6	26.2	45.0	28.8	
08/02/1956 – 10/22/1957	446	-21.6	29.6	-2.0	72.4	
12/12/1961 – 06/26/1962	196	-28.0	9.3	10.6	80.1	
02/09/1966 – 10/07/1966	240	-22.2	14.4	22.7	62.9	
11/29/1968 – 05/26/1970	543	-36.1	12.6	26.1	61.3	
01/11/1973 – 10/03/1974	630	-48.2	25.2	15.0	59.8	
11/28/1980 – 08/12/1982	622	-27.1	18.8	44.7	36.5	
08/25/1987 – 12/04/1987	101	-33.5	12.0	63.3	24.7	
07/16/1990 – 10/11/1990	87	-19.9	40.2	22.9	36.9	
03/24/2000 – 10/09/2002	929	-49.1	23.0	28.0	49.0	
10/09/2007 – 03/09/2009	517	-56.8	28.1	12.2	59.7	
Median:	482	-33.7%	22.8%	24.5%	39.0%	
<b>Median since 1960:</b>	<b>517</b>	<b>-33.5%</b>	<b>18.8%</b>	<b>22.9%</b>	<b>59.7%</b>	

InvesTech Research

The following two pages graphically illustrate the path Wall Street has traversed since 2009 – from the relentless “wall of worry” that accompanied the early and even middle years of this bull market (the “Oh-No!” stage), to the irresistible FOMO (fear of missing out stage) that exists today. Clearly, we are currently seeing distinct examples of both overconfidence and a lack of self-control that exemplify a mature or late-stage bull market...

# 2009 Bull Market “Wall of Worry”



**Dow 26,000: The stock market is a runaway freight train** – *CNNMoney*, 1/16/18

**Household stock holdings are at their 2nd-highest ever—behind only the dot-com era** – *MarketWatch*, 12/11/17

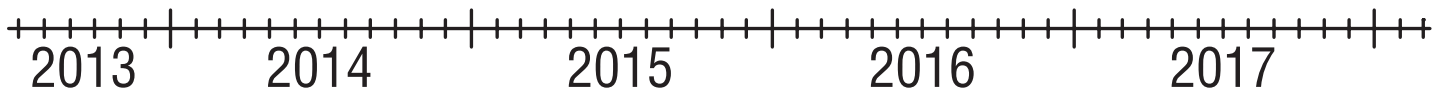
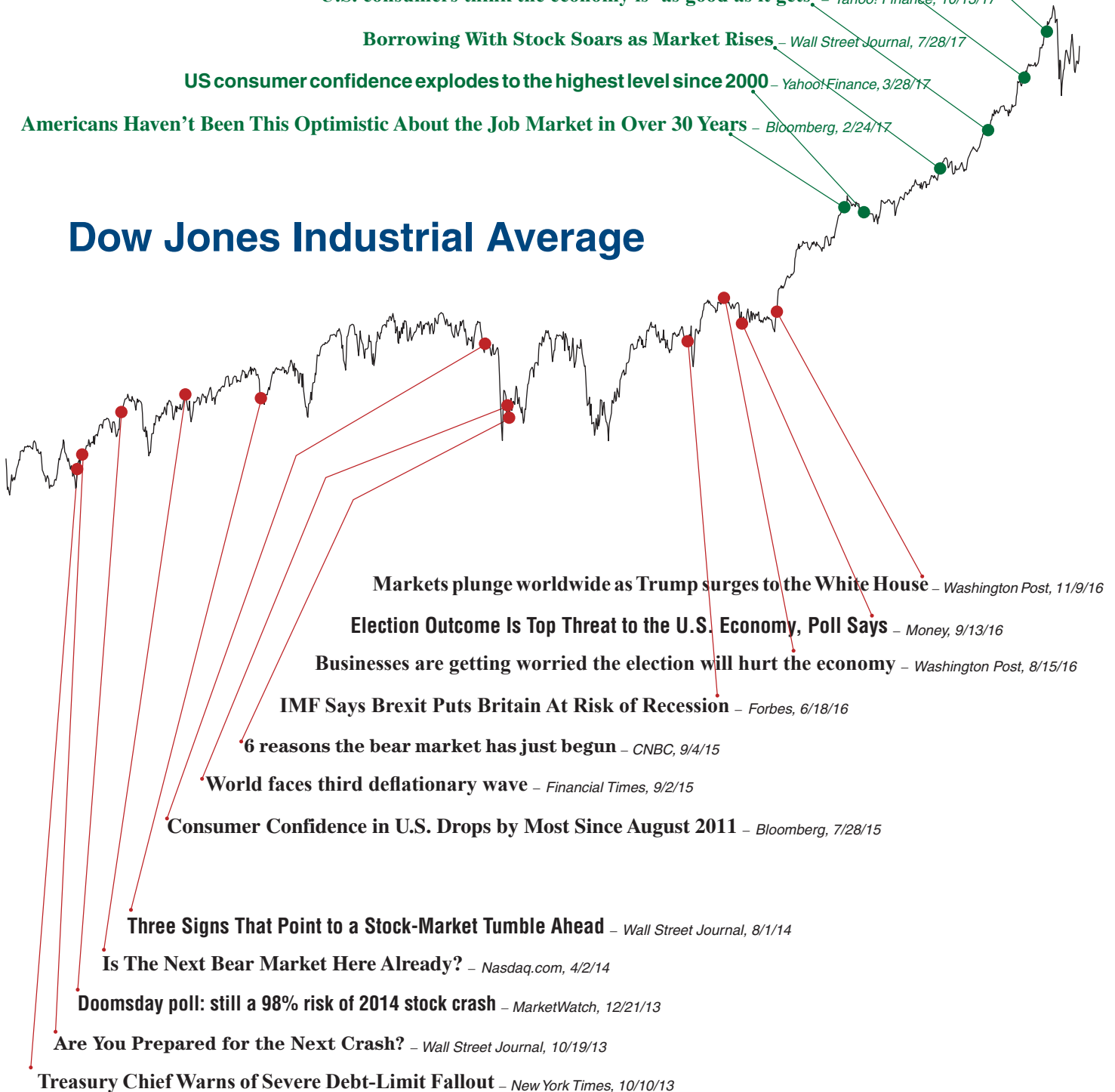
**U.S. consumers think the economy is ‘as good as it gets?’** – *Yahoo! Finance*, 10/13/17

**Borrowing With Stock Soars as Market Rises** – *Wall Street Journal*, 7/28/17

**US consumer confidence explodes to the highest level since 2000** – *Yahoo! Finance*, 3/28/17

**Americans Haven’t Been This Optimistic About the Job Market in Over 30 Years** – *Bloomberg*, 2/24/17

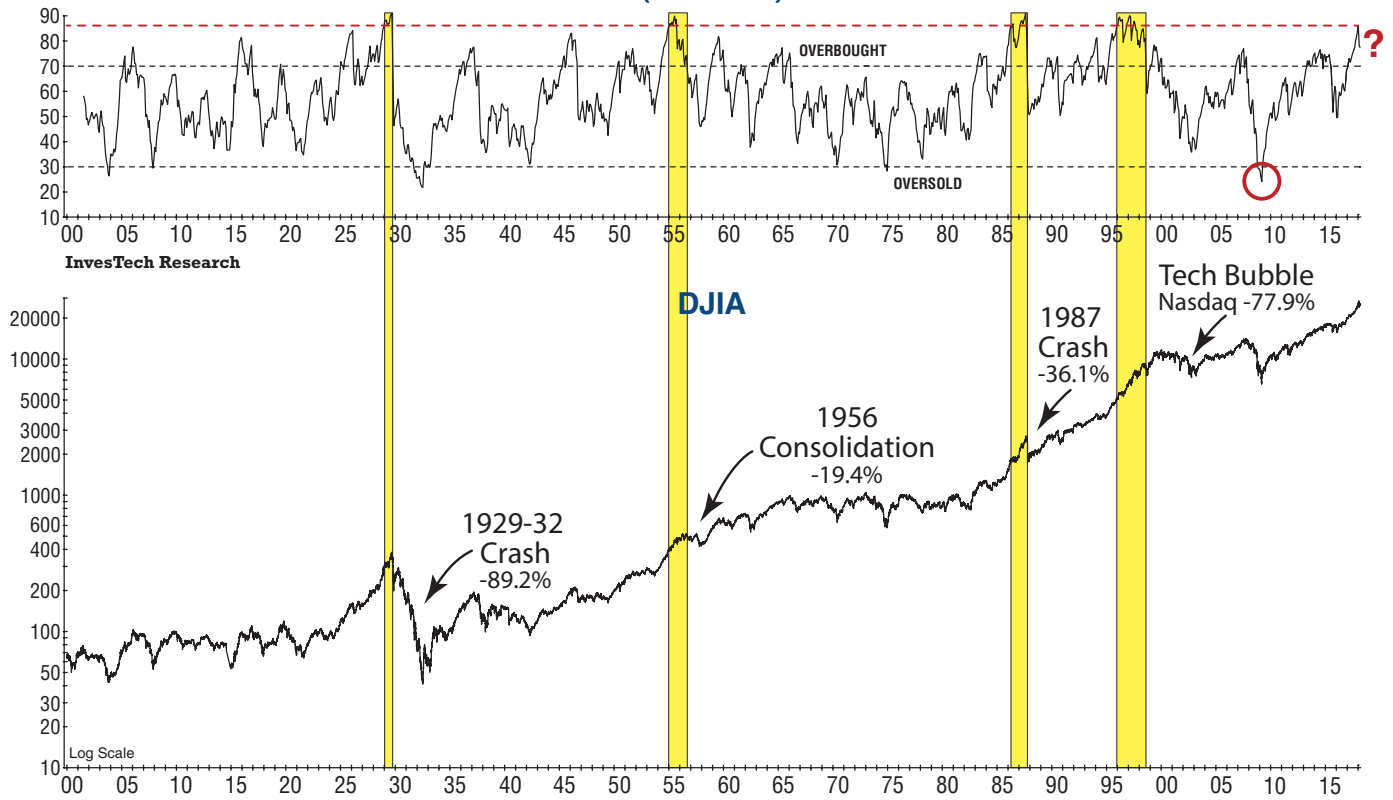
## Dow Jones Industrial Average



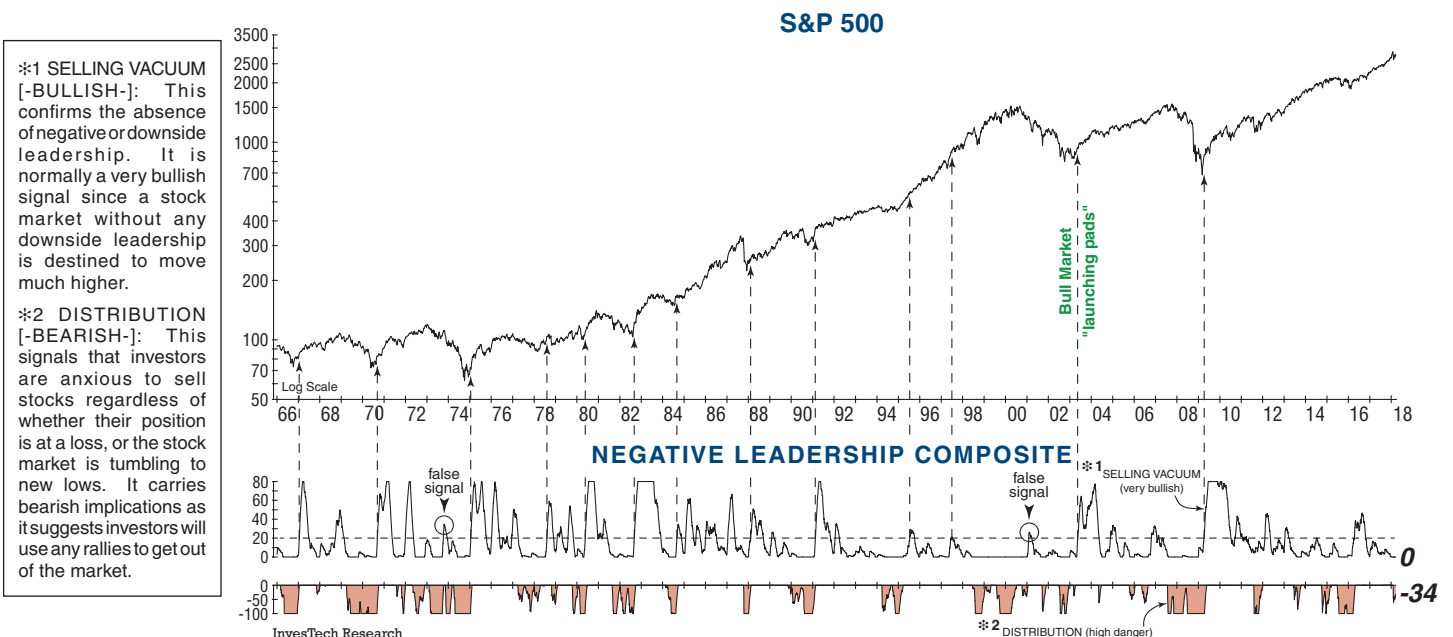
One of the characteristics of a Late-Stage Bull Market is when the emotional stampede into stocks drives prices to overbought extremes. The Relative Strength Index (RSI) is a popular gauge of such overbought and oversold conditions, and the 18-month RSI for the DJIA (shown below) is particularly useful for identifying important long-term turning points in the market.

For instance, the historically oversold extreme in March 2009 (red circle) was convincing evidence that a potential buying opportunity of a lifetime was at hand. Today, Wall Street is at the opposite end of the spectrum – with an overbought level only seen four previous times since 1900. And while an overbought extreme can persist for some time (yellow shading), a peak at this RSI level and a steady turn lower has invariably been followed by a serious stock market decline.

### RELATIVE STRENGTH INDEX (18-month)



The InvesTech Negative Leadership Composite (NLC) has stabilized after “Distribution” [\*2 – shaded region] dropped below the critical -50 level in last month’s sharp sell-off, before moderating to -34. If downside leadership increases again in the coming weeks or months, and Distribution falls deeper into negative territory, then 2018 could be a volatile ride for investors.

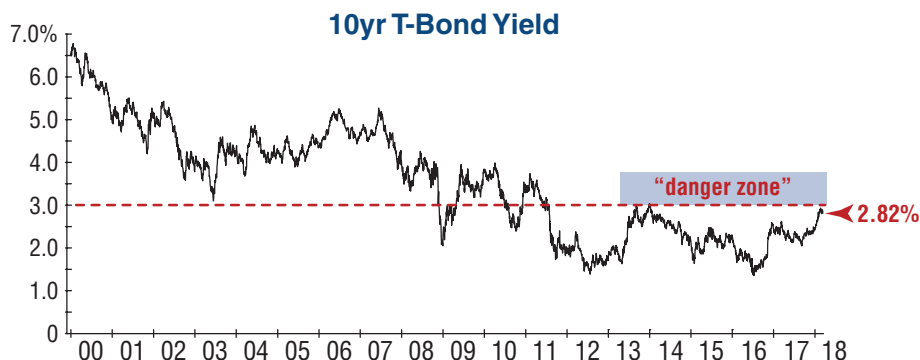


## STRATEGY UPDATE

With leading economic data suggesting that good times are set to keep on rolling, investors' "Fear of Missing Out" (FOMO) once again appears to dominate the current market psychology after last month's brief correction. Yet, the signs of excess and speculation highlighted in previous issues have not resolved, and some potential warning flags are precariously close to waving.

The Federal Reserve is poised to make another incremental hike in the Fed Funds rate next week, and is expected to continue the tightening cycle throughout the year. The Fed's moves have been slow and methodical, but for the past several

months, the bond market's moves have not. As shown in the graph at left, the yield of the 10-year T-bond has been trending higher in reaction to the strong economic outlook and in anticipation of higher future rates. The yield is set to rise above 3% into a "danger zone" where we believe this bull market could encounter headwinds.



Higher yields on Treasury bonds typically support a stronger U.S. dollar, but that's not the case today. The U.S. dollar has been trading lower since early 2017 and has now broken 3-year support levels. A weakening U.S. dollar will also increase inflation pressure, and could provide impetus for the Fed to move more aggressively than expected. Consequently, we'll let less disciplined investors run amok with a "FOMO" bias... while we focus on maintaining our safety-first strategy and carefully watching for bear market warning flags.

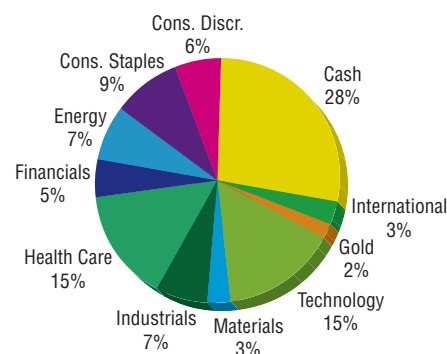


## MODEL FUND PORTFOLIO

**CHANGES SINCE THE LAST ISSUE:** No changes to the Model Fund Portfolio have been recommended since the last issue. The Model Fund Portfolio is currently 72% invested, with the remainder of the Portfolio (28%) held in short-term Treasuries or a money market fund. Continue to monitor the Financial Hotline for important strategy updates.

**FOR NEW SUBSCRIBERS:** Purchases after our initial recommendation must be made at your discretion. We currently advise bringing your portfolio in line with our recommended allocation by phasing into the market over at least six to eight weeks.

*NEXT ISSUE: April 20, 2018*



PERCENT	FUND	SYMBOL	52-WEEK		INIT. RECOMMENDED	RECENT	ALTERNATE FUNDS
			Hi	Low			
28%	T-BILLS/ CASH/ MONEY MARKET						Money Market Fund
6%	CONS. DISC. SELECT SECTOR SPDR	XLY	109.00	85.20	11/18/11	34.48	106.24
9%	CONS. STAPLES SELECT SECTOR SPDR	XLP	58.71	52.19	7/1/11	26.43	54.60
7%	ENERGY SELECT SECTOR SPDR	XLE	78.03	60.79	7/1/11	65.28	68.45
5%	FINANCIAL SELECT SECTOR SPDR	XLF	30.17	22.61	6/8/12	10.36	29.70
15%	HEALTH CARE SELECT SECTOR SPDR	XLV	91.54	72.59	7/1/11	32.26	86.51
7%	INDUSTRIAL SELECT SECTOR SPDR	XLI	80.66	63.09	7/1/11	33.09	78.45
3%	MATERIALS SELECT SECTOR SPDR	XLB	64.09	50.55	8/12/16	47.00	61.32
15%	TECHNOLOGY SELECT SECTOR SPDR	XLK	70.51	51.78	11/18/11	22.57	70.51
2%	VANECK VECTORS GOLD MINERS	GDX	25.29	20.93	9/29/17	22.78	21.57
3%	MATTHEWS ASIAN GROWTH & INCOME	MACSX	18.18	15.22	5/8/09	8.79	17.45
							iShares MSCI Pacific EX-Japan (EPP)

# PERSONAL PERSPECTIVE

## *Keeping our feet on stable (unemotional) ground*

We took a special side trip in this issue –away from our regular macroeconomic and technical update– for a reason. Mature bull markets are emotional traps. In the absence of economic storm clouds, and with the painful lessons of the previous bear market long forgotten, most investors treat today’s market as if it is riskless. *It’s not!*

In fact, lofty valuations and overbought extremes (see RSI on page 6) confirm that stock market risk is at the highest level in over a decade. In a similar show of unbridled optimism, margin debt as a percentage of GDP has soared to another all-time high with the latest report. While a willingness to assume debt (to buy stocks) has helped propel market gains, it poses a significant threat that even FINRA –the primary brokerage regulatory body– recognized in January:

### **Updated: Investing with Borrowed Funds: No “Margin” for Error**

*FINRA Investor Alerts – 1/18/18*

Along with this warning...

*“...we are concerned that many investors may underestimate the risks of trading on margin and misunderstand the operation of, and reason for, margin calls. Investors who cannot satisfy margin calls can have large portions of their accounts liquidated under unfavorable market conditions.”*

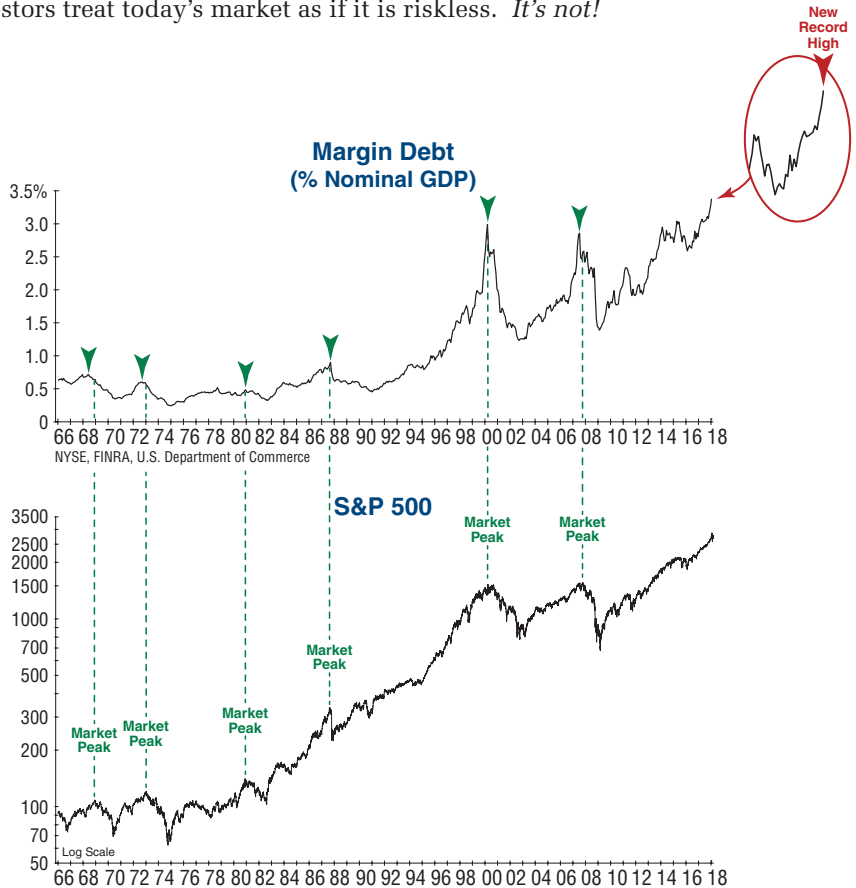
As noted in the FINRA release, margin calls can lead to unintended selling, and accelerate a bear market decline. Note that reversals from past peaks (green arrows) have preceded or coincided with the start of a bear market. *We will not treat the next downward drop in margin debt lightly!*

From both a historical and psychological perspective, we have few doubts that this is a “late-stage bull market.” It is likely that inflationary pressures, the dollar, and Federal Reserve actions will play a decisive role in how this market top develops. We have increased our cash reserve in recent months in response to the rising level of market risk. And as mentioned inside, we continue to watch closely for bear market warning flags. Our objective is to be proactive and preemptive in implementing defenses before major trouble strikes.



With tongue-in-cheek, we’ll also say that the construction of our new offices might play a role in the market’s outlook. As we dig out from a snowy winter and building frenzy heats up, we are now targeting a mid-to-late summer move in date, if all goes according to plan. What’s the investment connection? It was over 30 years ago in September 1987 when we moved into our current offices on Whitefish Lake. The next month, the 1987 Crash hit 😊.

*James B Stack*



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