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New highs for New York

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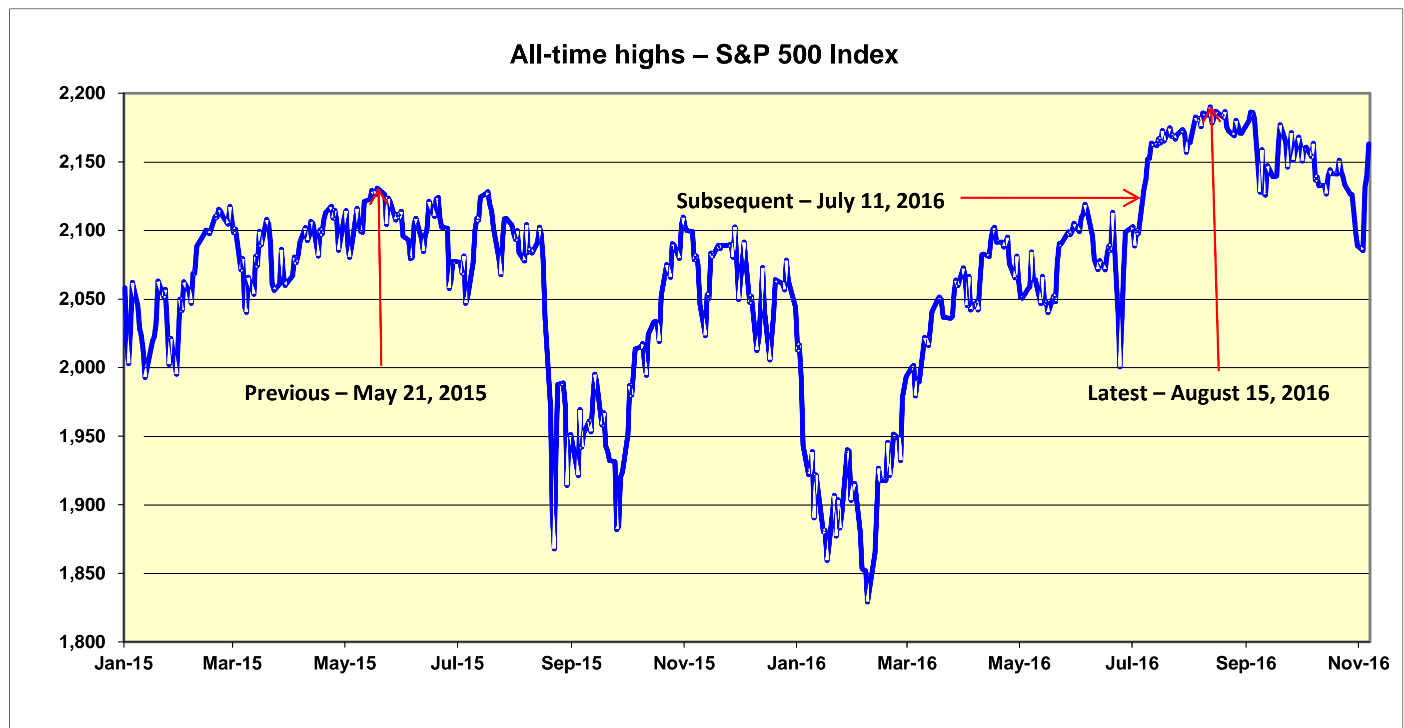
Perhaps it is not surprising that the ongoing global recovery in equities has been more pronounced in the United States than in other jurisdictions. After all, the U.S. was the epicentre of the 2008-09 financial market meltdown – a byproduct of questionable lending via sub-prime mortgages and the subsequent structuring of mortgage-backed securities based on the loans. At the peak of the crisis, many parallels were drawn between this financial calamity and the Wall Street Crash of 1929, which preceded the Great Depression. So strong was this prevailing sentiment, that the subsequent economic downturn was dubbed the "Great Recession." Understandably, one of the lingering consequences of the tumult has been the pervasive negative sentiment held by both market participants and the public in general. This remains true, despite the fact that the main U.S. market index fully recovered its losses by early 2013[1]. Sometimes, negative sentiment can provide an investment opportunity as unpopular securities often find a way to prove the majority wrong. Taking advantage of professional advice helps to remove emotion from the investment decision-making process.

U.S. equities



Source: Bloomberg

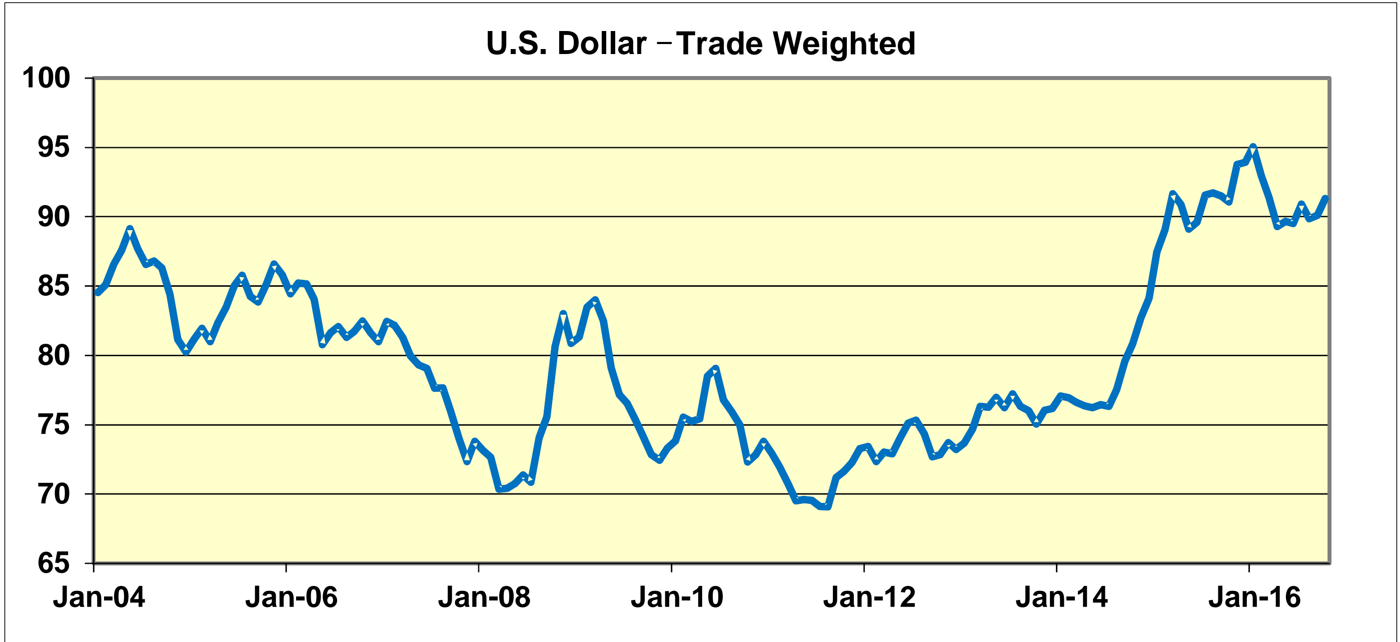
[1] The S&P 500 closed trading at 1,569.2 on March 28, 2013, the first new high since closing at 1,565.2 on October 9, 2007

The U.S. press has dubbed the ongoing bull market in American stocks as the "most hated" bull run in history[2]. Since most of the world's largest markets bottomed in the first quarter of 2009, the subsequent recovery has failed to inspire much investor confidence. A number of aftershocks have kept market players and the financial press busy. The so-called "taper tantrum" in 2013, the Greek referendum in 2015 and the Brexit vote in favour of the U.K. leaving the European Union earlier this year have punctuated the market story. Even more dramatically, the recent U.S. presidential election produced a remarkable swing in the market. Polling had pointed to a clear victory for the Democratic Party and the installation of Hilary Clinton as the first female president. Given this backdrop, Donald Trump's surprising victory and the Republican Party's continued control over both the Senate and the House of Representatives initially produced dramatic negative responses. Soon after the polls closed, the S&P 500 Futures Index was down 5%, hitting limit-down levels. Where markets were actually open for trading, heavy losses were seen. Tokyo's Nikkei saw the largest loss, closing down 5.4% after having been down 6.2% in heavy intraday trading.

However, these declines were eventually reversed, and far more quickly than those associated with Brexit. The main European markets recorded gains on the same day after initially moving down. In North America, the dramatic weakness in the futures markets was virtually eliminated at the market open with the S&P 500 Index closing the day up 1.1% to stand within 1.2% of its all-time high. As a group, each of these reversals, at least in the U.S., has shown less staying power as time goes on. In addition to these specific events has been the general narrative suggesting that valuations are too high, the market is living on "cheap money," and that the imbalances in the U.S. economy are not being properly reflected in the stock market. As can be seen in the preceding graph, after hitting a new high in May 2015, the U.S. market (S&P 500 Index as a proxy) experienced a material correction by the first quarter of 2016[3]. However, following that correction, a new high, the 109th of the current bull market, was achieved on July 11, 2016. Interestingly, the Brexit dip was clearly visible following the vote on June 23, 2016. However, as the sharp early losses associated with the U.S. presidential election occurred only in the futures market, the event appears only as an uptick in the graph above. As reluctant as the market appears to be, some signs still point to a continuation of this upward trend. Inflation and bond yields, both of which are at or near record lows, suggest that stocks continue to offer attractive relative yield. As well, some of the signs that typically accompany a market that is "overvalued" have not yet emerged.

[2] "The Most Hated Bull Market Keeps Chugging Along." *The Wall Street Journal*. Steven Russolillo July 11, 2016.
[3] The S&P 500 Index closed trading at 1,829.1 on February 11, 2016, down 14.2% from the close at 2,130.8 on May 21, 2015.

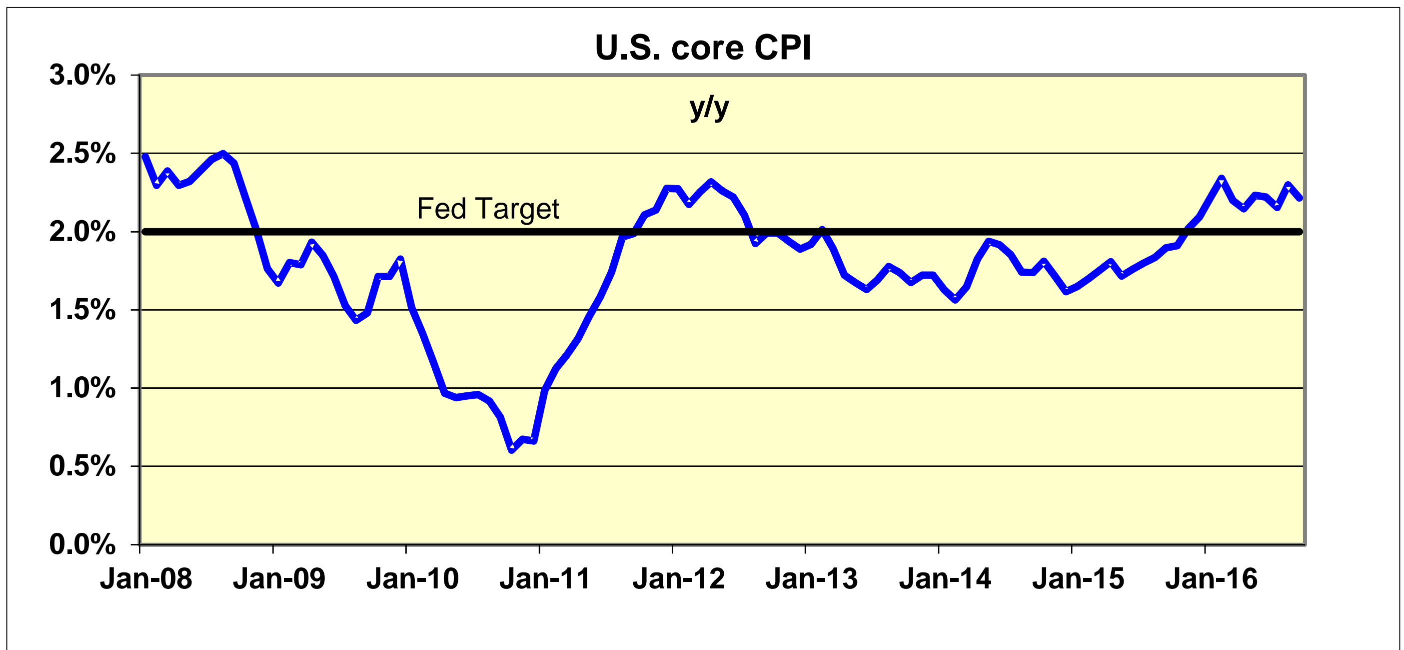
The dollar



Source: U.S. Federal Reserve

The surprise "leave" result from the Brexit vote on June 23, 2016 produced a dramatic downdraft for the pound sterling. Not surprisingly, much of the exodus from that currency found its way into the "safe haven" of the U.S. dollar. This was not a new phenomenon. The above graph shows the steady appreciation of the U.S. dollar over the past five years. Dissatisfaction with moribund economic growth in many regions had already fuelled buying interest in the greenback. As well, the favourable interest rate spread between U.S. Treasuries and sovereign debt from nations that had and continue to pursue negative interest rate policies drove investors into carry trades where they could borrow at negative rates in one country, take the proceeds and convert them to U.S. dollars and invest in the same maturities at positive interest rates and higher credit ratings. Even though the new administration is not yet in place, much of the campaigning during the U.S. election highlighted spending on infrastructure. With budget balances already stretched, implementation of this plan would serve to boost the deficit and could translate into weakness in the U.S. dollar against the other main currencies.

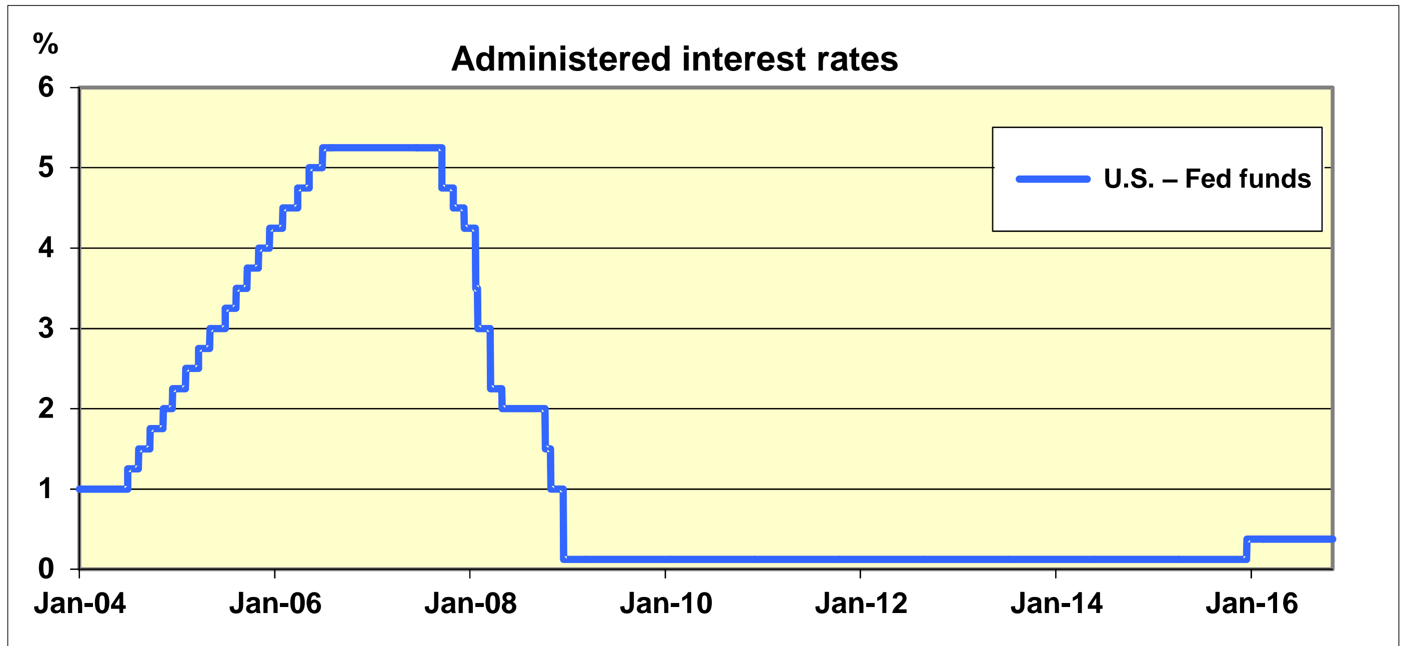
Inflation



Source: U.S. Bureau of Labor Statistics

One aspect of the U.S. economic landscape that has seen little change since the financial crisis has been the general absence of material inflationary pressures. Concerns over the risk of deflation (a steady and persistent decline in overall price levels) were primary drivers behind much of the concerted central bank activity seen globally in the immediate aftermath of the crisis. Since mid-2012, the overall consumer price index (CPI) has seen annual growth ranging from -0.2% to 2.2%. There have been brief hints of deflation, but they were not sustained. The U.S. Federal Reserve's inflation bogey (personal consumption expenditures excluding food and energy) has been even more stable, remaining in a 0.9% to 2.1% range since the beginning of 2010. This is well within range of the Fed's stated 2.0% target. Investors and the public in general have little reason to alter their inflation expectations. Interestingly, core CPI (which excludes volatile food and energy components) has begun to show signs of moving higher. As can be seen in the above graph, core CPI has seen annual growth above 2.0% since November 2015. Even though this is not the kind of price pressure that would typically elicit much of a reaction from the market or the central bank, there are signs of a modest fundamental shift. Perhaps more importantly, if the new U.S. government follows through on election promises to restrict international trade, the shift in inflationary pressures will be far more pronounced.

Interest rates



Source: U.S. Federal Reserve

The often repeated mantra of "lower for longer" with respect to interest rates has helped to further condition expectations. The Fed last raised rates on December 16, 2015, but by only 25 basis points (a basis point is 1/100th of one percent). This small increase came only after seven years of near-zero interest rates. Heading into the election, the market had widely anticipated a follow-up tightening move of the same size at the Fed's final 2016 meeting in December. Once again, the incoming U.S. government may alter monetary policy. At present, there are two existing vacancies on the seven-member board of governors. As well, Fed Chair Janet Yellen's term is set to expire in February 2018. Vice Chair Stanley Fischer's four-year term is also set to expire at the same time. If changes are to be made, it appears likely that more "hawkish" candidates would be selected. If this scenario materializes, the market will move in anticipation of such events and market interest rates would likely rise ahead of any Fed moves.

Elsewhere

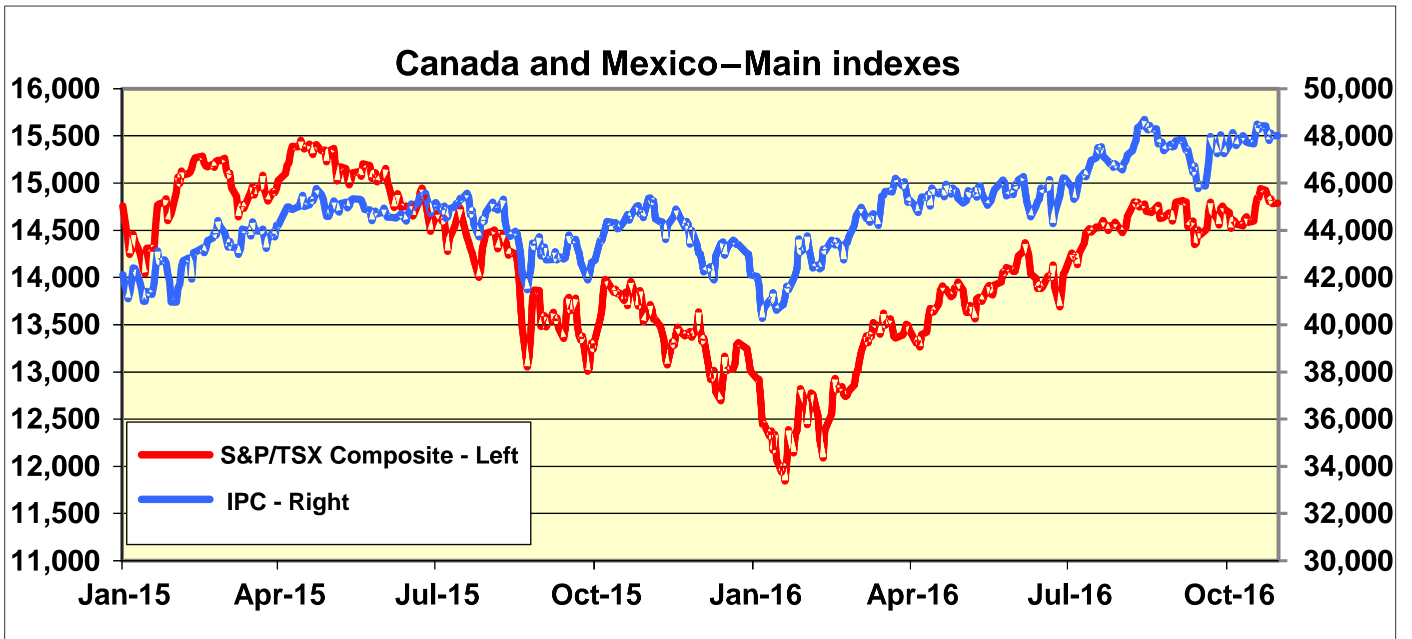
Much of the unease with the current investing environment seems to stem from straightforward mistrust. Market participants from all walks of life continue to doubt what they see. As Bloomberg View columnist Barry Ritholtz stated, "The rally (has) left these frightened folks behind. Blinded by cognitive bias, suffering from recency effects, failing to see both the coming crash and the recovery that followed, many were unable to adapt to or even accept the new market."[4] This is true not only in the U.S. but in most developed markets.

[4] "This Bull Market Is Powered by Your Indifference." Bloomberg. Barry Ritholtz. July 22, 2016

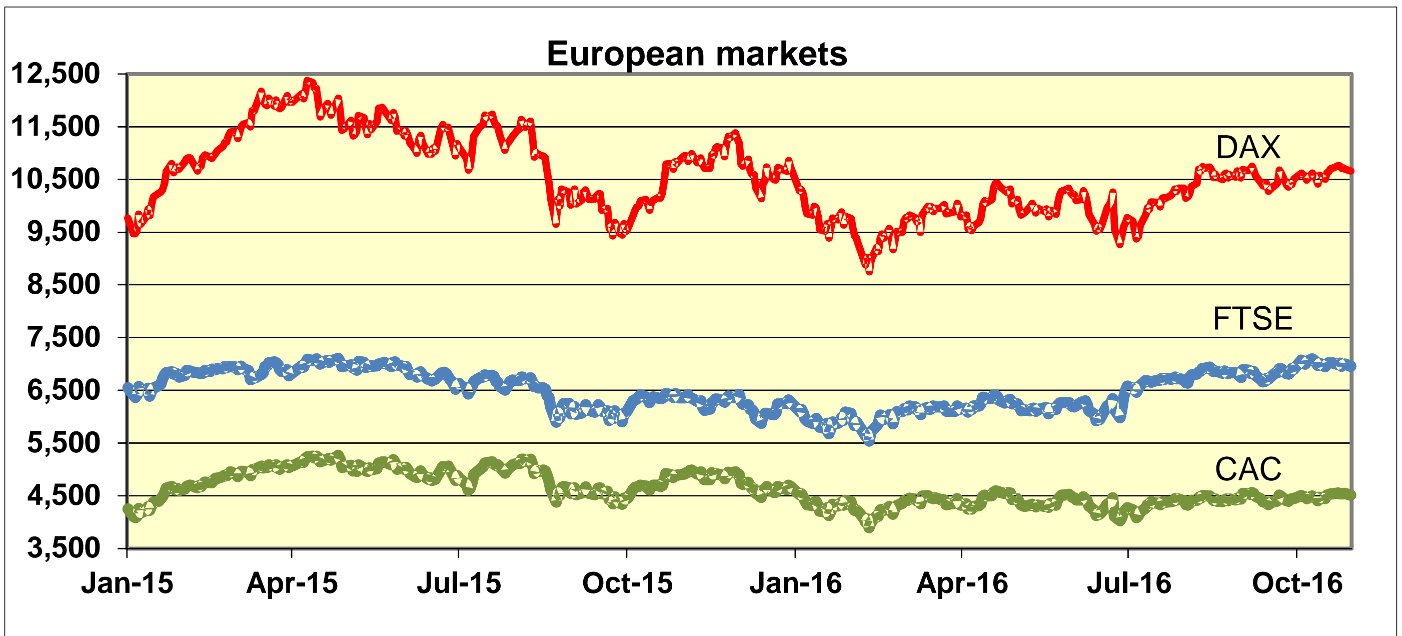
Market	All-time high (ATH)	ATH Date	Closing level on Oct. 31, 2016	Days since ATH	Advance need for new ATH
U.S. Dow Jones Industrial Average	18,636.1	15-Aug-16	18,142.4	77	2.7%
U.S. Nasdaq	5,339.5	22-Sep-16	5,189.1	39	2.9%
U.S. S&P 500	2,190.2	15-Aug-16	2,126.1	77	3.0%
Canada S&P/TSX Composite	15,657.6	3-Sep-14	14,787.3	789	5.9%
Mexico IPC	48,694.9	15-Aug-16	48,009.3	77	1.4%
Brazil Bovespa	73,517.0	20-May-08	64,925.0	3,086	13.2%
Germany DAX	12,374.7	10-Apr-15	10,665.0	570	16.0%
U.K. FTSE	7,104.0	27-Apr-15	6,954.2	553	2.2%
France CAC	6,922.3	4-Sep-00	4,509.3	5,901	53.5%
Japan Nikkei	38,915.9	29-Dec-89	17,425.0	9,803	123.3%
Hong Kong Hang Seng	31,638.2	30-Oct-07	22,934.5	3,289	38.0%
China Shanghai Composite	6,092.1	16-Oct-07	3,100.5	3,303	96.5%
Australia All Ordinaries	6,853.6	1-Nov-07	5,402.4	3,287	26.9%
India BSE	29,681.8	29-Jan-15	27,930.2	641	6.3%

Source: Bloomberg

As can be seen in the above table, the major markets all have different records with respect to setting new all-time highs as of October 31, 2016. While the main U.S. and Mexican indexes have posted relatively recent highs, the Canadian market has not experienced a new high since 2014. Brazil's market remains below its 2008 peak. In Europe, Germany and the U.K. saw highs in 2015 but France's CAC has yet to fully recover from the tech-bubble bear market of 2000-01. Further disparity is seen in Asia. India has been more in tune with Germany and the U.K. and reached its most recent high in 2015. Like Brazil, countries such as China, Australia and Hong Kong are looking to recover their pre-financial crisis levels. Japan remains the most notable outlier as the Nikkei must still look all the way back to 1989 for its last high.



Source: Bloomberg



Source: Bloomberg

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Conclusions

- By their very nature, unanticipated global events can result in material swings in securities prices. Looking to the longer term can help investors avoid making knee-jerk reactions to these events that could damage their portfolios.
- Despite the negative tone, unpopular markets can still provide opportunities. The pricing of assets, which can be biased to the broader mistrust, can yield bargains.
- Seeking professional advice can provide a disciplined approach to investing that helps avoid emotional responses to both market volatility and the prevailing emotional state of other investors.

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