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BULL LONG IN TOOTH

Living and investing in the fifth wave

Eric Parnell, a U.S. portfolio manager and CFA, wrote an interesting article on the Seeking Alpha website (seekingalpha.com) called "Uncomfortably Numb" near the end of June. As we approached the end of the first half of the trading year, Mr. Parnell noted that there were only two days when the stock market fell 0.7 per cent or more in the past six months. To quote from the article:

Keith Richards

"How truly unusual is it to have a market that has only gone down twice in the first six month of the year and four times over the course of a calendar year? Extremely unusual. To put this into context, over the past 88 calendar years of market history – which is a fairly decent sample size, to say the least, across all different kinds of market environments – the stock market will fall by more than -0.70 per cent on 17 per cent of trading days in any given year on average. Putting this differently, in any given trading year, stocks will fall by more than -0.70 per cent on 43 trading days on average. But this year, we are on pace for just four, which represents less than two per cent of all trading days for the year. Unusual indeed.

"How unusual is this disparity between upside and downside volatility in today's market?

"The normal ratio of +0.70 per cent to -0.70 per cent trading days in any given year dating back to the late 1920s is roughly 1.1-to-one. In 2017, it is setting up for a ratio of 5.5-to-one. This represents a more than +7 standard deviation event, if this ratio held through the remainder of the year. Put differently, what we are seeing take place in the U.S. stock market today in terms of upside volatility versus downside volatility is something we should expect to see once every 1.1 billion years. So yeah, I would say what we are seeing right now is a little unusual."

Below is a chart of the S&P 500 marked with Raf linear regression lines. Linear regression lines are drawn by starting the line at a low point on the chart where a trend began, and extending a line to the high point of the chart where it appears that the trend has ended or paused.

The middle line represents that starting and finishing point of the trend or wave, and the surrounding lines simply take the high and low points of volatility within that period.

The linear regression line gives us an eyeball on how much upward and downward price movement happened over the chosen period. I've selected the start and finish lines for my linear regression studies by using the five waves noted by students of Elliott wave theory (EWT). You'll note that in the most recent "wave" (Wave 5), the market has been in a very low-volatility state – as seen from the tight linear regression lines.

I should point out that I'm not a fan of Elliott wave projections. Not that there's anything wrong with Elliott wave theory when used in the right context.

EWT is an excellent tool for giving us a feel as to where we are in the cycle. And that's what I'd like to look at today. I really don't see any logic in using this theory to tell you at what level, and when, you should buy or sell. Sorry, Fibonacci lovers (EWT followers often use projections based on the work of famous mathematician Leonardo Pisano Bigollo, also known as Fibonacci, to identify buy and sell points).

Despite its failings in identifying times to buy and sell, EWT can offer excellent insight into the market's macro positioning. Here's how:

Elliott Wave helps us identify where we are in the investment cycle: Each wave of the 1-2-3-4-5-a-b-c sequence has a characteristic.

By noting the characteristics of the current market, you get a good feel for which of the waves the market is in right now. I covered those characteristics in my book *Sideways*.

I liken EWT to a world globe that might sit on your desk. Just as a globe doesn't help you pinpoint the neighbourhood and street you are on, EWT is not very good at pinpointing how much longer

a wave will last.

Elliott wave theory seems to inspire an almost cult-like belief system amongst some market prognosticators. They insist that you CAN in fact predict price turning points by using Fibonacci measurements within an Elliott wave sequence.

But, as I noted on my blog (valuetrend.ca) last January, these Fibonacci retracements and targets turn into moving targets as they fail. So I place no weight on such "target practice."

However, I do believe that markets have a tendency to behave differently during different phases of bull and bear markets. Elliott wave theory gives us an idea of what inning, so to speak, the stock market is in.

Waves shortening

For example, the first wave (or inning of the game) is one of disbelief after a bear market–it can be choppy.

The second wave is confirmation of their disbelief and profit-taking by participants –it is a corrective action ("I knew that was a head fake!").

The third wave is where the crowd joins in – which tends to make it the longest wave.

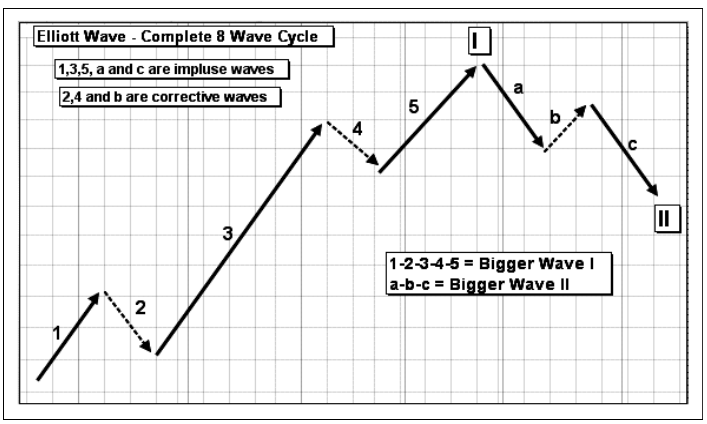
Then, a final correction (Wave 4) follows before a shorter, sharper wave of speculation (Wave 5) ends the game.

For that final fifth wave, the tendency is for something to add a "new paradigm" to the expectations of stock market participants.

For example, in the past, Wave 5 final market moves have been characterized by such new paradigms as the Nifty 50, which ended the bull market of 1950-64. It was the new paradigm of the Tech Bubble that ended the greatest bull market in history from 1982-2000. And it was the new paradigm of "Peak oil theory and subprime debt" that ended the 2002-08 bull market.

Each one of these "new paradigms" ended. In other words, they really weren't new paradigms. They were just events or developments that are part of human growth and market reflection of that growth.

As I have stated before, here and online, right now, I believe that the "new paradigm" is "TINA" –There is No Alternative. Super-low interest rates (historic lows) have driven investors into the stock market and out of safe investments.



That, along with the low rates inspiring easy leverage to over-inflated real estate in turn creates a "wealth effect". People buy a better car and better stuff when they have a valuable house and a good stock portfolio. This pushes earnings higher – justifying higher valuations. It keeps going until it can't keep going any more.

Wikipedia (which refers to various EWT experts for this definition) states, "Wave 5 is the final leg in the direction of the dominant trend. The news is almost universally positive and everyone is bullish.

"Unfortunately, this is when many average investors finally buy in, right before the top. Volume is often lower in Wave 5 than in Wave 3, and many momentum indicators start to show divergences (prices reach a new high but the indicators do not reach a new peak).

"At the end of a major bull market, bears may very well be ridiculed."

Does this sound familiar? Again--Note the incredibly tight, low-volatility environment over 2017, along with the falling volume on the chart above.

The final inning

We're probably in Wave 5 of the current bull market. It could run for another month, another quarter, another year, or even longer. So don't take my comment here as a suggestion to sell out.

There may be a good amount of upside left in this market. Nevertheless, there's no denying that we are not in the early phases of a bull market. We're in the final inning of the game, however long it may take to complete. Stay aware, and be prepared.

Keith Richards, Portfolio Manager, can be contacted at krichards@valuetrend.ca. *He may hold positions in the securities mentioned. Worldsource Securities Inc., sponsoring investment dealer of Keith Richards and member of the Canadian Investor Protection Fund and of the Investment Industry Regulatory Organization of Canada. The information provided is general in nature and does not represent investment advice. It is subject to change without notice and is based on the perspectives and opinions of the writer only and not necessarily those of Worldsource Securities Inc. It may also contain projections or other "forward-looking statements." There is significant risk that forward looking statements will not prove to be accurate and actual results, performance, or achievements could differ materially from any future results, performance, or achievements that may be expressed or implied by such forward-looking statements and you will not unduly rely on such forward-looking statements. Every effort has been made to compile this material from reliable sources; however, no warranty can be made as to its accuracy or completeness. Before acting on any of the above, please consult an appropriate professional regarding your particular circumstances.*