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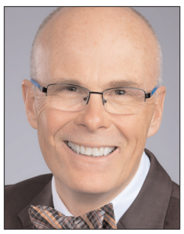
Crystal ball 'murky' on 2021



Keith Richards

Projecting market returns out a year or more these days is becoming a bit of a mug's game. Still, I can offer some near-termed thoughts that may help with decisions regarding tax loss selling into the year-end, and then tie those thoughts into a longer-termed outlook for markets. This is the best my "murky" crystal ball will allow.

As far as what sectors one might want to focus on with tax loss selling, there are a few. At this juncture, there are some sectors like REITs, financials, energy, and utilities that have lost quite a bit of ground this year. True enough, some of those sectors will be sold off in the coming weeks as portfolio managers attempt to offset capital gains in their tech stock sales with the losses in those sectors.

Further, by selling unfavourable stocks before year-end, the annual reports put out by investment firms don't show the ugly ducklings to their clients. This is known as "window dressing".

As an aside, ValueTrend clients hold "individually managed accounts", so they get to see all their holdings online every day. Window dressing won't hide our losers! But for a fund or pension manager, hiding the dogs before the year-end holdings reports come out can save a lot of face!

Another factor that may affect the markets in December will be rebalancing of portfolios. For example, balanced mutual funds and ETFs have had tremendous gains on the stock side of their portfolios. Meanwhile, bonds have lagged in performance. A traditional balanced fund holds a 60-40 mix of stocks to bonds. If that now looks like 70-30, you will see some stock selling and bond buying in the coming weeks by these folks to keep within their mandate. Same goes for pension funds. They have mandates to contain asset classes within a certain range. If stocks go too far out of their allotted range, there will be rebalancing at the end of the year.

True, all these institutions rebalance quarterly in most cases. But the final quarter of 2020 will be influenced by a double-whammy of tax loss selling across the board, along with institutional rebalancing.

The caveat to this potential for year-end selling will be WHAT the managers who are rebalancing, and tax loss sellers, will sell. For example, a couple of months ago, I suspected oil might be a victim of tax loss selling. Everyone hated oil. This was before it began its strong rise in November. Well, it seems that most investors are now convinced that oil is an opportunity. As such, these same investors may be less inclined to sell their holdings in the current bullish environment for oil stocks.

However, there are still some sectors that remain weak. For example, U.S. REITs continue to underperform. As reflected by the **Vanguard Real Estate ETF** (VNQ-NYSE/Arca), made up of U.S. REITs, the sector remains relatively confined to its consolidation pattern, despite breakouts on most other value sectors of the market.

Adding to that is the potential for a near-termed correction on the markets. In fact, by the time you read this magazine, it may already have happened, or have started.

One factor influencing a broader market correction has been a resurgence in investor optimism, as shown on many of the sentiment indicators I follow. Too much optimism is a contrarian sell signal. Take just one of them, the CBOE (Chicago Board Options Exchange) put-to-call ratio. As I write in late November, it's sitting at the same level as it has been at before several market corrections and inching toward where it was prior to the 25 per cent correction in 2011.

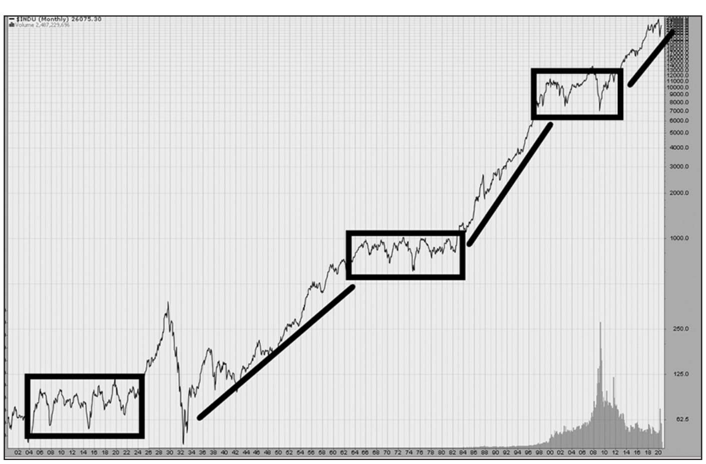
It also signalled an overly optimistic condition prior to the spring COVID crash, and it gave a very early signal in the summer that led into the volatility this fall.

Adding to that is the complacency I am seeing on several other sentiment studies that form part of the ValueTrend Bear-o-meter compilation (visit my blog at www.valuetrend.ca to read more about this risk-to-reward compilation). Many of the sentiment studies incorporated into the Bear-o-meter have moved from neutral to bearish. When we start to see a number of sentiment studies showing complacency amongst investors, the market is likely in for a short-termed correction.

At the end of November as I write this, we are holding about 15 per cent cash in our ValueTrend Equity Platform for this reason. We view such a correction, should it happen, as opportunistic - as I will discuss below.

While I am no economist, I can relay that the stock market projects a forward view on the economy, usually by six-to-eight months or so. Given the vaccines coming out, the market is telling us – though a resurgence in the reflation names (cyclicals, etc.) and value names (traditional economy versus technology) – that it believes the economy will be strong in the coming year. This suggests that 2021 will continue its bullish pattern seen since the 2020 COVID crash in March.

Adding to the bull case for 2021: Below, you will see the mega-long-termed chart of the Dow Jones industrial average going back to 1900. I was a youngster back then, so I don't remember much (haha). Mind you, Joe Biden said he got to the Senate



180 years ago. He might remember. Anyhow, notice how the chart illustrates the long-termed sideways periods that can last for one or two decades. I've enclosed these mega-consolidations within black boxes. From there, I note the bull markets with thick black trend lines.

These mega bull markets last decades as well. The bull coming off of the 1929 crash ended up with a 20-fold gain before it ended in the mid-'60s. The bull that began in 1982 after that consolidation ended with a 10-fold gain coming into 1999. The market's bottom in 2009 led into the current bull that is already about 10 years old.

The current bull is already up threefold. The bull market from 1984-99 went up 11-fold. The bull market prior to that rose 16-fold between 1932 and 1966.

If history is a guide, we have lots of room both on a percentage gain basis, and in the lifetime of the current bull. This does not imply a lack of sharp corrections like our recent COVID crash. In the last bull market, we had some pretty severe corrections – the worst of which was in 1987 (Black Monday). So it won't be a smooth ride.

Sector rotation tends to be a major factor in creating market volatility. A century of market history shows us the value of sector rotation in reducing the impact of severe market downside. My last column for *Investor's Digest* outlined some of those sector rotational decisions we have been making at ValueTrend to reduce portfolio volatility and position portfolios to take advantage of the current rotation.

I'd recommend reading that column if you haven't already. Going forward, I hope to offer readers of *Investor's Digest* ideas on how they might participate in this long-termed bull market, yet smooth some of those bumps by reducing the impact of the biggest downside moves on the markets. Despite those bumps, history suggests it will be a long and prosperous ride for several years to come.

Keith Richards is Chief Portfolio Manager & President of ValueTrend Wealth Mgmt. He can be contacted at info@valuetrend.ca. *He may hold positions in the securities mentioned. 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. 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.*