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STRATEGIES FOR SUCCESSFUL INVESTING

MARKET WISDOM

Know When to Fold 'em

ARE WE IN A BUBBLE?

Keith Richards

THERE'S QUITE A BIT OF TALK THAT housing and stock markets are in "bubble territory." While I am not an expert on real estate, I can offer some thoughts based on basic housing sales patterns when compared to historic averages. In my column today, we'll look at charts of housing and the stock market today to see if evidence leans towards the fact that either of those markets may be in bubble territory. Keeping in mind that even if we ARE in a bubble in either market, we still don't know exactly when that bubble will burst.

But .... we can still have a strategy in place to deal with a bear market crash if or when it happens. That's what this column is about. Knowing where we are and having a plan to deal with whatever comes our way. Let's get started:

> **"Buy when you are scared to death; sell when you are tickled to death."**
>
> *–Old Market saying*

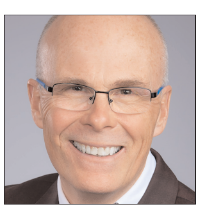
Let's look at real estate in Canada before getting to the stock market.

Economist David Rosenberg notes that home-price to rent and home-price to income numbers in Canada are higher than they were during the U.S. real estate bubble in the early 2000s. The rampage is so strong that along with multiple offers for houses, buyers are willing to pay exorbitant premiums over the listed prices. Some are buying sight unseen (virtually). And 1 in 10 buyers are learning that the bank appraisal is below what they are paying for their house! Sounds like 2006-7, when homes were bought high, "knowing" they would go higher still. Until they didn't….

On the following page is a chart (I believe the source is Stats Canada) updated to the end of March for Canadian housing sales that go back to the 2007 housing bubble. Note that the 10-year Simple Moving Average is around 40,000 monthly sales. Since the COVID crash, sales have literally gone parabolic. At 70,000, they are above that Moving Average by 75 per cent!!! There's no arguing that housing sales are aggressively up from a historic perspective. Clearly, this is a red flag for anyone believing in mean-regression – such as myself.

Meanwhile – Canada ranks amongst the highest in the world when it comes to household debt to GDP, at 113 per cent as of December 2020 (rank 3rd), and household debt to income at 170 per cent, also as of December 2020 (rank 4th). With sales going through the roof (pardon the pun) and a highly leveraged consumer buying those houses… the setup is there for some trouble.

Our leveraged consumer will be facing new economic pressures.



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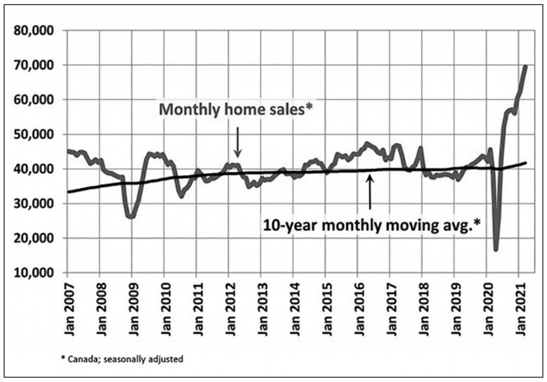

Canada's job numbers were out in early April and they looked robust. But that was before the latest lockdowns. Thank you, Canadian federal Government for unforgivably blowing it on vaccine distribution. The CDC in the U.S. (Center for Disease Control) now recommends that travelers avoid Canada - yikes! All of this continues to place a strain on the Canadian economy. How will this impact an already overleveraged consumer? How will this affect a real estate bubble in Canadian housing? As noted above, you don't know when a bubble will implode. But…you can have a plan.

My take: I'm not so sure that now is the time to buy your next real estate investment in Canada. Perhaps it's time to review an exit strategy on investment properties outside of residential and recreational usage.

And yet… there are always opportunities

Canadian federal government bumbling aside, the U.S. and other countries continue to be on top of their vaccine ºdistribution and subsequent reopening strategies. Travel by air in the U.S., for example, is **back to 80 per cent of pre-COVID levels!** Disney is seeing good flow in their parks. In my last *Money Letter* article, I noted that the airline sector was setting up for a breakout. In that article, I identified certain names in that space that were looking good. We bought American Airlines (AAL-US) and Air Canada (AC-T) in our Value-Trend Aggressive Platform. We continue to hold these names. So far, the American Airlines trade appears to be performing as anticipated. We are also up on the Air Canada trade, but by much less due to Canada's COVID problems. Nonetheless, our outlook remains positive for a long-term outlook on the stock. We anticipate that Canada will eventually catch up to the rest of the world in vaccine distribution and re-opening strategies. Air Canada will benefit from a catch-up trade.

"In a bear market everyone loses. And the winner is the one who loses the least."

—Richard Russell,
Dow Theory Letters

The U.S. markets appear to be in a bubble. Technical indicators on U.S. market indices are stretched . For example, the S&P 500 is 15 per cent over its 200 day/40 week Moving Average. This is a prime sign of overvaluation, and suggests that a pullback is immanent. I do not like to see a market index go much higher than 10 per cent above its 200-day moving average. Momentum indicators measuring the velocity of movement on stocks have been overbought. The angle of ascent for the S&P 500 in April was parabolically steep – another sign of an

overbought market. For this reason, we at ValueTrend have slowly been raising cash. We've also been selling a few of our overbought stocks and moving into defensive sectors. Consumer Staples, utilities, value stocks and dividend payers have been our focus of late. For those interested, I publish a bi-weekly blog at www.valuetrend.ca where I cover these types of trades. I also publish a weekly video available on that website. I recently compared dividend aristocrat stocks to growth stocks to assess their ability to withstand market weakness if the growth stocks underperform. This video may be of interest to readers who are heavily invested in growth stocks.

Perhaps you agree with my analysis regarding the overbought status of the stock markets right now. Does this indicate that the S&P 500 is in a bubble? The fact is that just because the market is overbought does not necessarily indicate a bubble. So, what constitutes a market bubble?

Below you will see a list of conditions that Jason Goepfert of Sentimentrader.com published on identifying market bubble conditions. When examining this list, you might notice that we may indeed be approaching market bubble conditions. You might note that we currently meet each of these conditions. Crypto-coin anyone?

- ☛ High optimism
- ☛ Easy credit (too easy, with loose terms)
- ☛ A rush of initial and secondarey offerings
- ☛ Risky stocks outperforming quality stocks
- ☛ Stretched valuations

Conclusion

As I mentioned in the opening paragraph of this column, just because the conditions are there for a bubble, doesn't mean that you will time it correctly and get out at the top. After all, the market can remain "wrong" longer than we might anticipate. For this reason, I continue to endorse the basic technical analysis approach to managing one's investment risk. This approach does not get you out at the top. It will, however, get you out with less damage than a buy-and-hold strategy during a bear-market selloff. Effectively, you want to watch a weekly chart for signs of a breakdown in trend. Bullish trends are identified by a series of higher highs and higher lows on a weekly chart, with the market remaining above its 200 day Moving Average. When the market violates this rule, I begin to step out – but I do it in stages. You can read my book *Sideways: Using the Power of Technical analysis to Profit in Uncertain Times* for a detailed breakdown of this trading strategy.

If you will follow a basic trend analysis approach as described in my book, along with following my monthly Bear-o-meter risk/reward readings on my blog, you will have an edge. Sector rotation strategies and good stock picking will allow you to stay invested in the right areas through the lower risk times, and broad market trend analysis along with a quantitative risk analysis assessment like my Bear-o-meter will help you move out of markets when risk rises. For our clients, that's more important than chasing every last nickel in an overinflated market.

A final note: I just finished submitting the manuscript for my newest book entitled "*Smart Money, Dumb Money: Beating the Crowd through contrarian investing*." I anticipate that the book will be available by July. It goes much deeper than my past books. While it's not written for sophisticated investors, I know that many of you reading this column will appreciate the deeper dive. I literally wrote this book for you! ▼

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