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Market timing, when does it work?

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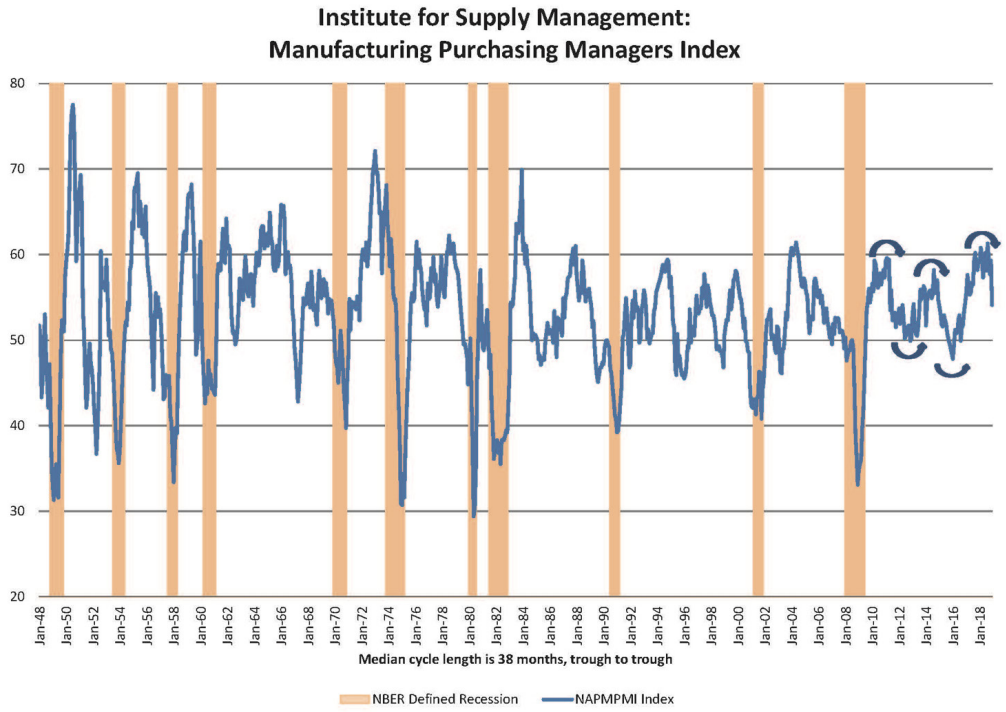
January 25, 2019

The economy's manic Jack Russel terrier, "Stock Market" ("Stocky"), went into full panic mode in December. That's a lousy time to panic as liquidity is often poor at that time of year. But when investors are panicking, they aren't worrying about liquidity, they just want to hit the sell button. The same applies to trading ETFs, which allow investors to panic into and out of positions whenever their emotions dictate. After 44 years of involvement in capital markets I continue to be perplexed by how emotional and subjective investors tend to be. They rarely pause to ask the question: "Is this a good idea at the right time?"

The calls into our sales team are typically in response to clients asking their advisors for change. They want to migrate to lower risk strategies or sell in anticipation of a larger decline. However, quite often they won't buy back if the hoped-for decline happens. Evidence of that includes how few inbound calls we get from market timers wanting to get in on the pull back.

My commentaries last year focused on risk management and suggested clients upgrade both their fixed income and equity portfolios. Now that there has been a sharp decline in both equities and lower quality bonds, we are getting calls in to upgrade portfolios. It is a bit late, but upgrading while maintaining the same asset mix still make sense.

Initially, commentators blamed stock market weakness on mildly rising 10-year bond yields. But I disagree. I believe the primary reason for a decline in equity markets is that global purchasing manager indices (PMIs) are rolling over, which is a reliable leading indicator of softening economic activity. The U.S. typically has the best data, so I'll use theirs to represent the relationship.



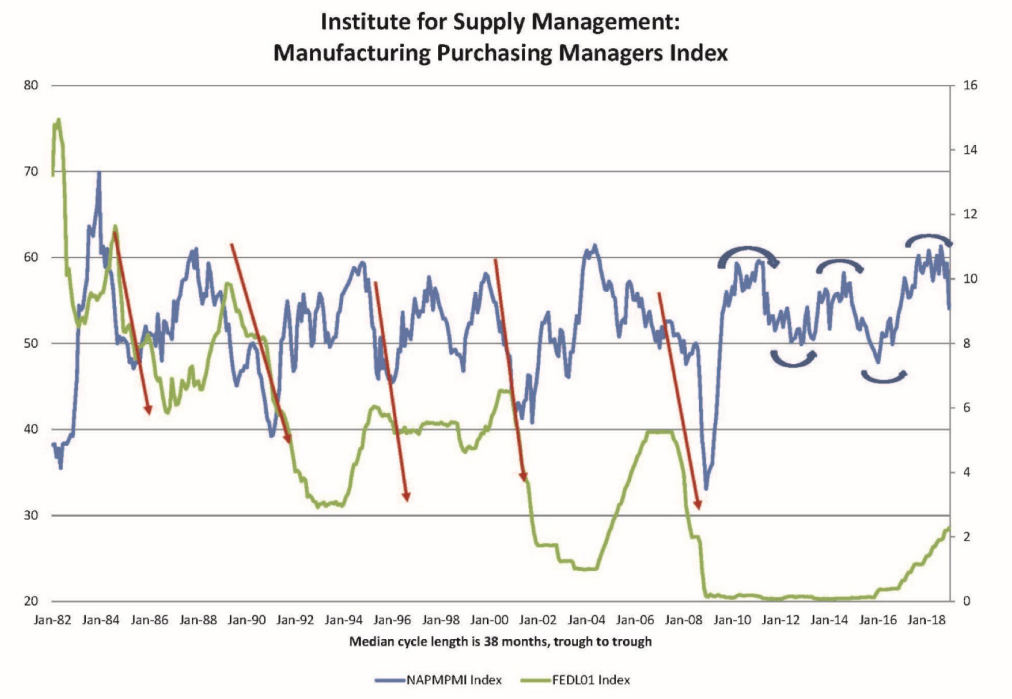
Source: Institute for Supply Management; Bloomberg L.P.; CI Investments

As of December 31, 2018

The first take-away from the previous chart is that PMIs are cyclical, and the PMI cycles since the early 1980s do not necessarily match the length of the credit cycle. In this expansion we have had three distinct PMI cycles and, over the lifetime of the Institute for Supply Management data, the median length of a PMI cycle has been 38 months. This cycle is 36 months long and the "new orders" series seems to indicate that this cycle will likely end in Q1 2019. It is unlikely that the data series can recover quickly as the U.S. government shutdown finally ends (even if only temporarily) and trade wars with China continue. The stock market saw the data coming and yelled "SELL!".

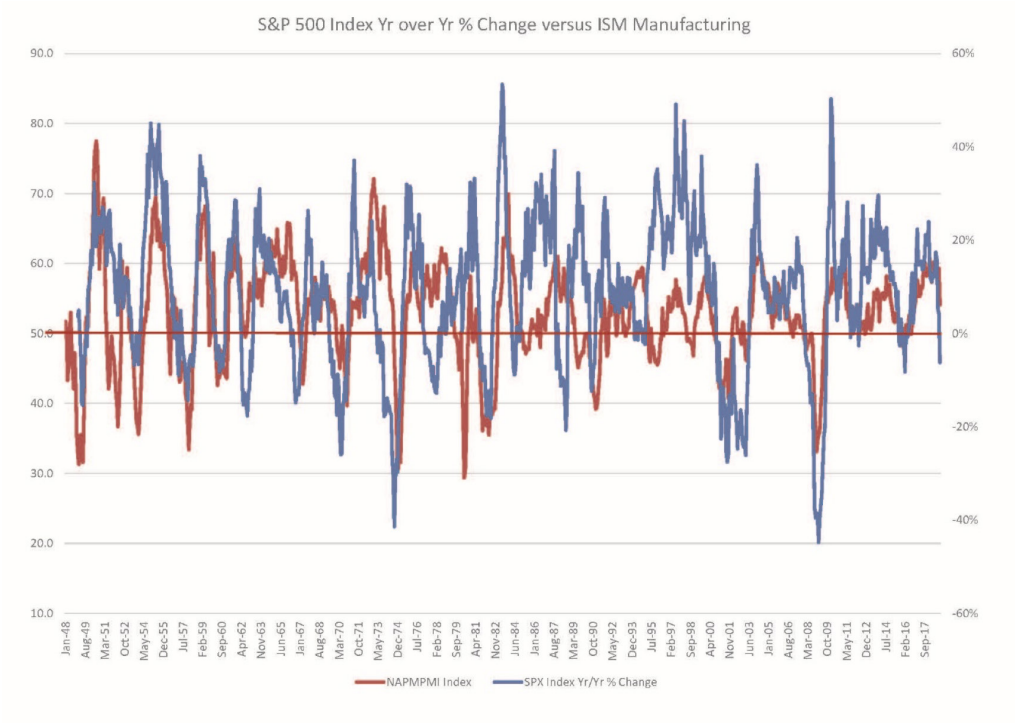
Source: Institute for Supply Management; Bloomberg L.P.; CI Investments As at December 31, 2018

So is "Stocky" always right? There have been many PMI downturns within rising equity markets. Where a PMI downturn gets problematic is during active Federal Reserve tightening cycles. While it is rare, there have been instances when the Fed has eased within a tightening cycle, in part due to declining PMIs. Fed easing in 1984 and 1995 generated soft landings for the economy. In every case since the peak of rates in 1981, the Fed was easing as the PMI went below 50.



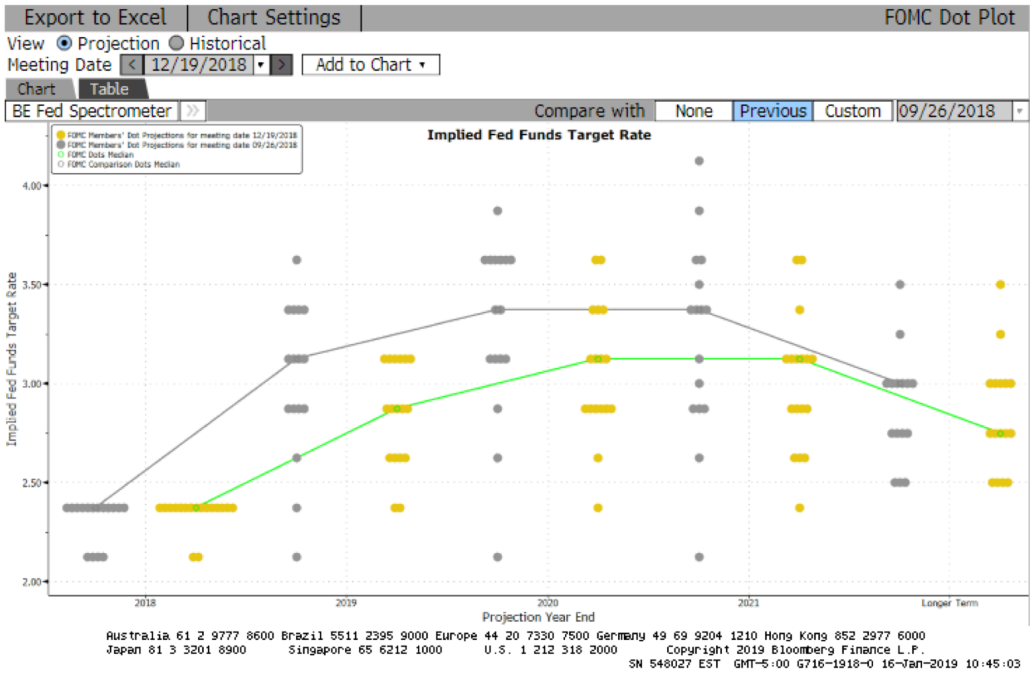
Source: Institute for Supply Management; Bloomberg L.P.; CI Investments As at December 31, 2018

The direction of PMIs is important and the influence of the Fed tightening on PMIs is clear. Why does this matter? The correlation between PMI direction and the S&P 500 appreciating or depreciating is very high.



Source: Institute for Supply Management; Bloomberg L.P.; CI Investments As at December 31, 2018

Is the deterioration in PMIs enough to stop the Fed? What is the bond market telling us? The most recent Federal Reserve DOT Plot was released in December. When compared to the September plot, it is clearly more dovish.



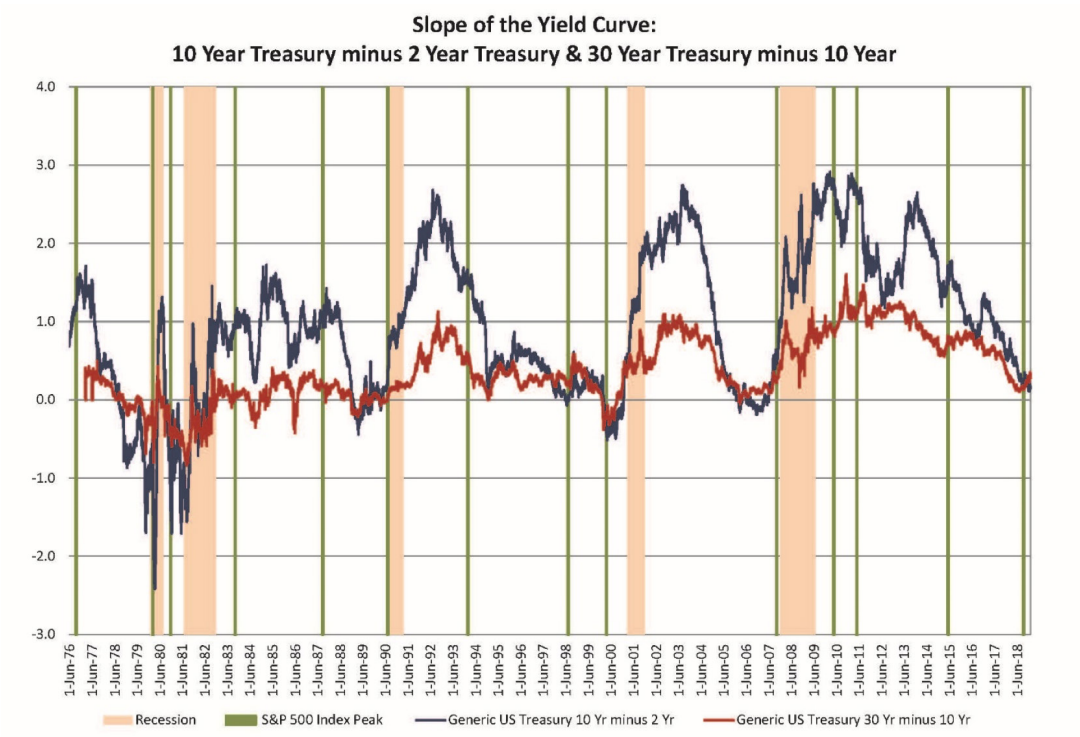
Source: Bloomberg L.P. As of January 16, 2019

The bond market has reacted rapidly to the deterioration in the PMI series. Today the effective Fed Funds Rate (FFR) is 2.4%. The Futures implied FFR for September 2019 is 2.44%. The Fed is skewing dovish and the market is pricing in a pause at the lower bound of "normalized" FFR. What does short-term bond math tell us about rates next year?

Bond math as of January 25, 2019:

- Current 3-month Treasury Bill: 2.38%
- Year 1 average 3-month with one hike in June: 2.54%
- Current 2-year Treasury: 2.60%
- Year 2 average 3-month should be: 2.66%

The market is pricing a pause at 2.40% in 2019 and one more hike in mid-2019. If the Fed pauses then cuts, the 3-month will likely fall in yield and the 2-Year will follow it down. The 2-Year has already declined from a peak of almost 3% in November to 2.55% as of January 25. In my view it is now more likely that the yield curve should steepen, not invert. The popular 2s and 10s yield curve is now beginning to respond to the lower 2s and recent rises in 10-Year yields by steepening from a low of 10 basis points (bps) in mid-December to 16 bps on January 25.

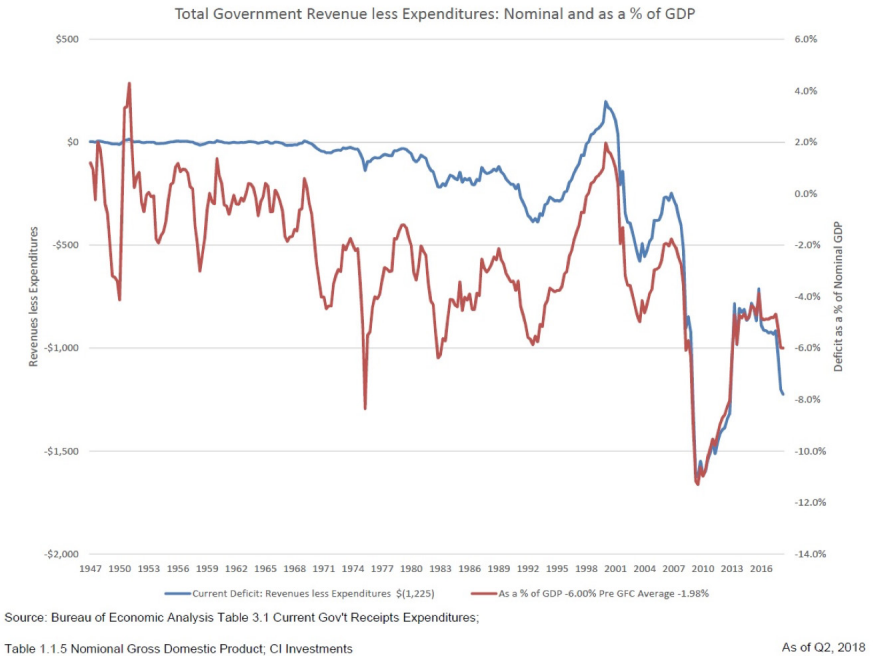


Source: Bloomberg L.P.; CI Investments

As of January 11, 2019

The long-bond curve (30s minus 10s) is now steepening. It hit a low of 10 bps in July with the 30s at 2.95% and 10s at 2.85%. The current 30-Year of 3.07% minus the current 10-Year of 2.63% = 44 bps. This curve tends to lead the mid-term curves. I spent most of last year suggesting that the yield curves would invert in 2019 if the Fed continued the course indicated by the sequentially more hawkish DOT plots. But I am coming around to the concept that spreads may have gotten as tight as they are going to get for 2019. The 5 trillion-dollar question is: "Are we going into a recession now?"

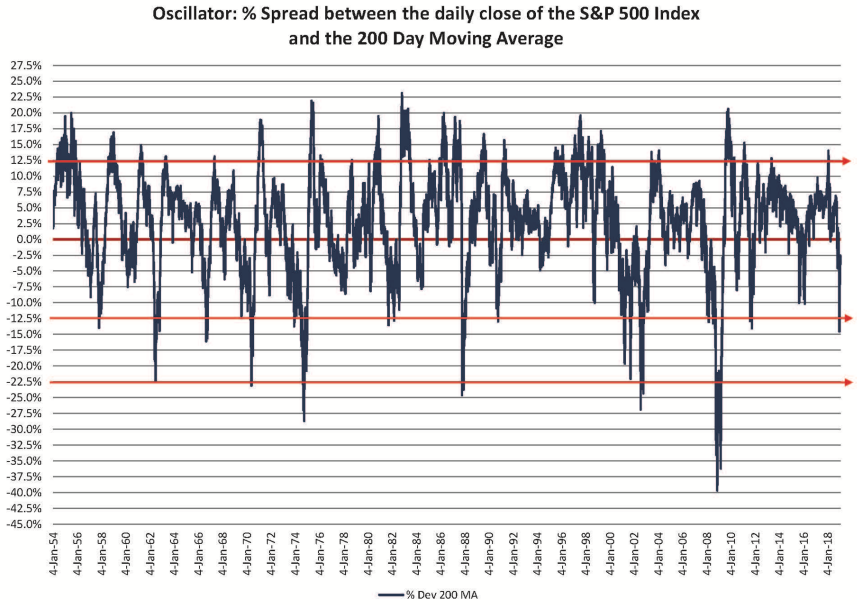
This is an important question on many levels. First, recessions are bad for corporate earnings and stock markets. They are bad for credit spreads and borrowers. They also are bad for government deficits. Given the recent government shut-down and the bad blood between Congress and the White House, it is highly unlikely that budget compromises will come easily. In the meantime, the deficit is growing both in nominal terms and as a percentage of GDP. The U.S. is ill prepared for a recession. I would be surprised if the Fed were unaware of this issue.



Source: Bureau of Economic Analysis Table 3.1 Current Gov't Receipts Expenditures; Table 1.1.5 Nominal Gross Domestic Product; CI Invesments — As of Q2, 2018

Note that these calculations ignore the unfunded status of Social Security. The cure for deficits is higher tax revenue. A little wage push inflation would be a positive outcome for the U.S. income statement and balance sheet. I am of the view that the Fed's policy error will be that it favours the side of its mandate targeting full employment and errs on inflation by allowing modest wage push inflation to creep into the economy. If so, this cycle does not end in 2019.

Having set the stage for 2019 possibly being a soft landing or very mild recession, what do investors do? I love playing with data and luckily that is now my primary job. For the past 25 years I have used "oscillators" to manage risk in portfolios. There are proprietary traders in Toronto that have seen their value and use them to manage their exposures. The primary oscillator uses the spread between the spot market, which as of January 25 is 2,665 on the S&P 500, and the 200-Day (2,741) and 50-Day (2,617) Moving Averages. The current spread is -2.8% for the 200 and +1.8% for the 50. When expressed graphically you can see how this works.



Source: Bloomberg L.P.; CI Investments — As of January 25, 2019

I have added red lines at 12.5% above and below the zero line. In positively trending markets these levels have been points to distribute or accumulate stock. I have also added a line at -22.5% below the zero line. This level has been hit for six brief periods in 64 years. The -12.5% line was hit in December. It was this rapid decline that lit-up the phone lines to our sales team. The question? Should I sell?

I went back and studied all outcomes when the market was at these extremes. The stock market in the 1920s, 30s and 40s was much more volatile than modern markets, and had a huge skew due to the depression bear markets of 1929-1932 and 1937-1938. Using the modern period shown above I found some interesting outcomes. If you bought or held the market when it was trading at a 12.5% premium to the 200-day moving average, you participated in 8.7% of all trading days and had a positive outcome one year later 80.7% of the time. I haven't played with the 1st derivative; rate of change, yet but I would expect it to improve on this outcome.

Where the oscillator stuns are in down markets. If you bought or held when the market was 12.5% below the 200-day MA or more, 3.5% of all trading days, you had a positive outcome 90.8% of the time. This includes all secular bear markets. In secular bull markets the spread occurs in less than 1% of all trading days and the positive outcome percentage improves to 95.4%.

There are 141 days where the spread is -22.5% or greater. Five days, 3.6% of occurrences, occurred during secular bulls, once in 1962 and four times in 1987. The average return one year out was +24.4%. In the modern era secular bears the -22.5% level has been hit 136 times. The positive outcome one year out success rate was 100% with a one year out return of 30.1%. And yes, this includes the early down spikes in October of 2008. Selling down spikes is bad portfolio management. It increases your execution risk while ensuring that risk capital is reduced at market lows. The full table follows:

S&P 500: Spread between Last Price and Moving Average

	If Mkt 12.5% or > 200 Day MA; 1 Yr (252 Trading Days) Subsequent Rtn	Positive Rtns	Negative Rtns	If -12.5% or < 200 Day MA; 252 Trading Days Subsequent Rtn	Positive Rtns	Negative Rtns	If -22.5% or < 200 Day MA; 252 Trading Days Subsequent Rtn	Positive Rtns	Negative Rtns	If Mkt < 200 Week MA; 252 Trading Days Subsequent Rtn	Positive Rtns	Negative Rtns
Since Inception: December 27, 1927												
Trading Days	22,873	Positive	12,262	53.6% Avg:		0.7%	Negative	10,611	46.4%	Avg:	-0.8%	
From Dec 30, 1927												
Trading Days	2458	1742	715	1427	961	464	502	319	183	5067	3553	1513
% of Up Days vs. Down		70.9%	29.1%		67.3%	32.5%		63.5%	36.5%		70.1%	29.9%
% of all Trading Days	10.7%	7.6%	3.1%	6.2%	4.2%	2.0%	2.2%	1.4%	0.8%	22.2%	15.5%	6.6%
Average Return	7.72%	16.63%	-13.97%	8.80%	27.61%	-30.11%	15.44%	40.38%	-28.05%	12.29%	23.66%	-14.41%
Modern Era												
Trading Days	16,107	Positive	8,589	53.3% Avg:		0.7%	Negative	7,518	46.7%	Avg:	-0.7%	
From Jan 31, 1954												
Trading Days	1417	1144	273	568	516	52	141	141	0	2621	2105	516
% of Up Days vs. Down		80.73%	19.27%		90.85%	9.15%		100.00%	0.00%		80.31%	24.51%
% of all Trading Days	8.66%	6.99%	1.67%	3.47%	3.15%	0.32%	0.86%	0.86%	0.00%	16.02%	12.87%	
Average Return	8.63%	13.32%	-11.05%	21.00%	24.55%	-14.22%	29.92%	29.92%		12.36%	19.62%	-17.27%
Secular Bulls												
Trading Days	13,176	Positive	7,284	55.3% Avg:		0.6%	Negative	5,892	44.7%	Avg:	-0.6%	
Dec 30, 1927 to Sept 15, 1929 Trading Days	164	9	155	-	-	-	-	-	-	-	-	-
Average Return	-14.1%	13.7%	-15.7%									
% of Up Days vs. Down		5.5%	94.5%									
April 28, 1942 to Jan 12, 1968 Trading Days	648	556	92	151	142	8	1	1	-	728	727	1
Average Return	11.5%	15.6%	-13.2%	18.3%	19.5%	-1.3%	32.7%	32.7%		23.3%	23.3%	
% of Up Days vs. Down		85.8%	14.2%		94.0%	5.3%					99.9%	0.1%
Aug 12, 1982 to Sept 1, 2000 Trading Days	766	565	201	64	64	-	4	4	-	10	10	-
Average Return	9.97%	16.86%	-9.37%	14.12%	14.12%		22.33%	22.33%		45.70%	45.70%	
% of Up Days vs. Down		73.8%	26.2%		100.0%	0.0%					100.0%	0.0%
Oct 3, 2011 to date Trading Days	9	3	6	2	1	1	-	-	-	5	5	-
Average Return	-62.38%	12.85%	-100.00%	-34.24%	31.52%					28.41%	28.41%	
% of Up Days vs. Down		33.3%	66.7%		50.0%	50.0%					100.0%	0.0%
Ttl Trading days	1,423	1,124	299	217	207	9	5	5	-	743	742	1
% of Up Days vs. Down		78.99%	21.01%		95.39%	4.15%					99.87%	
% of all Trading Days	6.22%	4.91%	1.31%	0.95%	0.90%	0.04%	0.02%	0.02%	0.00%	3.25%		
Avg Bull Mkt Rtn	10.23%	16.24%	-12.37%	16.59%	17.92%	-1.11%	24.39%	24.39%		23.62%	23.65%	
Secular Bears												
Trading Days	9,498	Positive	4,859	51.2% Avg:		0.9%	Negative	4,639	48.8%	Avg:	-1.0%	
Sept 16, 1929 to Apr 28, 1942 Trading Days	483	274	208	781	376	404	361	178	183	1,937	940	996
Average Return	8.87%	27.92%	-16.19%	-0.43%	34.26%	-32.72%	9.78%	48.66%	-28.05%	9.52%	33.35%	-12.94%
% of Up Days vs. Down		56.7%	43.1%		48.1%	51.7%					48.5%	51.4%
Jan 12, 1968 to Aug 12, 1982 Trading Days	228	175	53	168	164	4	20	20	-	1,034	879	155
Average Return	4.90%	9.16%	-9.17%	25.41%	26.70%	-27.69%	28.93%	28.93%		15.33%	20.56%	-14.36%
% of Up Days vs. Down		76.8%	23.2%		97.6%	2.4%					85.0%	15.0%
Sept 1, 2000 to Oct 3, 2011 Trading Days	160	160	-	261	214	47	116	116	-	1,354	993	361
Average Return	8.32%	8.32%		19.29%	26.00%	-11.25%	30.33%	30.33%		7.70%	17.23%	-18.52%
% of Up Days vs. Down		100.0%	0.0%		82.0%	18.0%					73.3%	26.7%
Ttl Trading days	871	609	261	1,210	754	455	497	314	183	4,325	2,812	1,512
% of Up Days vs. Down		69.92%	29.97%		62.31%	37.60%		63.18%	36.82%		65.02%	34.96%
% of all Trading Days	3.81%	2.66%	1.14%	5.29%	3.30%	1.99%	2.17%	1.37%	0.80%	18.91%	12.29%	6.61%
Avg Bear Mkt Rtn	7.73%	17.38%	-14.76%	7.41%	30.27%	-30.46%	15.35%	40.63%	-28.05%	10.34%	23.66%	-14.42%

Source: Bloomberg L.P.; CI Investments

As of January 11, 2019

It is hard to tell the clients that they are wrong, but I believe that in December we were given a buying opportunity in a secular bull market. I acted on it by adding to my exposure to Sentry Canadian Income Fund and Sentry U.S. Growth and Income Fund. I also added several new lines: Signature High Income Fund, Cambridge Bond Fund and Black Creek International Equity Fund. I am not fully invested, I also have tactical cash that I can use if and when "Stocky" decides to retest the December lows. After all, it is very normal for "Stocky" to go sniff around where he "squatted" in his last panic. For a detailed discussion of how that works, please take a look at my earlier commentary "Anatomy of a Bear Market Bottom" from January 2009.

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