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July 25, 2017

WHAT YOU DON'T SEE AT MARKET BOTTOMS: EUPHORIA & WILD CLAIMS

Highlights

It is said that while bottoms are events, tops are processes. Translated, markets bottom out when panic sets in, and therefore they can be more easily identifiable. By contrast, market tops form when a series of conditions come together, but not necessarily all at the same time.

We have stated that while we don't believe the stock market has made its final cyclical top, we are in the late stages of a bull market (see *Four Steps, Where's the Stumble?*). Nevertheless, psychology is becoming a little frothy, which represents the pre-condition for a major top.

As a result, we are publishing a second report in an occasional series of "things you don't see at market bottoms", where we are seeing signs of euphoria from both retail and institutional investors, as well as wild claims by promoters and market participants.

- Retailphoria: TD-Ameritrade Investor Movement Index hits all-time high
- Retailphoria: E*Trade parties like it's 1999
- Surging Street bullishness
- Bob Shiller gets very, very bullish
- Wild claims: USA Today edition
- Wild claims: Chinese property stampede edition
- Wild claims: Chinese overseas financing edition

Interested readers can review the report in the first edition in this series, *What You Don't See At Market Bottoms*.

What You Don't See at Market Bottoms

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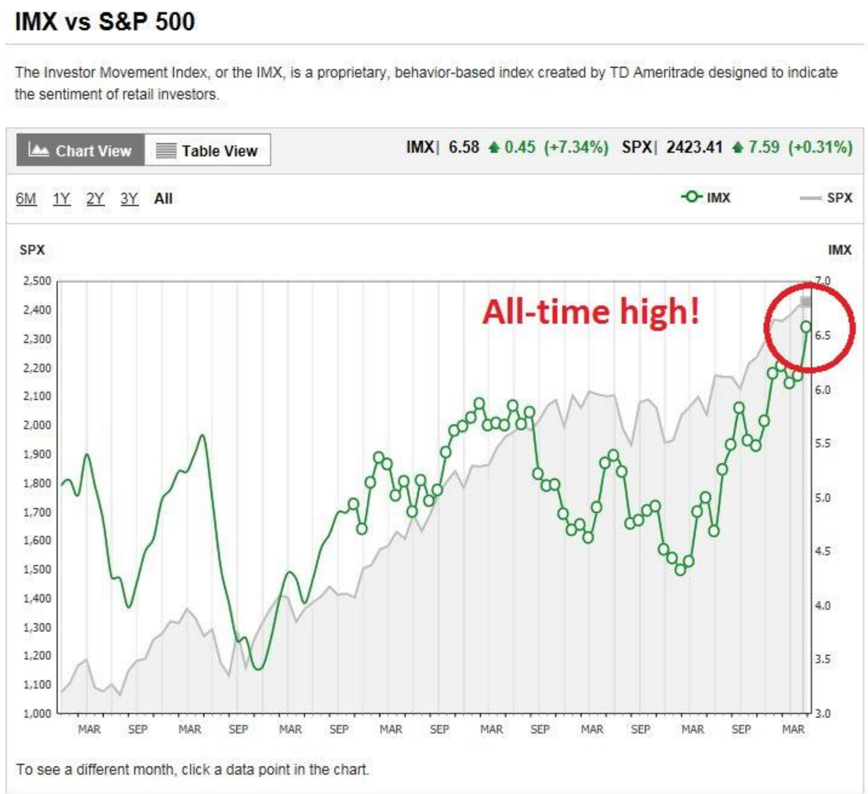
Retailphoria: TD-Ameritrade IMX Hits All-Time High

The TD-Ameritrade Investor Movement Index measures the sentiment of the firm's customers. The latest update shows IMX at an all-time high since its inception in 2011.

Exhibit 1: All-Time High for TD-Ameritrade IMX



Source: TD-Ameritrade

For additional colour on individual investor sentiment, TD-Ameritrade CEO Tim Hockey stated on its [Q2/17 earnings call] [emphasis added]:

> ***We are seeing this quarter very broad-based engagement in the market, so everyone from brand-new customers opening their first account to very active traders seem to be engaged in the market.*** *We saw a good activity across pretty much all of our products, futures were down a little bit year-over-year, because we had such a strong comparable. In terms of holdings, we are still seeing the trend where the ETF's are increasing a bit as a percentage of assets. We continue to see good holdings in mutual funds and really across all of the products that we typically see.*

E*Trade Parties Like It's 1999

We present the following ad from E*Trade without further comment, as it is reminiscent of E*Trade ads from the dot-com era.

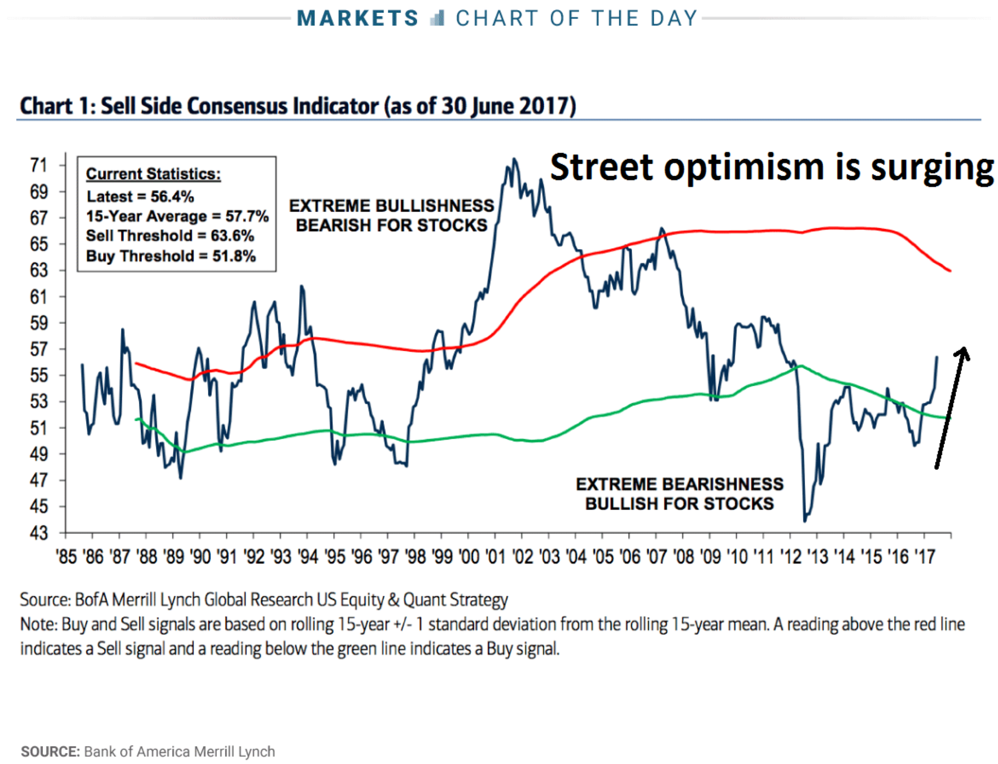
Exhibit 2: E*Trade Ad Reminiscent of Dot-Com Bubble Era

*Source: E*Trade*

Surging Street Bullishness

BAML has developed a Sell Side Indicator, which measures the equity asset allocation of Street strategists. This indicator has proven to be a good contrarian signal at extremes. As the chart below shows, Street bullishness is surging. BAML strategist Savita Subramanian wrote, "The recent inflection from skepticism to optimism could be the first step toward the market euphoria that we typically see at the end of bull markets and that has been glaringly absent so far in the cycle."

Exhibit 3: Signs of Surging Wall Street Bullishness



Source: Bank of America Merrill Lynch

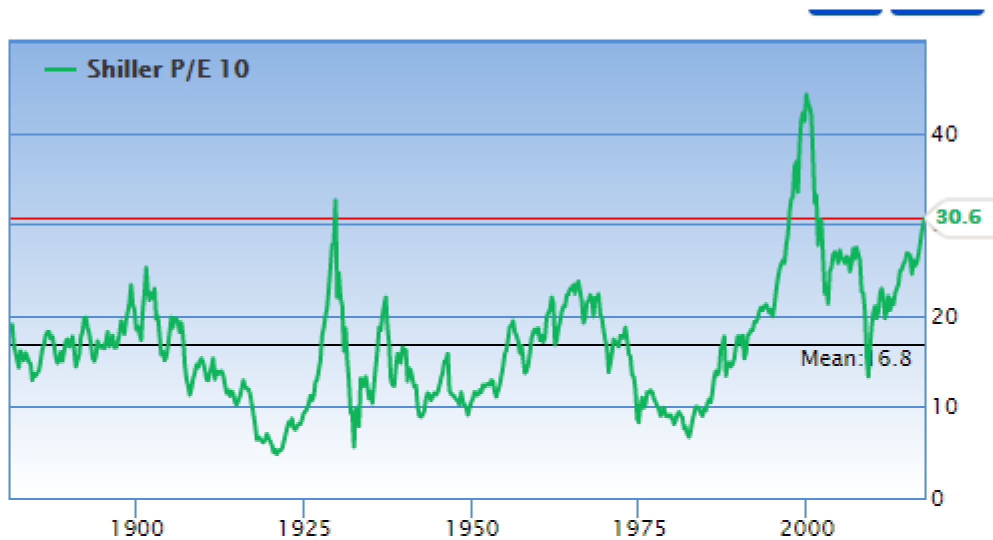
Shiller Gets Very, Very Bullish

Bob Shiller, who developed the CAPE valuation metric that shows stock markets to be richly priced, stated in a CNBC interview that upside potential is up to 50% from current levels. He did, however, qualify that remark:

> *Stocks are "highly priced now, which means I don't expect them to outperform so much," he said. "But for a long-term investor and most people are, I think there should be a place for stocks in the portfolio and they could go up a lot from where they are now … they could also go down."*

As a reminder, the Shiller PE10 shows that U.S. equity valuations are stretched when compared to its own history.

Exhibit 4: Shiller PE10



Source: Macro Man

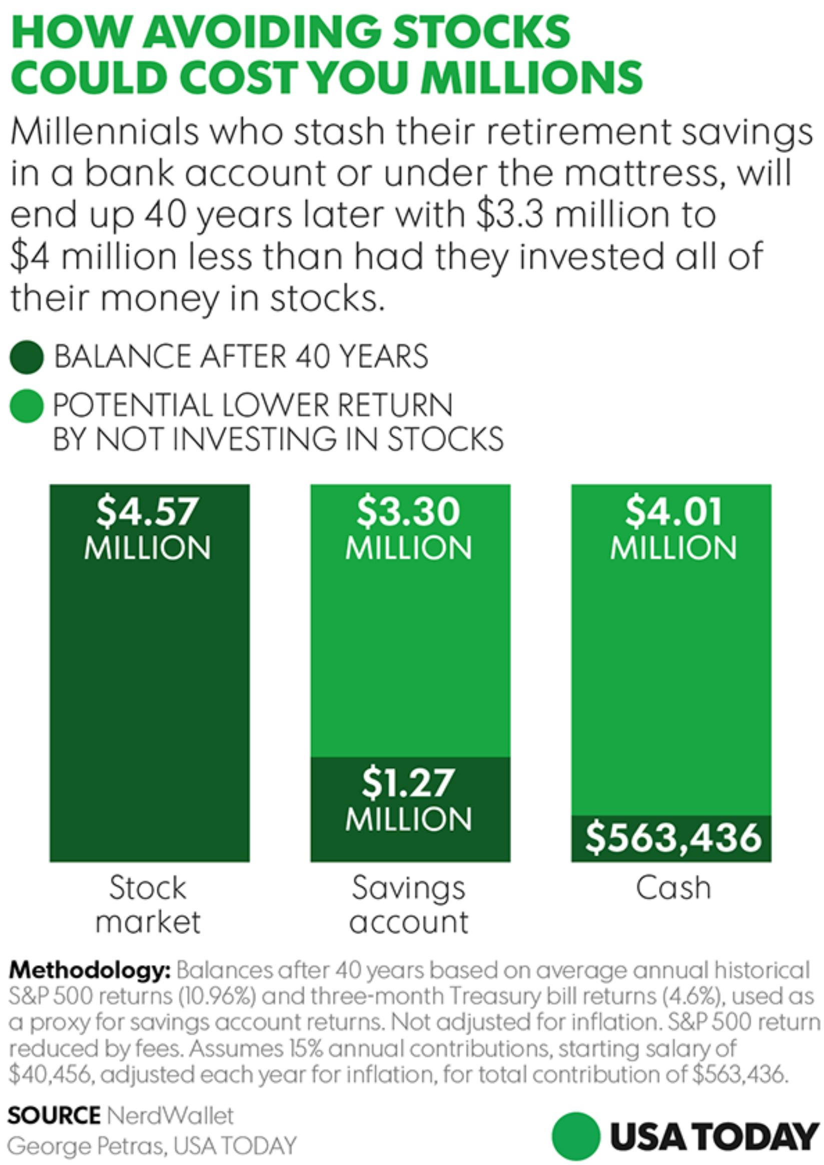
Wild Claims: USA Today Edition

It is said that one of the signs of a market top occurs when observers and scam artists start making wild claims about the future. In particular, when a major magazine features headlines on the topic of finance, such events can be taken as a contrarian indicator of a developing inflection point.

It was therefore with some surprise that we found USA Today breathlessly proclaimed that *Millennials' fear of stocks could cost them $3.3 million*.

Below is the graphic that accompanies the analysis.

Exhibit 5: USA Today Return Projections

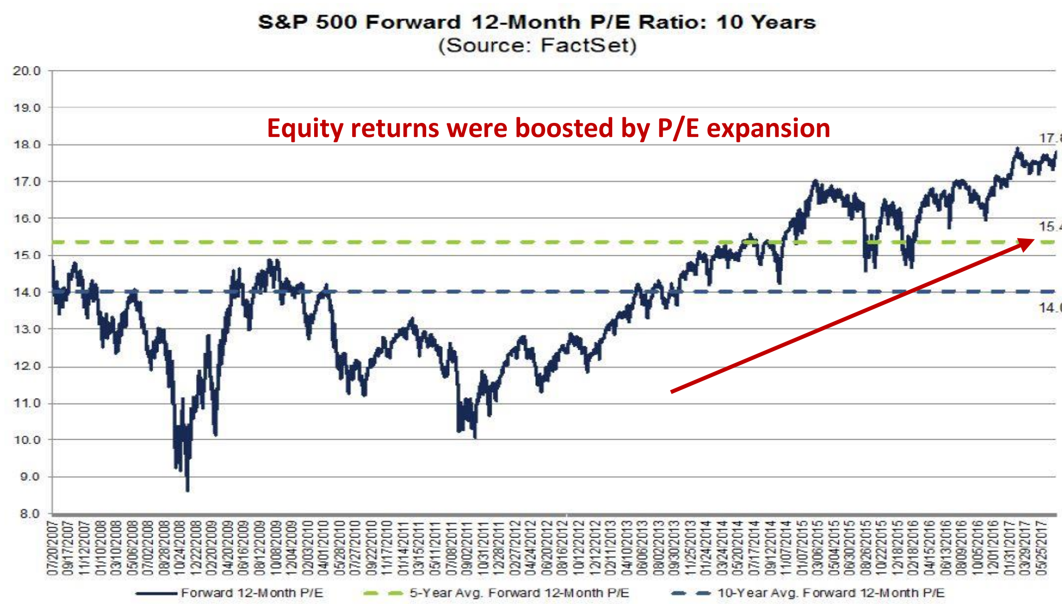


Source: NerdWallet, USA Today

When we read the fine print, the USA Today return projections are laughable. They are based on the historical returns of 4.6% on 3-month T-Bills and 10.96% returns on equities.

Someone please tell us where we can find a 4.6% return on a T-Bill today. Then explain the market implications of such an environment. It would take a highly aggressive Fed for the T-Bill yield to reach 4.6%. Moreover, the following FactSet chart of forward P/E ratios shows that current forward P/E levels are highly elevated compared to its own history. In effect, some of the past returns for the equity asset class can be attributable to multiple expansion. Can we realistically expect a similar level of P/E expansion in the future? If so, what does that mean for interest rates (and is that consistent with a 4.6% T-Bill yield assumption)?

Exhibit 6: Forward P/E



Source: FactSet

To realistically achieve a return of 11.0% on equities, the market would need to see a price downdraft of 50–70%. To reach a 4.6% T-Bill yield, interest rates would have to rise dramatically from today's levels.

Wild Claims: Chinese Property Stampede Edition

Another sign of wild claims about the future can be seen in Canadian property markets. Toronto and Vancouver residents are familiar with the overheated property market in their cities, which is attributable to a combination of overseas demand from the Mainland Chinese, low interest rates and speculative fever by local residents in a FOMO (Fear Of Missing Out) buying stamped. The Chinese property portal Juwai, in support of its Chinese offshore property business, recently projected that Chinese investors will spend US$1 trillion on offshore real investment in the next 10 years:

> *Toronto and Montreal have surpassed Vancouver as the Canadian cities that Chinese homebuyers are most interested in, according to data from Juwai, China's largest real estate portal.*
>
> *The company predicts that Chinese investors will pour some $1 trillion (C$1.27 trillion) into real estate around the world over the next decade, of which a considerable amount is likely to land in Canada. The country is the fourth-largest destination for Chinese real estate investment, behind the U.S., Australia and Hong Kong.*

Exhibit 7: Chinese Outbound Investment Flows

Source: Juwai

While it is easy to project trends in a straight line, experienced investors also know that trends have a mean reversion characteristic as well. Christine Duhaime, a Canadian lawyer who specializes in money laundering issues, recently estimated that about $2 trillion in corruption proceeds had been spirited offshore from China, most of which went into property investments (click link for details).

For some perspective on valuation, the following chart shows the price to rent ratio for Canada compared to Australia, the U.K. and U.S.

Exhibit 8: Price to Rent, Selected Countries

Source: The Economist

Are we seeing the start of a trend of outbound Chinese fund flows, or will they mean revert in the future? Maybe we are showing our age, but does this feel like past episodes of fin de siècle hubris, such as:

- Robert Campeau's foray into American retailing, with his purchase of Bloomingdale's and Federated Department Stores using junk bond financing during the mid-1980s
- Japanese investors buying up American trophy properties, such as Pebble Beach, in the late 1980s
- Jean-Marie Messier, the CEO of Vivendi, making wild takeovers for the media assets of Seagram's, MP3.com, Houghton Mifflin and USA Networks before and after the peak of the Tech Bubble. The episode culminated with Messier using corporate funds to buy a $17.5-million apartment for his personal use in New York City. We know what happened to the TMT sector afterwards.

Move right along, there's nothing to see here.

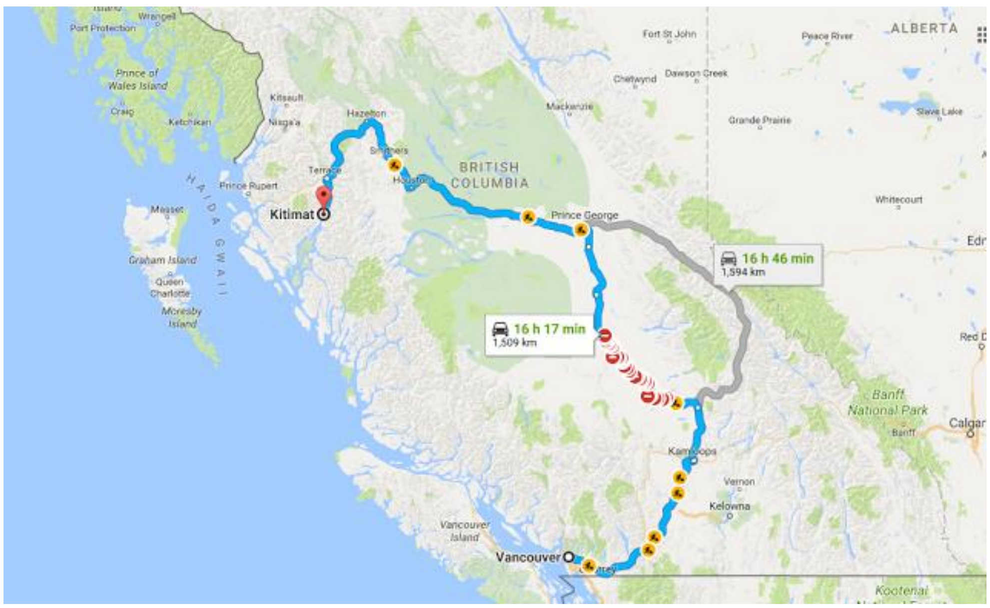
Wild Claims: Chinese Overseas Financing Edition

Speaking of wild claims and gold rushes, it was with some amusement that we found a warning from the B.C. Securities Commission about a "Vancouver Stock Exchange Corp.":

> *The British Columbia Securities Commission (BCSC) has become aware that a British Columbia (B.C.) company called Vancouver Stock Exchange Corp. (VSEC) appears to have been issuing stock exchange listings to companies in China and B.C. VSEC claims to operate from Kitimat, B.C., with an enquiry centre in Shenzhen, China.*
>
> *VSEC holds itself out as being the old Vancouver Stock Exchange (VSE). In fact, the VSE no longer exists, as it merged with another stock exchange in 1999. VSEC claims that, in June of 2016, the old Vancouver Stock Exchange was reinstated as an independent exchange.*

For readers who are unfamiliar with the geography of British Columbia, we include a map showing the location of Kitimat.

Exhibit 9: Kitimat and Vancouver



Source: Google Maps

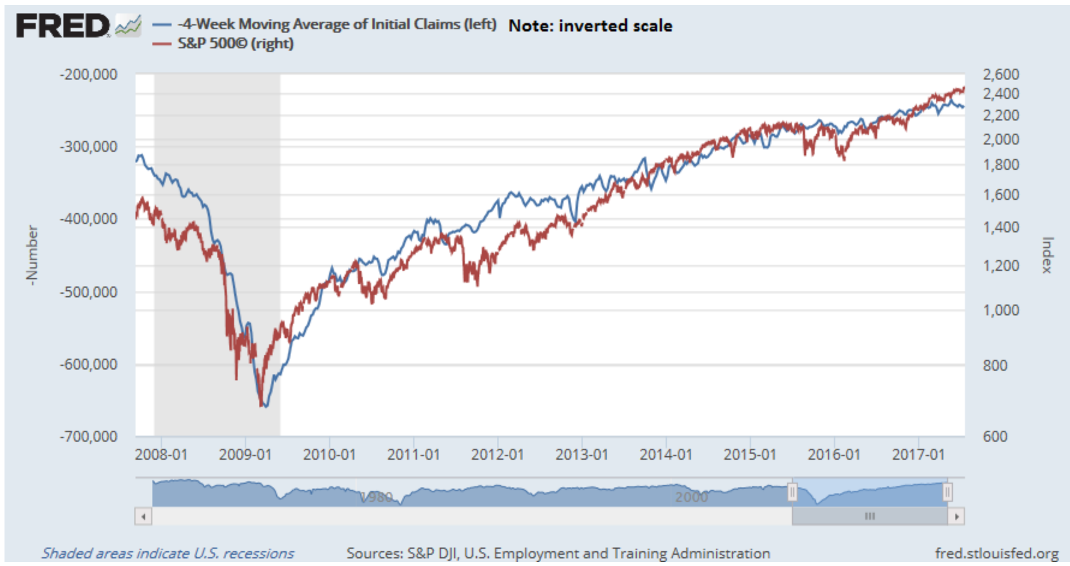
If Chinese businesses are gullible enough to seek capital from a "Vancouver Stock Exchange Corp.", what does that tell us about their degree of due diligence on overseas property purchases?

This Will Not End Well, But…

For now, we believe the frothy excess that we have cited in this and past reports represent a "this will not end well" narrative. But sentiment doesn't function well as precise market timing tools. For now, the nowcast of short-term indicators remain bullish.

The following chart shows the 4-week average of initial jobless claims and the S&P 500. The two data series has shown a remarkable inverse correlation during this expansion cycle.

Exhibit 10: Initial Jobless Claims and S&P 500



Source: FRED, Federal Reserve Bank of St. Louis

We reiterate our belief that this is not the top of the equity market (see our recent report, *Four Steps, Where's the Stumble?*). Nevertheless, investors should be aware of the risks of an environment in which sentiment has become increasingly frothy without regard of the risks involved.

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