ACCESS | WEALTH MANAGEMENT

October 17, 2017

Signs are emerging that we could be entering the latter stages of this economic cycle, so what should investors do?

Key Points

- There is no shortage of things to worry about, but the market's Teflon coating has prevented anything from sticking.
- U.S. stocks continue to grind higher, with little appearing able to knock them off course. The possibility of a pullback always exists but a melt up is also reemerging as a real possibility.
- Earnings tend to drive equity market direction, and the next few weeks should help set the tone for market action for the rest of the year. Expectations came down a bit as we entered reporting season and recent robust economic data gives support to the potential for companies to meet and/or beat estimates.
- Global economic growth continues to improve, which should help support both domestic and global stock markets.
- Attitudinal sentiment measures are mixed, but behavioral measures show elevated optimism.

U.S. stock indices have continued to push to record highs, with little apparently able to throw them off course. The grind higher has pushed through multiple natural disasters, the Las Vegas tragedy, domestic political failures, international political tensions, and North Korea firing missiles over other countries — an ample "wall of worry" for stocks to climb. We're likely entering or already in the latter innings of this long-running bull market and economic expansion, but as baseball fans know there's still a lot of game left after the middle innings—including the possibility of extra innings. Although there is little of the excess that would suggest recession risk is near, we do see signs that the characteristics of the economy and market may be changing. Bond yields have crept higher, international markets have performed better, and cyclical sectors such as energy and materials have outperformed—all potential signs of the latter stages of a cycle. We've seen brief periods when these shifts have occurred before, but the strength and length of the recent moves gives us reason to believe a change in character is afoot.

So what should investors do if we are entering the latter innings? At this point, we suggest making sure strategic allocations are appropriate for risk profiles as well as long-term goals, and to make adjustments as needed via tactical rebalancing. There remains the possibility of a pullback, with any number of catalysts possible. Attitudinal measures of investor sentiment are currently showing excess optimism, which is typically a contrarian indicator. This has been a characteristic of most of 2017, but of course we have yet to see a significant pullback.

A melt-up is also reemerging as a possibility should investors' actions start to follow the attitudinal sentiment indicators. Remember though—as good as a melt-up might feel while underway, they have historically not ended well.

Are We Comfortably Numb? An Update on Investor Sentiment

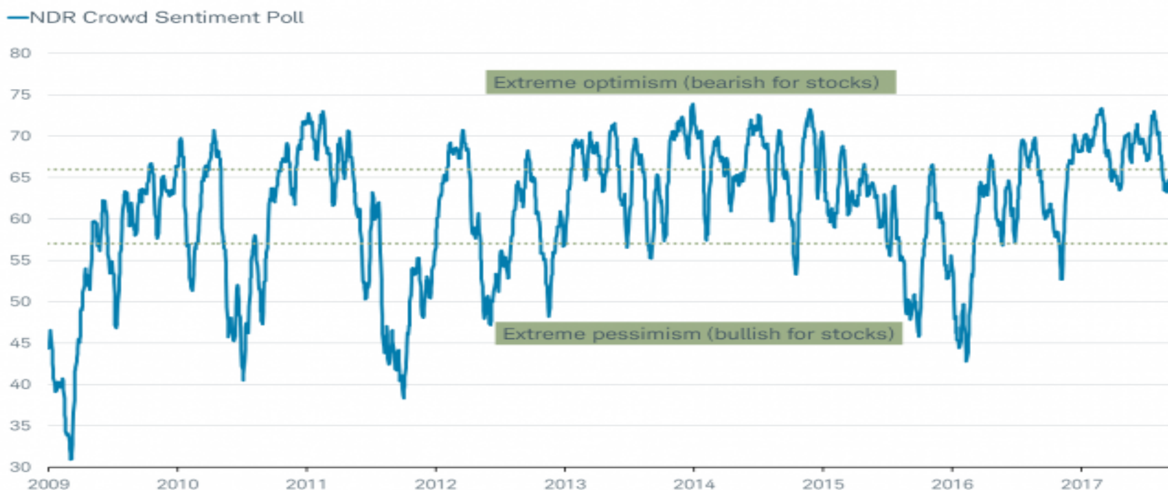
The war of words between President Trump and North Korea's Kim Jong Un has heated up; culture wars are raging; healthcare reform looks unlikely (again); Harvey, Irma, Jose and Maria have been uninvited and unwelcome visitors; there remains toxic partisan conflict in DC; and the Fed has taken a giant step toward monetary policy normalization.

The stock market's reaction: What, me worry? There's no shortage of things about which to worry, but the stock market's Teflon coating has so far prevented any of the aforementioned uncertainties from sticking. Specific to the hurricanes, the S&P 500 has performed significantly better in the three weeks since Harvey hit than it did following Hurricanes Katrina and Sandy.

It's time again for an update on investor sentiment, and the latest update of surveys and indices takes into consideration the stock market's new highs; albeit highs which have come via small percentage gains and tight trading ranges. It should not come as a surprise that sentiment has become more optimistic; but the nuances are important.

Attitudes

Let's start with the Crowd Sentiment Poll (CSP) from Ned Davis Research, which is an amalgamation of a number of individual sentiment indices. As you can see in the chart below, sentiment has rebounded further into "extreme optimism" territory; a zone in which stocks have experienced their lowest returns historically (see table).



S&P 500 Index performance (12/1/1995-9/19/2017)		
NDR Crowd Sentiment Poll	**% gain/ annum**	**% of time**
Above 66	-4.81	23.41
57-66 from above	4.66	18.11
57-66 from below	21.08	19.15
Below 57	10.16	38.83

Source: Ned Davis Research (NDR), Inc. (Further distribution prohibited without prior permission. Copyright 2017 (c) Ned Davis Research, Inc. All rights reserved.), as of September 19, 2017.

Behaviors

Separate from attitudinal measures of sentiment, we can look at those that measure the actual behavior of various cohorts of investors. One pair which Liz Ann Sonders, Chief Investment Strategist at Charles Schwab, tracks on a daily basis—and one that's typically included in reports like these because of its popularity—are the "Smart Money" and "Dumb Money" Confidence indices put together by SentimenTrader (ST).

The indices are a unique innovation that allows ST's subscribers to see, in one quick glance, what the "good" market timers are doing with their money compared to what "bad" market timers are doing. Generally, investors should follow the "Smart Money" traders when they reach an extreme and do the opposite of what the "Dumb Money" is doing when they are at an extreme.

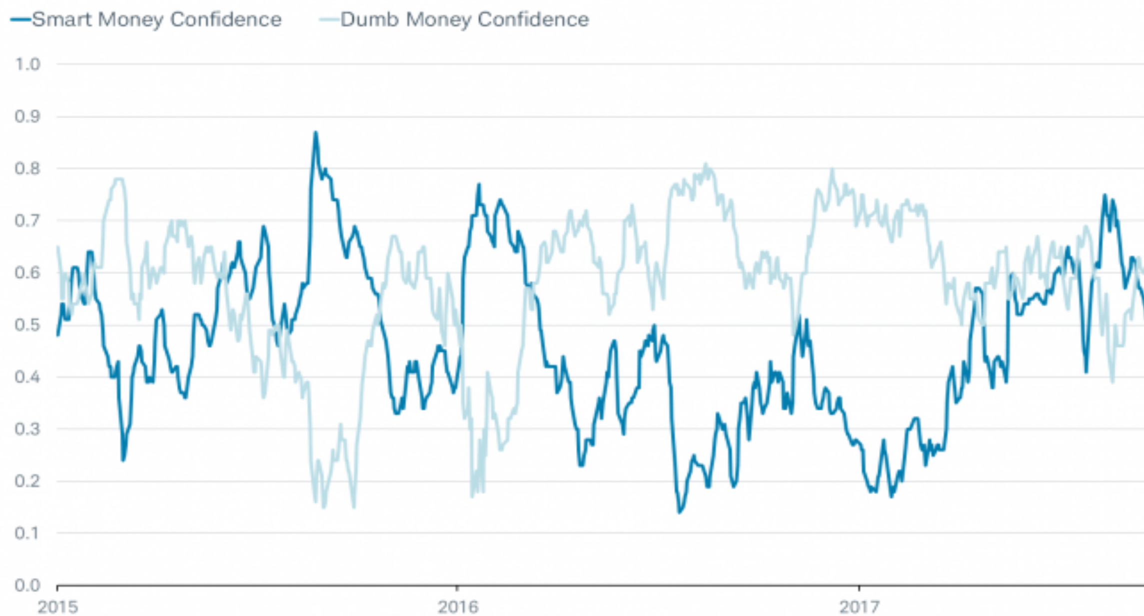
Examples of some Smart Money indicators:

- OEX put/call and open interest ratios
- Commercial hedger positions in equity index futures
- Current relationship between stocks and bonds

Examples of some Dumb Money indicators

- Equity-only put/call ratio
- Flow into and out of (bullish/bearish) Rydex series of index mutual funds
- Small speculators in equity index futures

As you can see in the chart below, the latest move by the ST cohorts has meant they've crossed as they're moving in opposite directions. The "Smart Money" has been getting more pessimistic, while the "Dumb Money" has been chasing stocks higher and higher and has become more optimistic.



Source: SentimenTrader, as of September 22, 2017.

The closest thing to a "free lunch"

As we all know, there are very few free lunches in investing or in life. Asset allocation, diversification and periodic rebalancing are as close as you get. One of the most important areas where we offer advice is the development of a long-term strategic asset allocation plan, which can help you create an appropriately diversified portfolio.

Rebalancing—that is, maintaining your target asset allocation by adding to underperforming asset classes and trimming outperforming ones—goes against the emotions of fear and greed that often drive investment decision making. It may be challenging to sell investments that have done well and add to holdings that haven't performed as well, but developing and maintaining the right long-term asset mix is by far the most important set of decisions an investor will ever make. Rebalancing forces us to do what we know we're supposed to do, which is "buy low, sell high."

That line – "buy low, sell high" seems so obvious, but in real life we see investors really struggle to implement that simple common-sense strategy. What we see is investors wanting to get more heavily invested in stocks when the market is rocking and rolling and wanting to get out of stocks when the market is tanking. So, buying stocks at high prices and getting out of stocks at low prices? Of course, that doesn't make sense on either end. Some of this can be attributed to what they call today "FOMO" – or the "fear of missing out". But that's not the fear you need to be focused on. The fear you need to be focused on is the fear of not being able to accomplish your life goals. If you are in a position to successfully achieve the goals you want for you and your family, that's all that matters. Put the focus on that.

Patience and stick-to-it-iveness

A market that could be in or entering the latter innings can provide both opportunities and risk and investors should stay vigilant. Earnings season should propel stocks to further gains but signs of inflation and the potential of a melt-up pose some risks. Most analyst outlooks are bolstered by better global growth, which could keep the game going for a while longer.

Admittedly, the development of a long-term strategic asset allocation plan isn't the hard part—it's sticking to it that often becomes the real challenge. That can be especially difficult when markets are volatile and uncertainty is high. But if we learn from our mistakes, use our brains over our hearts and look to our portfolios as rebalancing guides, we can expect a more successful investing future and maybe even get a free lunch along the way. We will continue to work hard to make sure that you are in a position to successfully achieve your goals – while tightly managing the risk you have to take to do so.

Respectfully,

Tony Christensen

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