Remember when trends were all about tie widths and skirt lengths. Now the zigging and zagging of just about everything is tracked. Though, trend-following dates back to the dawn of time—even during biblical times—recall the 7 fat years followed by the 7 lean years.

A trend is a tendency for general movement in one direction. Sometimes, as the saying goes, “The trend is your friend.” This is the order of the day for the stock market. With the U.S. bull market now in its 96th month without a correction exceeding 20%, it’s the second longest bull market in history.

Though, Mark Dodson, of Hays Advisory, recently commented that, currently, the trend is your friend but your only friend. That’s because undervaluation, monetary stimulus and negative market psychology are all lacking. These essential elements normally combine to sustain a bull market.

That said, markets can maintain an upward bias for some time, especially if interest rates are low (i.e., opportunity costs of investing elsewhere are low). And, with the continued backdrop of anemic global economic growth (still at a lower pace of real GDP growth than most periods), there continues to be no evidence of a near-term global recession, anathema for stock markets.

Our own Economic Composite (TEC™), designed to alert us to recessions in various regions around the world, is not forecasting a peak in the business cycle. Though U.S. equities have lifted to all-time highs, and are trading just above fair value in our work, bear markets rarely occur without a recession. And, typically, a market peak is accompanied by euphoric sentiment which still isn’t apparent. Contrary to conventional wisdom, markets don’t die of old age but from full or overvaluation as a result of overexuberance at a time when the economic growth is about to be choked off.

Our TRIM™ stock market indicators, which warned in early ’16 (we didn’t weight it too heavily in the absence of the typical overlapping TEC™ alerts), are back on buy in most regions. But, after the recent market run-up, and since the market is currently substantially overbought, we wouldn’t be surprised to see a market correction—averaging about 6% in a bull market.

Meanwhile, we continue to scour for bargains, though our own research, where our search for stocks trading for 85 cents-on-the-dollar or less, is providing the least number of potential investment opportunities in some time. Another reason a correction could be close is that stocks tend to inflect down from TRAC™ ceilings/FMVs (fair market values) once achieved, when they run out of short-term potential, as they appear to have now.
While a stock market correction could occur at any time, we still believe any decline in the near term will likely be modest and that growth and equity prices should continue higher, although likely at a below-average pace.

**Trend Reversal**

After years of low and falling interest rates, rates in most jurisdictions have been moving higher. U.S. 10-year Treasuries, after bottoming at 1.3% last July, now yield 2.4%. Foreigners, specifically China and Japan, have been net sellers of U.S. bonds in the last several months after years of buying. The recent bearish extreme in the bond market—because rates may have moved too far too fast and too many are betting on higher rates—might mean that rates could fall back somewhat again but if so, it would likely only be temporary. Foreign selling, Fed selling (and lack of ongoing buying as QE has wound down), higher inflation and accelerating economic growth should all conspire to lift interest rates.

Interest rate levels around the world still remain lower than in the U.S. 10-year rates in the U.K., Germany and Japan are 1.2%, 0.3% and 0.1% respectively, so rates in the U.S. shouldn’t skyrocket, especially since the U.S. dollar continues to somewhat defy gravity. It’s higher than its purchasing power parity (its FMV) and is putting pressure on corporate earnings and overall competitiveness. But, because rates are so relatively high in the U.S., that should offer continued support for the high U.S. dollar.

As long as rates don’t move too high, it should not affect the stock market. In fact, a slow, steady increase in rates may continue to benefit stocks as a migration away from bonds and toward stocks continues. Not to mention, most of the factors conspiring to lift rates also favour boosting stock prices. The latest data points showed an advance in global industrial production, along with a pickup in global trade, both recovering to a 2.7% pace, an acceleration in economic growth. For now, data like this should extend the bull market since it bolsters corporate earnings. Only when growth is too fast and inflation too high will the central bankers act to quell growth. Inflation has been muted but the latest release did show U.S. inflation at a 2.4% rate (the highest in 5 years), and the Global Inflation Surprise Index has surged in recent months. While moderate rising inflation is harmful for bond investors it’s a boon for stocks. With an earnings yield of 6%, even with 10-year Treasuries up to 2.4%, stocks are relatively more attractive than bonds, but if rates rise well above 3%, without a meaningful boost in corporate earnings, the relative attractiveness of stocks would dissipate.

**Uptrends and Downtrends**

In the U.S., leading indicators still show good growth ahead and unemployment continues to decline, now at 4.6%, and wages have been stable. This, and with promises of stimulus from large tax cuts and infrastructure spending, should maintain the U.S. growth outlook. Corporate income tax rates for Germany, Japan, the U.K. and Canada averaged 36% 10 years ago and now sit at 27% (Canada matches the average). U.S. corporate taxes have remained at 39% throughout. A Trump-levied lower rate should assist the competitiveness of U.S. corporations while boosting profits. Though, longer term, as the stimulus bolsters growth, it will likely raise inflation and contribute to rising deficits.

Negatively, debt levels, at all branches of governments, in most jurisdictions are at levels of serious
concern, and now for corporations and consumers too (auto loan delinquencies at the highest levels since '09). While the high debt levels themselves won’t necessarily tip the economy over, they can heavily impact the severity of the next recession. And, rising interest rates will increase debt burdens adding fuel to the potential fire.

Geopolitical issues may also be cause for concern. Whether it’s Russia asserting its power while it appears to have a friendly U.S. head of state; South China Sea tensions as the U.S. takes a hard line against a determined China; or Euro pressures from Brexit, or an outright Euro breakdown if we have Frexit too with Marine le Pen and her National Front Party leading in the polls for the April 23 election.

As money mangers we are constantly evaluating issues that might negatively impact our current or prospective holdings. Competitive threats, changing demographics, cost pressures or excessive leverage among other issues all need to be analyzed. And, as long/short managers (where authorized to include short sales from time to time), we need to look at the same issues to ferret out companies which are vulnerable to these issues. Whereas in the dot-com bubble shorting stocks felt easy, especially in retrospect as plenty of stocks were way overvalued, shorting, normally, is much more difficult. Especially since a rising tide tends to lift all boats. Because of this, our strategy has been to avoid most single name shorts for the last couple of years. But if we can find businesses that are susceptible to negative trends—think newspapers or shopping malls—or that are fads, and where the business is overleveraged and overvalued, we could hedge our portfolios with shorts. We are always on the lookout for these types of opportunities.

Trendy

What’s trendy today? Apps, Internet of Things, Big Data, 3D printing, FinTech, Sensors, Right wing policies (or perhaps just the politicians—the scariest trend over the last few years has been toward government leaders who resemble fictional villains—think the Riddler or the Joker—look no further than Russia, Iraq, North Korea, and, unfortunately, now the U.S. too, hopefully to a much lesser degree). Things that are currently in vogue tend not to endure. That’s why we gravitate to unpopular stocks, especially those that are ignored or misunderstood and therefore mispriced.

As value investors we are constantly looking for investment opportunities in undervalued companies but we also seek those whose share price may have positive momentum—an uptrend. The best time to buy occurs when the momentum is about to turn back up or accelerate ahead. We apply common sense and TRACTM in an attempt to optimize the timing of our purchases. And while it’s harder than most times now to find stocks to purchase that meet our criteria, that’s our raison d’être, and we’ll continue to work hard, turning over rocks and completing fundamental analysis in pursuing those opportunities.

Today, trends seem to come and go in a flash. Isn’t “fake news” so last month? The stock market, on the other hand, has exhibited less volatility with the volatility index at the lowest level in years. The overall market isn’t ebbing and flowing like it does normally. The S&P 500 has now gone over 90 trading days without a 1% decline and 50 days without a 1% move in either direction. While this lack of movement in and of itself doesn’t necessarily portend a market correction, we shouldn’t be lulled into complacency either. Times ahead will likely be much more volatile. And
strangely, while volatility has been low, uncertainty, likely created by weak growth and Trump’s policies, is at a major high. Something to watch.

Secular Trends

The biggest investing trend today is the acceleration toward passive (index) investing. We continue to believe this should be a boon to us stock pickers. It certainly doesn’t make sense that this trend is hastening at a time when the markets are fully valued, offering the lowest prospect of long-term returns in years—the Value Line appreciation potential index, which has been remarkably accurate over the years, forecasting a 5-year return of about 5% per year. Clearly there’s a powerful force that guides trend following. Whether it’s with skinny jeans, narrow lapels or index investing. We stock pickers appear to be headed for the endangered species list. But, in the years ahead, when we expect slim long-term equity index results, it wouldn’t surprise us to see stock picking become trendy again.

When It Breaks

Economist Herb Stein quipped, “Trends that can’t continue, won’t.” So we watch for the inevitable end to the bull market—for the next recession, using our economic composite and for the market panic that normally follows, using our market momentum indicator. Meanwhile, both remain positive and appear far from alerting us to bear markets in most regions around the world. We also closely monitor our TRACTM signals for the overall markets, for a negative inflection from a ceiling and to embrace the trend in place. Currently, the U.S. market is at a ceiling and a bit overvalued, based on our TVMTM work.

Next month the S&P 500 will make history for the longest (from the ’09 low) bull market—without a correction in excess of 20%. However, this is nuanced because it fell 22% on an intra-day basis in a 6-month period ending in October ’11, but only 19% on a closing basis. And there was clearly a bear market in broader U.S. indexes. For example, the Russell 2000 fell 27%, in the decline which ended early last year and, while the S&P 500 fell 15%, the median stock fell 25%.

We have not been finding nearly the same number of investment opportunities as usual. While we prefer to be fully invested, perhaps the markets are indicating there may be a better opportunity ahead to become fully invested. Given the full valuations of the equity indexes and current overbought levels, we remain comfortable being underinvested in our growth accounts in equities. Believing, as we do, that we are in a prolonged economic cycle, we welcome any correction to provide us the investment opportunities to be more fully invested.

Meanwhile, if some of the recent positive trends reverse, and our tools alert us, we won’t be shy about attempting to diminish and, where we are authorized, hedge off risks.

The term “trend” now has a broader use. Trending is a term used in reference to the buildup of posts on social media. And we find ourselves in a day and age when the leader of the free world is posting using stream of consciousness—annoyingly against a department store that no longer supports his daughter’s line of clothing or worse, tweeting against judges who disagree with his policies. This is a trend we shouldn’t miss.
And there are plenty of past trends we don’t miss. Like mohawks, avocado green appliances or shag carpet. The complete saying we noted above is, “The trend is your friend until the end when it breaks.” We will miss the upward trending market once the current trend breaks so we’ll try our best to choose our friends carefully.

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