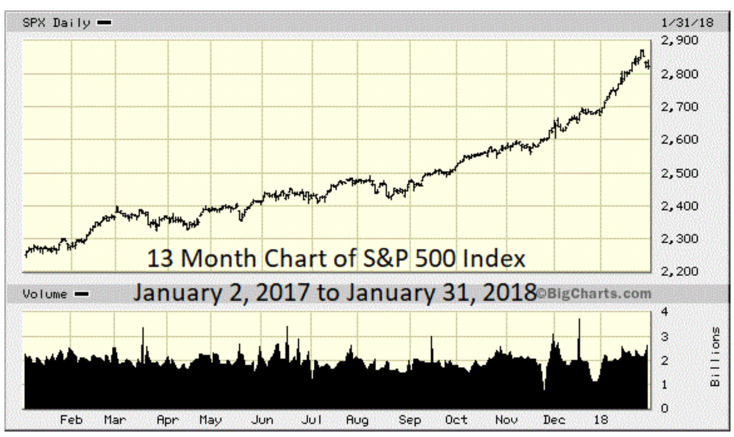
Melt-up Market Risks

As recently as six months ago, investors' attitudes were best described by one word: **ANXIETY!** Yet, in hindsight, it was a perfect world. The economy was exhibiting encouraging improvement and, while similar encouragement had flickered on-and-off over the prior eight years only to evaporate, in mid-2017, economic vitality began to appear sustainable. The new administration was still in its infancy but business was already seeing an initial easing of regulatory burdens. Earnings revisions had begun to tilt much higher—adding justification to stock prices. The stock market was in a Goldilocks mode, stocks were slightly over-valued based on some metrics but ever higher prices, were fully justified based on many other metrics. Best of all for investors, stocks doggedly sustained the long ascent that began back in March 2009. Investors were delighted with the approximate 8% gain stocks logged in the first half of 2017, as well as the +15% advance logged over the prior twelve months.



Looking back from the vantage point of one month into 2018 makes it difficult to understand last year's concerns. The economy is now in cruise control and accelerating into the fast lane. Business and consumer confidence levels are touching ten-year highs and spending plans continue to ramp higher. And, the powerful U.S. economy is getting an extra boost from synchronized growth from every major economy around the globe. We won't go so far to say that the current administration is functioning smoothly but the business-friendly environment, decreased regulations and the new tax code are all major positives for the economy. ***Then…there is the stock market!!!***

The steady gains of the first half of 2017 accelerated into the final months of the year and the market performed well beyond the most optimistic expectations. The fourth quarter alone saw a 10% increase in the Dow and the year ended with a gain of 25% for the Dow and 19% in the S&P 500. As great as 2017 was for investors, the New Year seems determined to make 2017 look meager as the bull market has become a RAGING BULL MARKET—the Dow soared 5.8% and the S&P rose 5.6% in January!

Indeed, the market has become the story. Stocks are in a ***"melt-up"*** that is both euphoric and terrifying. We have discussed in recent ***Market Comments*** (and many conversations with clients) why this great bull market has been justified—and why the outlook continues positive. We have enjoyed the ride and hope to continue to benefit—but the reality is that ***animal spirits are now in control***. Anyone with a history of investing remembers similar periods in the not too distant past when market euphoria and skyrocketing prices lead to devastating declines. Yes, it can happen again—and the more the gains accelerate and the higher prices go, the greater the potential risk of a dramatic decline. It is time for a gut check for all investors. They must determine if they are being inspired by fear, greed or—hopefully—a rational investment strategy.

With such thoughts top of mind over recent weeks, we were captivated by a chart from **First Trust** showing the extent and duration of bull and bear markets since 1926. To get the full impact, you need to click here to view the chart. To summarize, there have been eight bear markets since 1926; the worst (1929) dropped 83.4% and lasted for 2.8 years; the mildest decline was -21.8% (1946); the shortest duration was the "crash" of 1987 which lasted just three months; the most recent two, 1999/2000 and 2007/2008 were number two and three in severity after 1929, with declines of 45% and 51% over 2.1 and 1.3 years. The average decline of the eight bear markets was just over 40%. ***Those numbers are scary*** –especially to anyone who has been burned before (plus, it goes against our growing preference for a risk-free environment) but the chart also—importantly—highlights that the bear phase is **much less than half of the story**. The duration and strength of the **bull markets** make the bear markets look puny. The four best bull markets lasted approximately 13 years to 15 years and each generated gains over 800%. The current bull market is fifth best, after those four, currently 8.9 years old with a gain of 390% (adding January's gains onto the chart which ends 2017).

When worrying about the current bull market, two aspects of this chart standout. One is the varying length and gains of prior bull markets illustrate there is no dependable historical trend to base an investment strategy upon. Second—and somewhat contradicting the first point—history shows the current bull market is not excessive relative to past runs. The current age of 8.9 years is right in the middle of the four longer and four shorter bull markets and the bull could last about four more years before it would tie the two bull markets which lasted 12.8 and 12.9 years. The current gai n of this bull market, at 390%, is also fourth best and this market must gain another 425% before it ties the third and fourth best bull market gains of approximately 815%.

With all those heady statistics, we should add some caveats. We looked at above n umbers from the ***optimistic*** viewpoint. Since this bull market is squarely in the middle of previous statistics, we could have painted a pessimistic picture as well. Second, the ***"past performance does not imply future results"*** disclaimer is, as always, appropriate. We must emphasize the concept mentioned above—the driver of our investment strategies—that is that we base investment decisions on sound investment policy, not fear, greed, of simple rules of thumb.

Considering the long history of previous bull markets—and adding the extremely strong and encouraging economic environment of today, and the bull/bear market chart does help provide confidence. We will continue to try to relax and enjoy this great bull market—even while we continue our ever-increasing watch for excessive risk.

Best regards,

Ted Ingraham

EGI Financial, Inc.
American Heritage Securities, Inc.

Questions or comments?
Email us at: ahs@egifinancial.com or call 330-535-0881. Visit us at www.EGIFinancial.com