Where we Stand

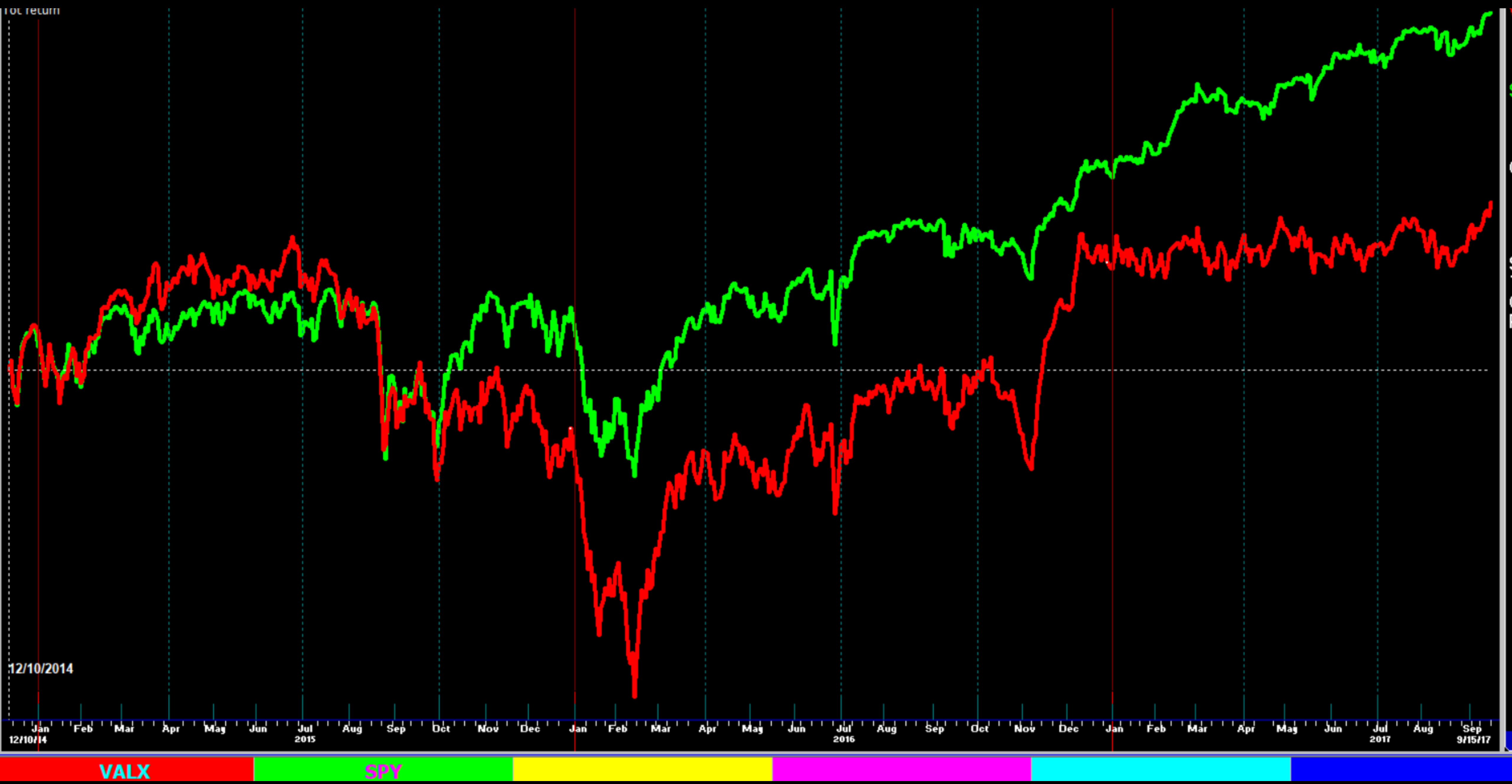
Don Gimpel – October 2017

Before we start today’s presentation …

- I feel keenly that your AAII Chapter leaders have an implied responsibility in its presentations because many of our attendees believe any selected speaker has something of value to say. That is not always the case.

- At the last Skirball lectures, the head of ValIdea.com made a presentation where he offered to emulate the strategies of noted investors such as Warren Buffet and others. He claimed to have abstracted the essence of the strategies that made them so successful … assuming that those strategies have been fully disclosed.

- You can invest with him via an ETF incorporating all those winning ideas and this is what you will get …



Tot return
12/10/2014
Jan
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec
12/10/14
2015
2016
2017
9/15/17
VALX
SPY

What this lecture is all about …

- I have only two topics in choosing the matter for this lecture series.
- The first is that the material is really useful in making the audience better investors.
- The second criteria is that I know something about the topic.

- This lecture is about using macroeconomics to answer important questions about the market such as “Shall I sell everything and get out of the market right now?”
- To make the points that I want to make, there will be some duplication with some previous lectures. The duplication is essential to the question/answer theme of this lecture. Please bear with me.

The handout …

- A handout accompanies the lecture and is essential to its understanding. Its title is “8. Market indicators.” It is a set of selected Stock and Bond Market indicators that have significant impact on the market.
- The table lists the topic, importance, evaluation and link.
- Much of the evaluation is based upon the now unavailable BullandBearWise.com internet site now unavailable.
- This handout will also be available at AAIILosAngeles.org on “Don’s Page.”

- Those macroeconomic indicators with strong impact on the stock or bond market are shown in shaded rows with emphasized type.

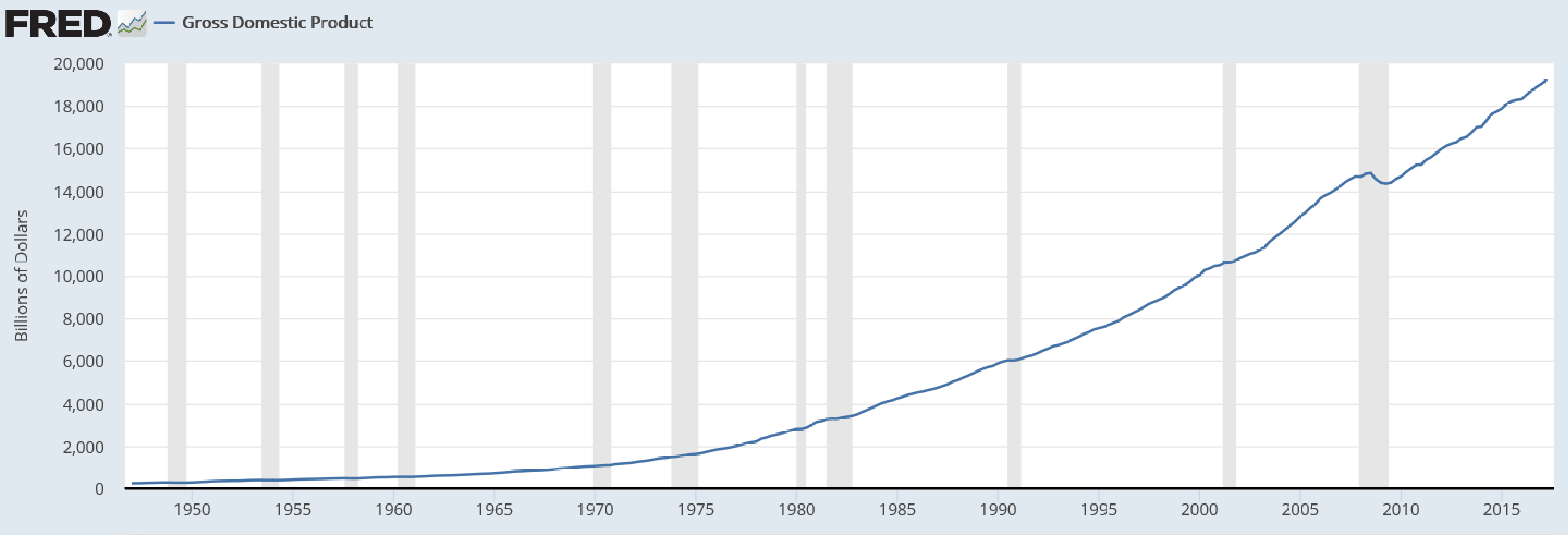
Should I get out of the market right now?

- There's always a pundit writing that the market is about to tank right now. On the long term, the market is driven by the health of the economy as measured by a number of macroeconomic indicators. On the short term, the market is driven by surprises – deviations from that which is expected.

- Recessions are easy to predict because a recession onset is defined by two negative quarters of the Gross Domestic Product. There is one big complication in that large investment institutions do not wait for the GDP to go down – they anticipate the event so that they are not surprised when it actually happens.

- The following is a GDP chart.

https://fred.stlouisfed.org/series/GDP



Anticipating the GDP results …

- The GDP is such an important indicator that it is actually published before its finished. Normally its final form is available a few weeks after the close of a quarter but the FED now makes it available as its being constructed so that you see its (tentative) conclusions without waiting in the hope of eliminating all surprises. You can follow it at: **https://NewYorkFed.org/research/policy/nowcast**

- Some of us can't even wait for these results and would like GDP projections. These are easy to get at:
- **http://www.Rbc.com/Canada.html**
- Go to the bottom of the page and click on "News and Information/Economics."
- Click on "Quarterly economic Update" and then select the latest outlook. For this lecture, it is September 2017.
- Go to page 6 and you will find the projected GDP growth for the next six quarters.
- I've copied them on the next page.

Real growth in the economy

Quarter-over-quarter annualized % change unless otherwise indicated

	Actuals						Forecast						Actual		Forecast	
	2016				2017				2018				year-over-year % change			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2015	2016	2017	2018
Consumer spending	1.8	3.8	2.8	2.9	1.9	3.3	2.7	2.4	2.6	2.4	2.1	2.0	3.6	2.7	2.7	2.5
Durables	1.0	8.5	9.4	9.2	-0.1	9.0	7.1	3.1	3.0	2.7	2.1	2.1	7.8	5.5	6.1	3.6
Non-durables	2.6	4.7	0.1	2.5	1.1	4.3	2.2	2.8	3.1	2.8	2.2	2.0	3.1	2.8	2.3	2.8
Services	1.7	2.8	2.7	2.1	2.5	2.1	2.1	2.2	2.4	2.2	2.1	2.0	3.2	2.3	2.3	2.2
Government spending	1.8	-0.9	0.5	0.2	-0.6	-0.3	1.2	1.0	0.6	0.4	0.4	0.4	1.4	0.8	0.0	0.6
Residential investment	13.4	-4.8	-4.5	7.1	11.1	-6.5	0.5	5.1	6.0	6.7	6.4	6.7	10.2	5.5	2.2	4.6
Non-residential investment	-4.0	3.3	3.4	0.2	7.1	6.9	3.9	4.4	4.3	3.9	3.1	2.8	2.3	-0.6	4.5	4.1
Non-residential structures	2.2	0.5	14.3	-2.2	14.8	6.2	-1.0	4.5	4.5	3.8	2.9	2.3	-1.8	-4.1	6.2	3.4
Equipment & software	-13.1	-0.6	-2.1	1.8	4.4	8.8	6.5	4.8	4.8	4.3	3.2	2.9	3.5	-3.4	3.8	4.8
Intellectual property	6.3	11.1	4.2	-0.4	5.8	4.9	3.8	3.7	3.4	3.3	3.2	3.0	3.8	6.3	4.2	3.5
Final domestic demand	1.5	2.6	2.2	2.3	2.4	2.7	2.5	2.5	2.6	2.4	2.1	2.0	3.3	2.1	2.5	2.4
Exports	-2.6	2.8	6.4	-3.8	7.3	3.7	1.0	1.5	2.5	2.8	3.2	3.2	0.4	-0.3	2.9	2.4
Imports	-0.2	0.4	2.7	8.1	4.3	1.6	3.0	3.4	3.3	3.3	3.5	3.0	5.0	1.3	3.8	3.2
Inventories (change in $b)	40.6	12.2	17.6	63.1	1.2	1.8	16.0	23.0	18.0	18.0	18.0	17.0	100.6	33.4	10.5	17.8
Real gross domestic product	**0.6**	**2.2**	**2.8**	**1.8**	**1.2**	**3.0**	**2.6**	**2.4**	**2.4**	**2.3**	**2.0**	**2.0**	**2.9**	**1.5**	**2.2**	**2.4**

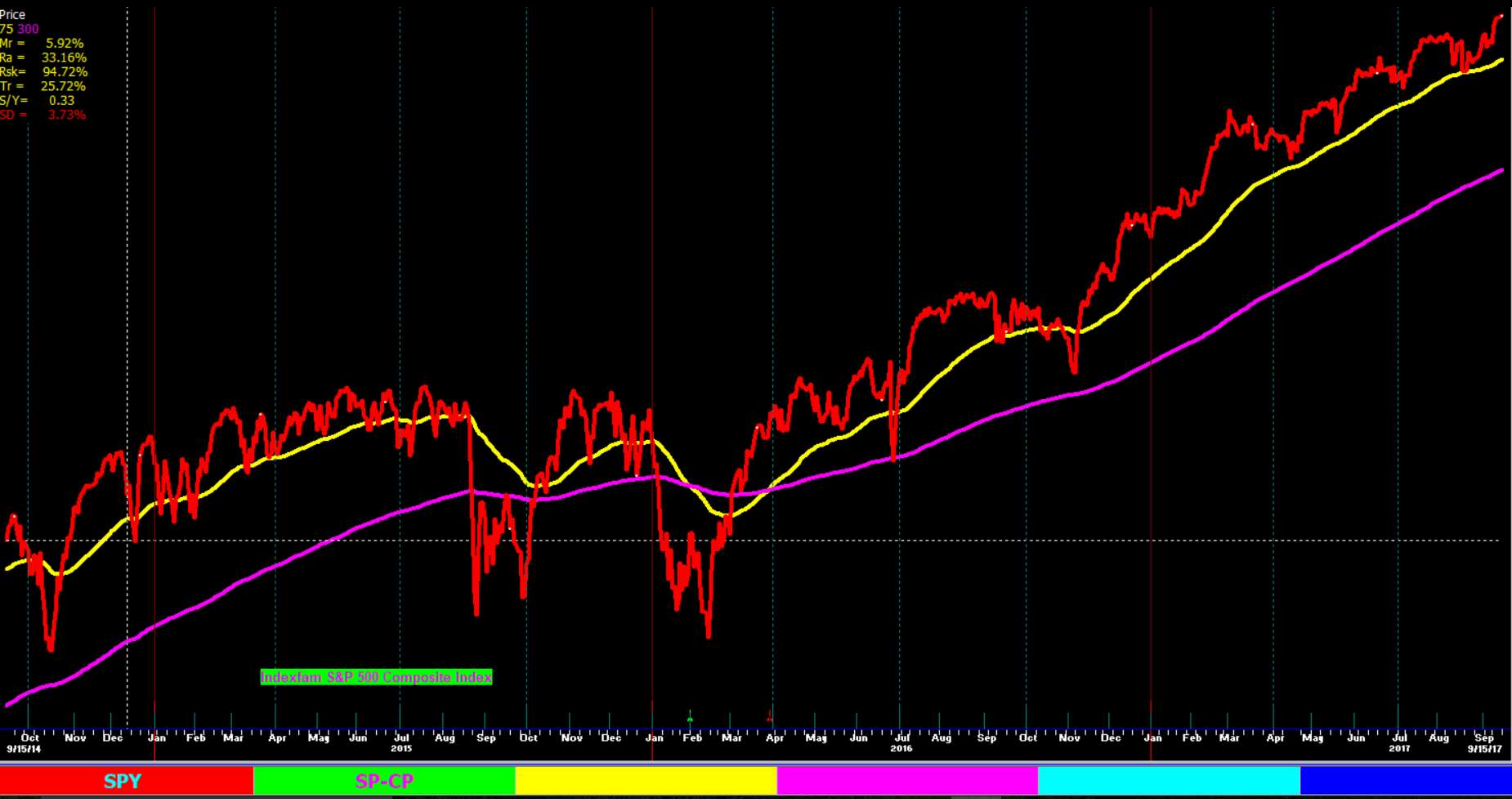
What do you see?

- I see GDP underperformance but no anticipated negative quarters. Note that the growth numbers are in "Real" terms and that means after inflation.

- I use a 2 exp. Moving average crossover signal to time my market exits. The parameters are 75 and 300 to reduce any false exits which can be expensive tax-wise.

- The graph on the next page shows the results of this procedure using Investor's FastTrack data.

- There is no need to exit the market now.


Price
75 300
Mr = 5.92%
Ra = 33.16%
Rsk= 94.72%
Tr = 25.72%
S/Y= 0.33
SD = 3.73%
Indexfam S&P 500 Composite Index
Oct Nov Dec Jan Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec Jan Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec Jan Feb Mar Apr May Jun Jul Aug Sep
9/15/14
2015
2016
2017
9/15/17
SPY
SP-CP

What drives the market?

- You already know the answer to this one. On the long term, the market is driven by Pre-tax Corporate Profits … its as simple as that with one small detail exception.

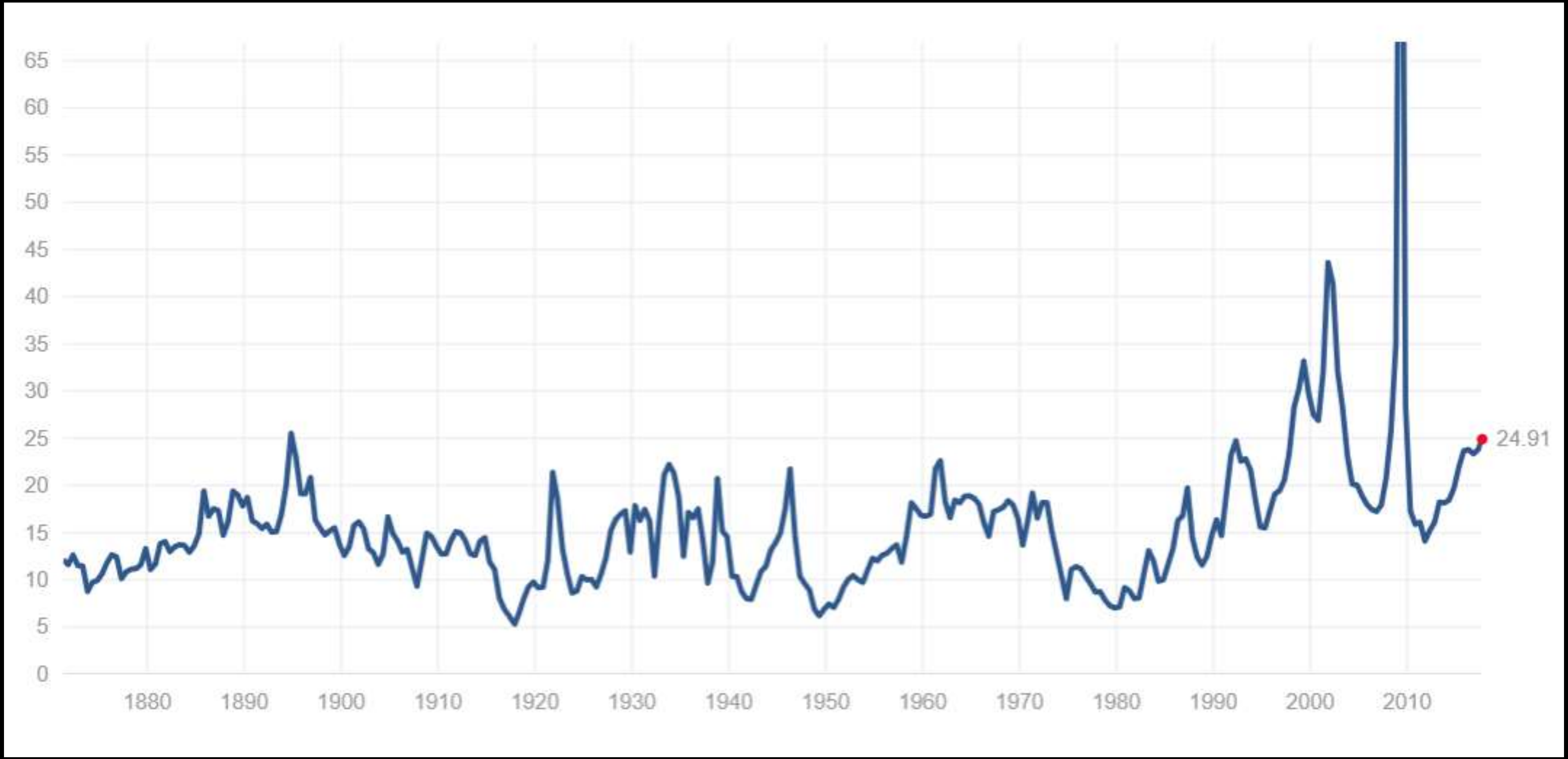
- Its easy to calculate the Price Earnings Ratio which relates corporate earnings to price. It would be nice if this ratio were a constant for then the ratio would be absolutely determining, but it isn’t so its effect upon the market index (S&P 500) should be factored in. See the following chart.

Other indicators

Year-over-year % change unless otherwise indicated

Business and labour																
Productivity	-0.2	-0.4	-0.1	1.0	1.1	1.3	0.9	0.7	1.2	1.2	1.2	1.2	1.1	0.1	1.0	1.2
Pre-tax corporate profits	-6.2	-8.2	-1.6	8.7	3.3	7.0	2.3	0.3	3.4	2.6	2.4	2.1	-1.1	-2.1	3.1	2.6
Unemployment rate (%)*	4.9	4.9	4.9	4.7	4.7	4.4	4.4	4.4	4.4	4.4	4.3	4.3	5.3	4.9	4.5	4.4
Inflation																
Headline CPI	1.1	1.0	1.1	1.8	2.5	1.9	1.8	1.6	1.2	1.8	2.0	1.9	0.1	1.3	2.0	1.7
CPI ex. food and energy	2.2	2.2	2.2	2.2	2.2	1.8	1.6	1.7	1.6	1.9	2.1	2.0	1.8	2.2	1.8	1.9
External trade																
Current account balance ($b)*	-477	-433	-441	-456	-467	-455	-466	-485	-494	-506	-514	-518	-435	-452	-468	-508
% of GDP*	-2.6	-2.4	-2.4	-2.4	-2.5	-2.4	-2.4	-2.5	-2.5	-2.5	-2.5	-2.5	-2.4	-2.4	-2.4	-2.5
Housing starts (000s)*	1153	1158	1150	1248	1238	1165	1241	1271	1300	1333	1362	1396	1107	1177	1229	1348
Motor vehicle sales (millions, saar)*	17.3	17.2	17.5	17.8	17.1	16.8	16.7	17.3	17.5	17.9	17.9	18.1	17.4	17.5	17.0	17.8

The Price-Earnings Ratio



Our economy is sensitive to 2 two things …

- The word sensitive is not quite strong enough … scared silly is better!

- The first item is inflation which devalues our money and destroys our savings.

- The second item is overheating where the economy expands to rapidly forcing the FED to raise the Fed Fund Rate and this raises short-term interest rates which raises the cost of borrowed money and you know what that does … it reduces corporate profits and the market goes down.

- Fortunately, the thresholds for both are easy to measure.

What drives inflation?

- Inflation starts when there is high demand for limited assets. Unemployment is a really way of seeing if we are in a problem area.
- The rule is simple. Core employment is about 4.6% and this means that you can expect this number in good times where there is no strong demand for new employees. When unemployment dips below this number there is increasing demand for workers and you have to pay them more to get them.
- Control of the Unemployment Rate is one of the Fed’s two major responsibilities as ceded by Congress in 1914. The Fed can and will intercede in the economy if the Unemployment Rate drops below this number. Refer to the handout for more details.

What drives disorderly growth?

- When demand exceeds supply, companies invest in new factories, machinery and workers. They borrow money to finance expansion.

- If you look at the handout, look for Manufacturing Capacity Utilization (CU). It tells you what percentage of the economies resources are being used. Disorderly growth and the potential for Fed action starts when the CU rises above 84%.

Using the table …

- Today’s handout is easy to use.
- Anything that causes Pre-tax Corporate profits to rise is good for the Stock Market.
- Some indicators are more important than others. The first 5 are:

1. Labor, Employment Situation
2. Growth, Non-manufacturing ISM
3. Labor, Initial Jobless Claims
4. Inflation, Consumer Price Index
5. Inflation, Producer Price Index

This is what I think about investing …

- Lets run a little experiment.
- List all ETFs ranked in order of their 3-year return.
- Strike out all sector funds, multiples and money funds.

- You will find that passive investing in the S&P 500 beats about 85% of all the other ETFs.
- QQQ beats more than 99% of the rest. Remember that QQQ, the tradable NASDAQ 100 has a high technology content
- Isn’t it obvious to passively invest in SPY or QQQ.

- What do you do if you still want to do better than that. Sector funds are the answer provided you can live with slow rotations and that you can identify hot funds in a timely manner. That’s what we’re going to talk about.

Table of ETFs in declining order of 3-year return

Num	Symbl	Name 1 of 1581 selected 69 at top	5_Year Return 09/28/2012-09/28/2017	Return 09/26/14-09/28/17
70	CQQQ	Guggenheim ETF China Technology	180.30%	59.85%
71	ITB	iShares ETF US Home Construction	90.58%	59.61%
72	IXN	iShares ETF Global Technology	116.15%	59.45%
73	SOCL	Global X Mgnt ETF Social Media	128.30%	59.01%
74	FTEC	Fidelity ETF MSCI Information Technology	-9999.99%	58.44%
75	VGT	Vanguard ETF Information Technology Ix	120.53%	58.13%
76	KBWR	PowerShares ETF KBW Regional Bank	110.69%	56.92%
77	RETL	Dirxn ETF Daily Retail Bull 3X	235.82%	56.83%
78	CN	Deutsche X Trackers ETF MSCI All ChinaEq	-9999.99%	56.51%
79	DWTI	Crdt Suisse ETN Invrs VelctySh3xCr\Disc	-9.85%	56.27%
80	RXL	ProShares ETF Ultra Health Care	300.53%	56.23%
81	UGE	ProShares ETF Ultra Consumer Goods	191.54%	56.06%
82	KBWP	PowerShares ETF KBW Prpty&Casualty Ins	122.30%	55.93%
83	XLK	StateSt ETF Tech Select Sector SPDR	108.61%	55.62%
84	XSW	StateSt ETF SPDR S&P Software & Services	114.98%	55.57%
85	KRE	StateSt ETF SPDR S&P Regional Banking	114.86%	55.47%
86	SKYY	First Trust ETF ISE Cloud Computing Fund	112.03%	55.02%
87	XMLV	PowerShares ETF S&P MidCap Low Volatil	-9999.99%	54.65%
88	DXJS	WisdomTree ETF Japan Hedged SmallCap Eq	-9999.99%	52.92%
89	IYW	iShares ETF US Technology	107.91%	52.91%
90	PSCF	PowerShares ETF S&P SmallCap Financials	97.43%	52.82%
91	CXSE	WisdomTree ETF China ex StateOwndEntrprs	72.91%	52.48%
92	PEY	PowerShares ETF Hi-Yld Eq Div Bd Achiev	112.76%	52.20%
93	URE	ProShares ETF Ultra Real Estate	98.01%	51.66%
94	MTUM	iShares ETF MSCI USA Momentum Factor	-9999.99%	51.37%
95	QQQ	PowerShares ETF QQQ	123.79%	50.95%
96	IAI	iShrs ETF US Broker Dealers & ScrtyExchs	178.81%	50.52%
97	TAO	Guggenheim ETF China Real Estate	68.16%	50.51%
98	EWO	iShares ETF MSCI Austria Capped	68.88%	50.00%
99	DFJ	WisdomTree ETF Japan SmallCap Dividend	92.67%	49.65%
100	AADR	AdvisShrs ETF WCM BNY MlnFcsd Growth ADR	91.52%	49.43%
101	LIT	Global X Mgnt ETF Lithium	27.22%	49.39%
102	CAPE	Barclays ETN + Shiller Capet	-9999.99%	49.37%
103	FXL	First Trust ETF Technology AlphaDEX Fund	128.03%	49.29%
104	SLYG	StateSt ETF SPDR S&P 600 SmallCap Growth	106.06%	49.19%
105	KIE	StateSt ETF SPDR S&P Insurance	132.23%	48.98%
106	PSCC	PowerShares ETF S&P SmallCap CnsmrStapl	112.55%	48.84%
107	SMLV	StateSt ETF SPDR Russell 2000 Low Vltlty	-9999.99%	48.53%
108	IAT	iShares ETF US Regional Banks	100.87%	48.37%
109	SPHD	PowerShares ETF S&P 500 High Div Low Vol	-9999.99%	48.34%
110	IJT	iShares ETF S&P SmallCap 600 Growth	106.15%	48.29%
111	VIOG	Vanguard ETF S&P SmallCap 600 Growth Ix	105.66%	48.23%
112	ARGT	Global X Mgnt ETF MSCI Argentina	82.00%	48.13%
113	ASHR	Deutsche X Trackers ETF HarvstCSI300CHNA	-9999.99%	48.08%
114	ONEQ	Fidelity ETF Nasdaq Composite Stock Fund	119.15%	48.07%
115	VFH	Vanguard ETF Financials Index Fund	119.40%	47.59%

Picking “Hot” sectors as a strategy

- Morningstar makes it easy to identify “hot” sectors. Go to Morningstar.com . Click on “Stock research/Market Fair Value” and you will be taken to a series of charts showing a “fair value” as compared to “market price” over different time periods. The fair value is the Net Present Value of the investment’s income stream.

- How do you select a hot sector. I choose those sectors that are selling for less than their intrinsic value and that are trending up to become even more valuable. A Morningstar graph is provided for the market as a whole and for about 170 sectors.

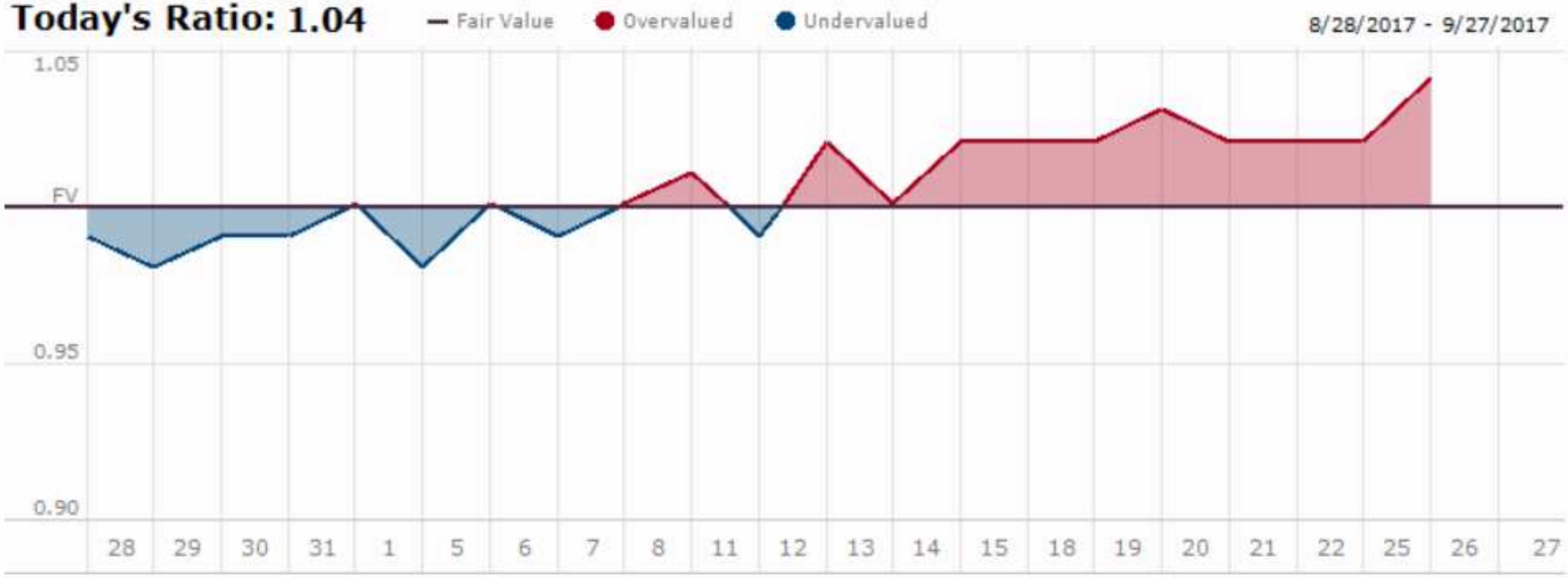
- The next page is the graph of a hot sector. All you have to do is cycle through all their possibilities and write down the sector’s name every time you run into a sector that meets the criteria. You can usually pick up 20 or so cases.

Coverage Universe:

All Rated Stocks

52-Week High 3/1/2017	52-Week Low 11/4/2016	All-Time High 12/31/2004	All-Time Low 11/20/2008
1.06	0.96	1.14	0.54

Today's Ratio: 1.04



What did you learn?

- The chart displays all rated stocks – the market.
- In the last 30-days, the valuation has risen by about 6%.
- The market is now about 4% above its fair value.

- Wouldn't it be better to choose sectors that are a bargain – undervalued – and that still have a way to go? Even in down markets, there's almost always a selection of "hot" sectors.

Hot Sectors – September 27, 2017

SECTOR	VALUE
Communication Services	Fairly
Energy	Under
Home Improvement Stores	Under
Recreational Vehicles	Fairly
Residential Construction	Fairly
Asset Management	Fairly
Banks, global	Fairly
Real Estate, Hotel	Under
Discount Stores	Under
Oil & Gas Equipment Services	Fairly

SECTOR	VALUE
Oil & GAS, Midstream	Under
Metal. Fabrication	Fairly