This Is Not a Market for the Fainthearted

The Dow Jones Industrial Average is snaking its way around the 20,000-point level.

Wall Street is in no doubt that, by year's end, the US market is destined to go higher…now there's a surprise.

According to a table recently published by CNBC, since 2000, Wall Street strategists have, on average, forecast a 9.6% per annum each year.

There has never been a year in which Wall Street has *not* held a positive outlook. Even though we've had the years of the tech bust subprime meltdown, which produced spectacularly negative numbers.

Wall Street is a circus with a one-trick pony; and, out of self-interest, they talk up the market relentlessly.

This is an extract from the introduction of my recent book, *How Much Bull Can Investors Bear?*

> '*There are a number of inherent conflicts of interest in the financial advice business model…and the major conflict is that over 8 financial planners have direct or indirect ties to institutions.*
>
> '*Financial planners rely on economic and market information that comes primarily from two sources: investment institutions and research firms. These commentaries are largely predictable.*
>
> '*They're always wise after the event, but rarely ever before it. In my opinion, institutional economists are professional marketers. always going to stick to the and promote the institutional line — ensuring money continues to flow into their employers' funds.*
>
> '*The institutional economists are the media's go-to people whenever a market or economic commentary is required. In spite of th pretty average (disappointing) track records, they project credibility. The public is constantly fed the same old spin — "things will going up", or, if they are down, "they will soon go up". Any economic downturn is destined to be a "soft landing".*
>
> '*The name of the game is to not do, or say, anything that spooks investors or potential investors.*'

Now that the psychological 20,000-point barrier has been breached, there is plenty of speculation about better times a.

However, history shows us that the first breach of these 'lines in the sand' is usually the *end* of — rather than the *beginning* of — a b takes years for the market to make a permanent breach through these 'barriers', as you'll see below.

Dow Jones point level	Year first breached	Year permanently breached	Number of years between
100	1916	1942	26 years
1000	1966	1982	16 years
10,000	1999	2010	11 years
20,000	2017	??	??

The US market is priced for perfection…meaning that stock prices are so high, there's little room for error. The market must keep ex analysts' expectations, otherwise it will be set for a major correction.

What I'd like to share with you today is an update from my advisory service, *The Gowdie Letter*, which I wrote on 16 December 2016 investors of the extreme dangers that lie a.

The investment industry champions the US market's rise as if it is the start of bigger and better things to come.

My advice is to be extremely cynical of the vested interest behind this sentiment; instead, look at historical precedent for what is like happen next.

The crowd's perverse perception

The Dow Jones is just shy of 20,000 points.

The S&P 500 index is at 2250 points.

The All Ordinaries is at 5600 points.

After Trump's election victory, markets have found a second wind.

The market seems to shrug off any news — Trump election, Italy's referendum, Fed raising the cash rate — as it marches into the record books.

Some questions I've been asked in recent days include:

- What is the market's outer limit?
- Will it keep rising?
- What can stop its record-breaking run?

The honest answer to these questions is 'I don't know'.

In the short term, markets can leave you scratching your .

The recent resurgence will have undoubtedly made many investors think about whether to increase their exposure to the seemingly unstoppable bull. That's a natural reaction. People like to back winners.

My view on the US market is well documented…by any long-term valuation measurement, it's expensive. Driving a market higher only makes it more expensive and, therefore, poses a greater risk to your capital. In my opinion, it's an equation that offers very high risk, with very low return.

Perversely, the investing public sees the opposite. A rising market is an open invitation to participate in the promise of higher returns with minimal risk.

The following tables have been sourced from the official website of the Financial Industry Regulatory Authority (FINRA).

Month/Year	Debit Balances in Customers' Securities Margin Accounts	Free Credit Balances in Customers' Cash Accounts	Free Credit Balances in Customers' Securities Margin Accounts
Feb-10	263,657	106,131	164,624
Mar-10	277,798	108,908	162,169

Source: FINRA
[Click to enlarge]

FINRA Statistics[2] (shown in $ millions)

Month/Year	Debit Balances in Customers' Securities Margin Accounts	Free Credit Balances in Customers' Cash Accounts	Free Credit Balances in Customers' Securities Margin Accounts
Jan-16	487,200	180,616	162,825
Feb-16	474,156	178,989	168,308
Mar-16	483,909	182,673	172,525
Apr-16	495,178	176,016	187,000
May-16	489,867	177,161	187,495
Jun-16	487,636	186,233	189,585
Jul-16	513,221	183,435	188,155
Aug-16	510,157	177,764	185,695
Sep-16	540,615	184,757	182,833
Oct-16	523,760	182,051	182,986

Source: FINRA
[Click to enlarge]

In early 2010, the balance between margin-lending debt and credit balances was approximately equal. After the events of 2008/09, investors were displaying a degree of caution…having a foot in both camps (debt and cash).

The latest data (up to October 2016) shows that investors have shifted the weight of those two feet. They are now firmly planted in the debt camp, with margin debt totalling US$523.7 billion, compared to the US$365 billion in credit balances…a difference of nearly US$170 billion.

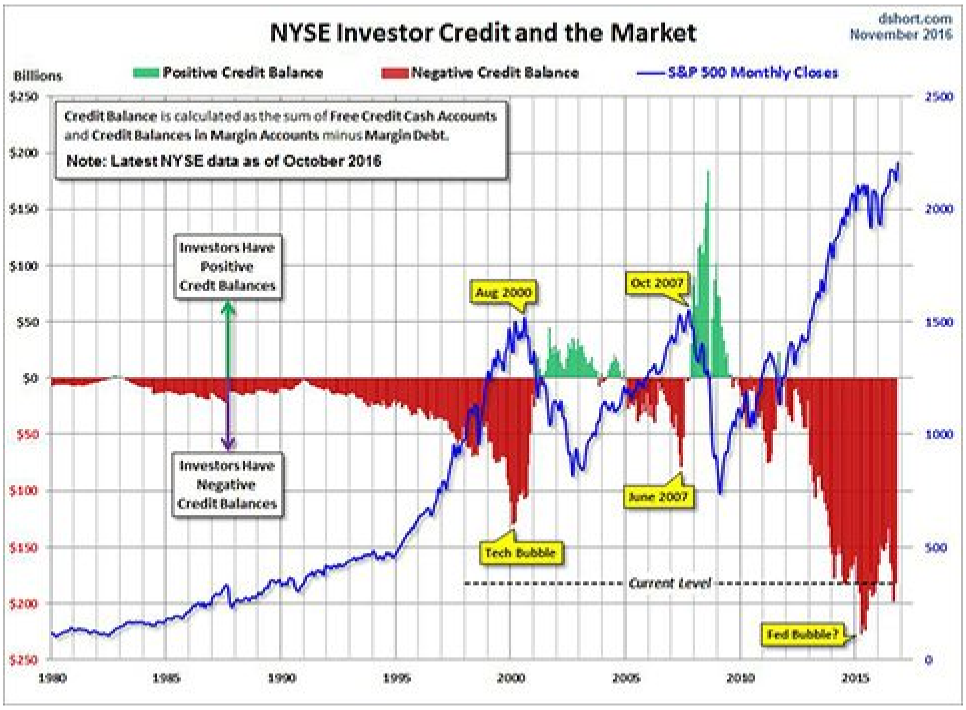
So, what does that all mean?

The chart below provides some context.

The blue line represents the S&P 500 index (the value of the index is referenced on the right-hand side of the Y-axis).

The red and green shaded areas (referenced to the left-hand side of the Y-axis) indicate where credit balances are either in the positive or negative camp.

The ‘current level’ is at the negative US$170 billion mark.



Source: Advisor Perspectives
[Click to enlarge]

You'll note the previous market bubble peaks (blue line) in August 2000 and October 2007 also coincided with peaks in negative credit balances.

That's hardly surprising. It is human nature to 'go all in' on an established uptrend *before* it reverses.

What's also not surprising is that, *after* bubbles burst, credit balances go into the positive (green zone). Investors sell up and retreat to cash *after* the market has fallen.

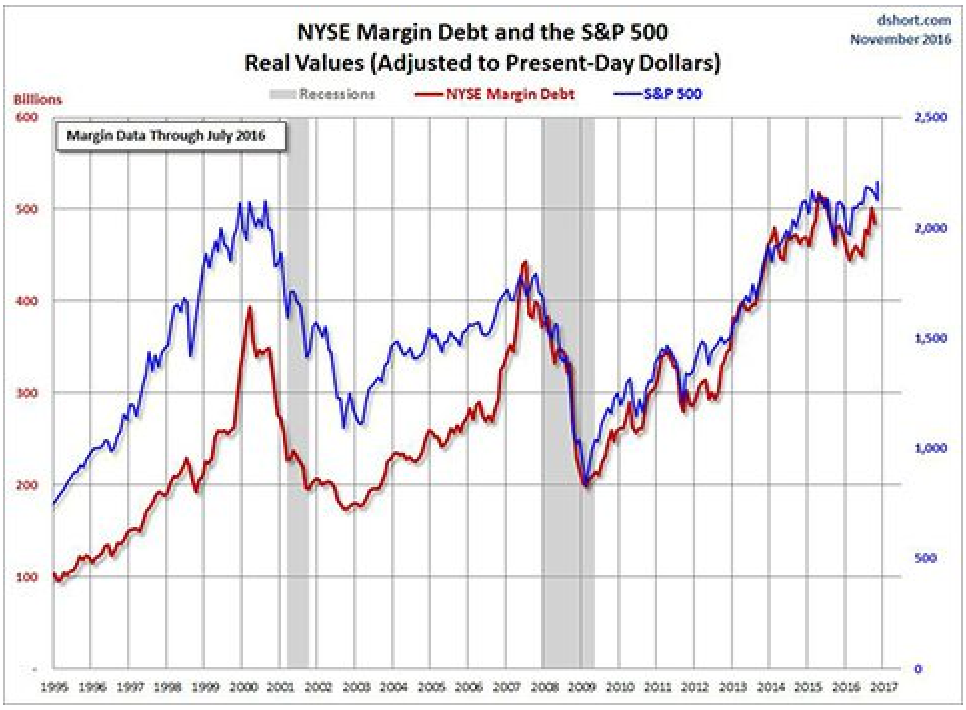
Just so predictable.

Now compare the previous extremities in peaks with the current situation.

The difference between the market level (value) and negative credit balances has never been further apart.

In fairness, a dollar in 2000 is not the same as a dollar in 2016.

Therefore, to provide balance, the following chart compares apples with apples — adjusting the value of a dollar in 2000 and 2007 with a present-day dollar.



Source: Advisor Perspectives
[Click to enlarge]

On an adjusted basis, the level of debt today stands higher than it did during the peaks of 2000 and 2007.

This growing appetite for risk — with borrowed money — should be a warning sign flashing in red.

However, based on historical behaviour, we know that investors see a completely different sign — one that says ‘Welcome’ (with the word ‘sucker’ hidden from view).

Is this time going to be different to previous peaks? Possibly.

Would you bet your retirement capital on it being different? I wouldn’t.

The upside, if it is in fact different, could be an extra few percent per annum for a period of time.

Whereas, if it’s not different, the downside is that you risk losing at least half, and probably more, of your capital.

Personally, that’s an unacceptable proposition.

An ‘overvalued, overbought and over-bullish’ warning sign has been triggered

John Hussman, of Hussman Funds, provides in-depth analytical research on the US share market. He uses long-term valuation models, reversion to the mean and mathematics to support his views.

Here’s an extract from his research (dated 16 July, 2007):

July 16, 2007

A Who's Who of Awful Times to Invest

John P. Hussman, Ph.D.

December 1961 (followed by 28% market loss over 6 months)

January 1973 (followed by a 48% collapse over the following 20 months)

August 1987 (followed by a 34% plunge over the following 3 months)

July 1998 (followed abruptly by an 18% loss over the following 3 months)

July 1999 (followed by a 12% loss over the following 3 months)

December 1999 (followed by a 9% loss over the following 2 months)

March 2000 (followed by a 49% collapse in the S&P over the following 30 months)

The defining characteristics of these instances were:

1) price/peak-earnings multiple above 18

2) 4-year high in the S&P 500 index (on a weekly closing basis)

3) S&P 500 8% or more above its 52-week moving average (exponential)

4) rising Treasury and corporate bond yields

Depending on how we define the interest rate trends, we can include two additional historical instances of these conditions: **October 1963** and **May 1996**, both closely followed by 7-10% corrections.

One more instance completes the list: **July 2007**.

Source: Hussman Funds
[Click to open in a new window]

The last line — which alludes to July 2007 — joined the list of awful times to invest.

With hindsight, we know this assessment was correct.

When did the peak in negative credit balances occur? June 2007.

The herd were not heeding the warning signs…and we know what happened next.

And, on 15 October, 2007 — just days before the market peak — he provided this insightful commentary (emphasis mine):

> '*…we have what has historically been a sharply negative additional feature:* ***our measures of market action are unfavorable*** *(contrast to points earlier this year, when we could infer the risk of abrupt corrections despite constructive internals).*
>
> '*There are only a handful of historical periods that fall into this syndrome of conditions: December 1972, August 1987, July 1998 1999, December 1999, March 2000, and October 2007.*
>
> '***All of the prior instances were followed by steep market losses. When the declines were not abrupt, they were protract There is not a single counter-example.***'

In October 2007, the methodology used to determine whether a market is over, under or fairly valued was producing a reading that had been seen only in a ***handful*** of historical periods — just prior to a major market reversal.

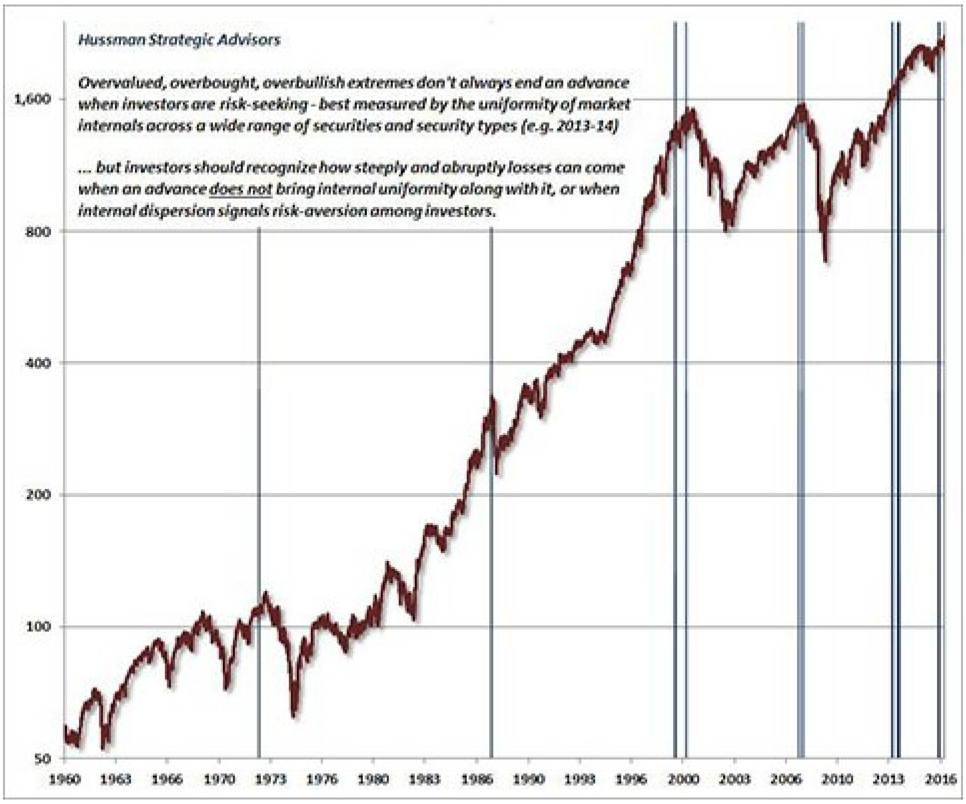
The following extract is from another Hussman update on 12 December, 2016 (emphasis mine):

'The single most extreme syndrome of "overvalued, overbought, overbullish" conditions we identify was restored last week; a se signal at a level on the S&P 500 that's 4% higher than the syndrome we observed in July. Recall that ***with one exception, that extreme variant has only emerged at the market peaks preceding the worst collapses in the past century****.*

'Prior to the advance of recent years, the list of these instances was: August 1929, the week of the bull market peak; August 197 which the S&P 500 would advance about 7% by year-end, and then drop by half; August 1987, the week of the bull market peak 1999, just before an abrupt 12% market correction, with a secondary signal in March 2000, the week of the final market peak; ar 2007, within a few points of the final peak in the S&P 500, with a secondary signal in October 2007, the week of that bull final ma peak.'

The following chart, from the latest update, shows the points at which the overvaluation signals (the thin, grey vertical lines) were triggered for the S&P 500 index since 1960.

The double lines in 2007 represent the July and October signals mentioned above.



Source: Hussman Funds
[Click to enlarge]

In 2013/14, the double signals were again triggered, but there was no correction.

This demonstrates just how powerful zero interest rates and QE have been in keeping this market aloft. The longer that it defies gravity, the greater that this divide between the market value and negative credit balances becomes.

Will this latest signal be a case of third time lucky (read: unlucky)?

Hussman places a caveat on this signal (emphasis mine):

'***Presently, market conditions are most consistent with a "blowoff" to complete the extended top-formation of the third financial bubble in 16 years****. However, an improvement in market internals would encourage us to give a longer leash to this speculation, and we will align our outlook as conditions change.'*

In other words, while the US market is overvalued, it doesn't mean that it can't go higher (on a longer leash), before going a lot lower.

This is not a market for the fainthearted, but it is one for the foolish.

Gambling your capital against history is invariably a losing bet…and it's not one I'm prepared to take.

Regards,

Vern Gowdie,
For *The Daily Reckoning*

Editor's Note: This is an extract from an article originally published in *The Gowdie Letter*.

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Vern Gowdie has been involved in **financial planning** in Australia since 1986. In 1999, *Personal Investor* magazine ranked Vern a
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