AGAINST THE FLOW

The Vestcap Point Of View

September 2015

The Pendulum Swings

The market dislocation witnessed over the past few months has been painful. In contemplating the next market move, we have some concerns that we may be in more than a "corrective" mode. Instead, we may be at an inflection point, the consequences of which we (and the markets) have yet to fully fathom. The trends which have fuelled markets for decades are now flashing yellow and that gives us cause to pause.

1-Interest rates are poised to rise. For thirty years, interest rates have fallen. Initially a result of the Fed's battle against inflation, the interest rate declines seen since the '08-'09 Financial Crisis have been a result of the Fed's battle against deflation. **As savers are very much aware, the level of interest rates today is abnormally low.** To return to a historically normal level of interest rates would require a rise in interest rates of at least 2%, which no one, including us, sees in the cards.

2-Trading has gone wild. It is estimated that 80% of the daily market volume is a result of program-related trading - computers trading with other computers. Today's master of the universe trader is not a Harvard MBA but rather a Cal Tech PhD who can code his algorithmic program to anticipate what the Waterloo PhD will be programming in his "algo" program. Algo programs seek liquidity; when liquidity dries up, the algos don't work as expected. The trading on Monday, August 24, when the Dow moved over 2,000 points intraday is testimony to that. The average holding period on stocks has fallen from years to months.

3-Liquidity isn't what it used to be. A result of Fed and Treasury requirements for investment banks to hold more capital (to insulate the system from an '08 repeat) is that there is less buffer capital to support both bond and equity markets. With less capital available, an accident (or an algo gone wild) has the potential to crater markets more quickly than before.

4-Asset correlation is very high. Historically, asset classes (bonds, stocks, industry groups, foreign holdings) were characterized by their different correlative characteristics (a particular asset class may rise when another goes down). In today's highly-charged trading market, correlations have all gone towards unity; all assets go up together, all assets go down together.

5-Momentum darlings are losing their strength. The asset classes that has benefitted the most over the past few years have been concentrated in growth-oriented, technology, consumer and health-related industries. A handful of stocks have generated all the returns in both Canadian and US equity markets. When the market hits new highs with fewer and fewer names participating, it is considered to have "bad breadth." Up until a few weeks ago, markets in both Canada and the US owed all their gains to a handful of names, which as of late have given up the ghost.

At Vestcap, we welcome the pendulum swing. We have raised cash in our client accounts and look forward to buying the names we like at prices we can set. As investors, we have not participated in the trading/momentum driven excesses of the past few years. In the pendulum shift, we are well-poised to prosper.

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