Rochester Financial Services

Fee-Only® Financial Management Services

Jeffrey Feldman Ph.D., CFP
Certified Financial Planner
Principal

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Dow Jones	S&P 500	NASDAQ	Russell 2000	10 yr Treas	Earnings Yield (S&P)	Gold	Crude Oil
29,100	3,581	12,056	1,592	0.65%	4.19%	$1,949	$41.64

Investment Strategy Report

The Incredible Stock Market Rally Continues

Remember in elementary school when your math teacher told you that the answer wasn't good enough. You had to "show your work". Well, we are seeing something similar to that now in regards to the stock market. It is not enough to say that the stock market is going up. You have to explain why. This is because most investors feel that there is a direct relationship between what is going on in the economy and the direction of the stock market. And if we are in the middle of a recession, with unemployment at 10%, and thousands of companies going out of business, then it doesn't make sense for stocks to go up. And investors will be reluctant to join the rally.

However, that is not how the stock market works. Financial historians will write books on why stocks did so well during the pandemic of 2020, and even then, they will be only guessing. The most plausible explanations that I have listed several times in my newsletters are that 1) the Federal government has added trillions of dollars to the economy since the end of March, both from Congress (over $2 Trillion) and the Fed (around $3 Trillion), and 2) the stock market looks 6-12 months forward, and senses that the economy will be much improved by then. However, if the stock market were to undergo a 10-20% correction over the next few months, that too could be easily explained. With thousands of companies and businesses not being able to survive, leading to the unemployment of millions of workers, the economy will suffer a devastating blow that will be difficult to recover from.

The reality, though, is that the best forecaster of the future health of the economy, as well as the health of the stock market, is the stock market itself. The extraordinary rally that we have seen in stocks over the past 5 months is itself an indication that 1) the stock market should be higher 12 months from now and 2) the economy should be doing much better by next year. However, what we have been experiencing over the last number of weeks can very easily fall under the category of irrational exuberance, or what Steve Sjuggerud described about a year ago, a melt-up. In the past 6 weeks, Apple is up 42% and Tesla is up 58%. And in the past 3 weeks, Zoom is up 87%! What has been going on recently is very reminiscent of the dot.com boom of 1999-2000. Back then, the tech heavy Nasdaq rose 250% from October 1998 to March 2000! Investors who sold after a 50% or 100% gain, would have missed out on much larger gains to come.

While there are similarities, there are definite differences, which is why I am not calling for a similar 50% drop in stocks (or 85% drop in the Nasdaq) that occurred during the 2000-2002 bear market. Or any significant drop, for that matter. Despite the closing of the economy back in the Spring, the reopening is going fairly well. Louis Navellier stated in his podcast today that both the housing market and the auto market are doing very well, as ultra-low interest rates have spurred demand. And the ISM Manufacturing index has risen for 4 consecutive months, to its highest level in 21 months.

Steve Sjuggerud recently stated that "the Fed is pumping more cash into the financial system than ever. As we saw during Bernanke's time as Fed chair, that's a recipe for a massive asset boom. Thanks to Powell, the outlook here is hugely positive. That's why my advice is that you need to own stocks now".

There is no question that the markets in the short term are currently overbought. Indicators such as the Relative Strength Index (RSI), which indicates an overbought security when its reading hits 70, is currently registering 80, or severely overbought. This metric is corroborated by Sentimentrader.com, which measures investor sentiment. Their indicators show "high optimism with signs of reckless speculation during what appears to be an unhealthy market environment". However, their active studies "show a heavy positive skew over the medium to long term. Breadth thrusts, recoveries, and trend changes have an almost unblemished record of preceding higher prices over a 6-12 month time frame". Which is basically what I said to end my letter last month, so I'll repeat it here: "With the huge runup in stocks that we have seen since the March lows, we still need to exercise caution in the short term. However, the market's long term prospects still remain quite positive." *Jeff Feldman*

Tel: 585 / 442-7580
Fax: 585 / 351-2458
Email: jmfeld@aol.com

7 Hastings Circle, Pittsford, NY 14534
http://www.rochesterfinancial.com

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