Rochester Financial Services

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November 1, 2021

Dow Jones	S&P 500	NASDAQ	Russell 2000	10 yr Treas	Bitcoin	Gold	Crude Oil
35,914	4,614	15,596	2,358	1.58%	61,184	$1,794	$83.91

Investment Strategy Report

Stocks Rebound in October, Despite Inflation Fears and Supply Chain Disruptions

In October, stocks recovered all of their losses from September and then some, as the seasonally favored 4th quarter got off to a very promising start. The S&P 500 gained 6.9% for the month, and the Dow and Nasdaq gained 5.8% and 7.3%. All the major indexes finished the month at record highs. These gains occurred despite continuing fears about inflation and supply chain shortages. After years of subpar inflation, averaging 1.5% per year, inflation is forecast to come in this year at 4.0% or higher, with it dropping to a still elevated level of 2.5% next year.

The Federal Reserve contends that this year's spike in inflation is transitory, resulting from factors related to the economy's emergence from the pandemic-caused recession. However, worker shortages are causing employers to hike wages in order to attract qualified employees. Will salaries come down once the workers come back? New and used car prices are up almost 25% and 10% respectively because of semi-conductor and other component shortages. How long will it take for the manufacturers to meet the demand for these parts and will these prices normalize? And we all know about housing prices surging in the past year.

It seems that as our economy emerges from the pandemic, the consumer is supercharged. In addition to strong vehicle and housing demand, "year-over-year retail sales show a robust gain of 14.9%, which is higher than in any other economic expansion in over 50 years" wrote Bob Brinker in his November letter.

A spike in the rate of inflation can certainly present a headwind for stocks. As manufacturers and employers have to pay more for supplies and labor, profit margins can get squeezed and earnings can suffer. However, at this point, investors don't seem to be concerned. And with the 10 year Treasury yield still at a relatively low 1.58%, it's hard to argue with them.

A headline on the cover of this weekend's Barron's Market Week section says "The Urge to Sell, and Why You Should Fight It". In the article, Ben Levisohn states "There are more and more reasons accumulating for why it's time to sell stocks. There were earnings disappointments from Apple and Amazon and Boeing, a weak US gross domestic product release, and even a quick flattening of the yield curve. But there's only one reason to buy: The stock market is going up".

This strategy, of sticking with stocks mainly because "the trend is your friend", is echoed among the technical analysts that I follow. Jason Goepfert of Sentimentrader.com, noted on 10/27 that "on 10/25, we saw the Advance/Decline Line for the S&P 500 brake out to a new high", doing so for the first time in more than 90 days. This metric simply measures the number of stocks going up vs. those that are going down. "New highs in this A/D line have consistently preceded stock gains". Jason's colleague Dean Christians added that "On 10/25, the S&P 500 equal-weighted index closed higher for the 10th consecutive day, a record high". His study of similar past occurrences concluded that "even though momentum has been strong lately, results suggest that it can continue".

Chris Igou of Stansberry Research cites another momentum-based study that looked at the recent strength in Nasdaq stocks, which examined both the number of stocks in that index that were rising plus the trading volume in those stocks. Whenever those parameters were rising to the extent that they have jumped in the last 10 days, in every case, the Nasdaq rose in the following month.

Using these types of studies to predict future stock movement is of course no guarantee. The point that I'm trying to make is that the opposite strategy, of avoiding stocks based on scary headlines, is a worse strategy. Stocks rise approximately 70% of the time, and unless there is a good reason to avoid them, such as an impending recession (which of course is difficult to predict), staying the course is usually the best game plan. *Jeff Feldman*

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