NAQVI | VAN NESS
ASSET MANAGEMENT, LLC

Applied Insights

July 12, 2016

Feature Insight

New Market Highs – History Suggests Higher

Charles DuBois, Partner and Director of Investment Strategies and Research

On Friday, the S&P 500 closed at 2129.90, a new 12 month high for the first time in a least 12 months. This week will likely see an all-time high. Buying new highs in the market is frequently not the best advice (obviously). However, you should agree that buying the "first" new high in at least 12 months is better than buying subsequent new highs. The "last" new high will, by definition, not be a good buy!

In any case, this is the 15th time since 1950 that the S&P 500 will have reached a 12 month high which was the first such new high in at least 12 months. This latter requirement means that the prior period was, by necessity, a period where stock prices had a material decline or a prolonged sideways movement and prices now are rebounding. The last such "signal" was in October 2009.

For the fourteen previous cases since 1950, the stock market (S&P 500 - price only) was higher a year later on every occasion. The average return was 18.0% and the worst 12 month returns were from the April 1967 (4.8%) and August 1978 (3.1%) "signals". The next major peak for the stock market occurred a minimum of 15 months after each "signal" (major peak defined as a peak preceding at least a 15% decline).

Coming 7 years into a bull market, such a "signal" could be readily dismissed. I'd be the first to say that the stock market is "overvalued" on most traditional measures and that long run (5-10 year) returns from here are likely to be limited and disappointing. Nevertheless, leading indicators of the U.S. economy are still favorable with no recession in sight and interest rates are at new lows - a favorable combination. Fiscal policy is also expansionary for the first time in several years. Europe is mired in a "permanent" economic policy dilemma due to a lack of fiscal flexibility - so that is a prominent risk factor.

In another bit of trivia, some of you may recall the favorable "technicals" which were noted in February and March. While I won't cover them here, recent market action has reinforced their favorable message.

Years ago, the original concept behind the "new 12 month high" indicator was that bear markets rallies, while often sharp and powerful, do not have sufficient sustainability to reach 12 month highs. Hence, a new 12 month high indicates that bull market conditions prevail. There is perhaps also a behavioral rationale, as it documented that investors are reluctant to buy "new highs". Those facts, of course, do not mean that the bull market cannot end the next day after an initial new high. But the point is that it is not a negative sign.

Thus, despite elevated valuations, it is probably not time yet to give up on this bull market. Caution on the market has been in fashion this year - which has been a positive. The first sign of problems ahead for the market will probably be an outbreak of optimism.