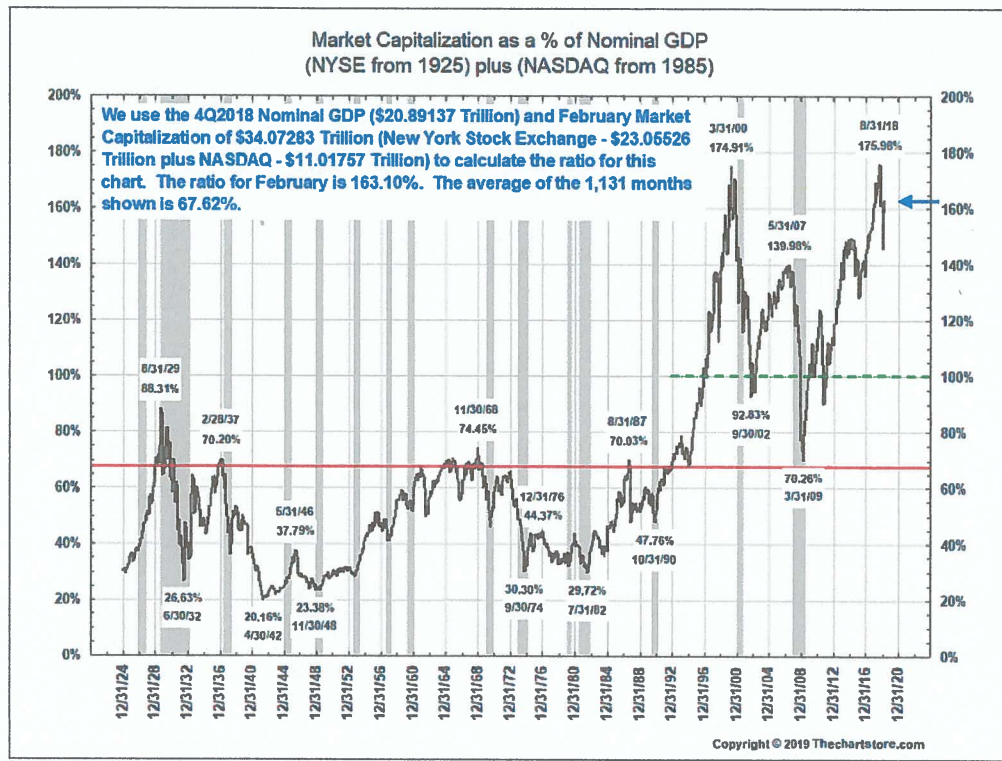


Grant's Spring Conference

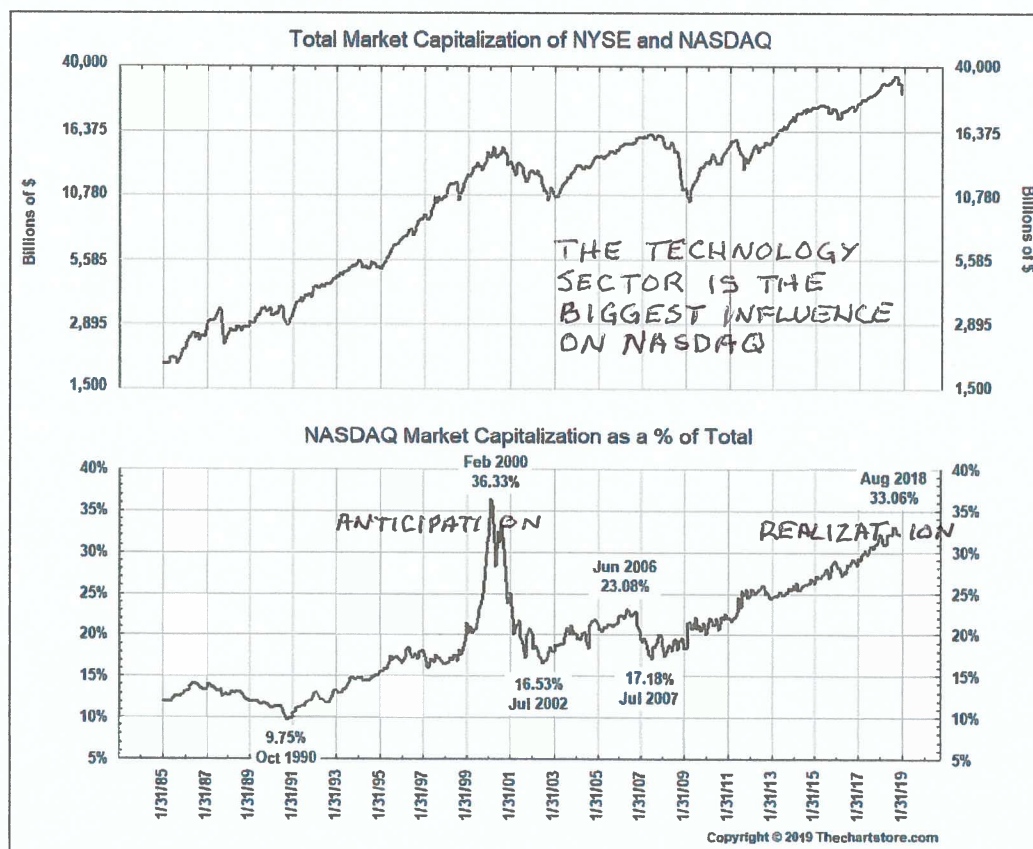
**BOB FARRELL'S  
CHARTS  
AND  
COMMENTS**

**APRIL 9, 2019**

HISTORICAL VALUATIONS CHANGED  
DRAMATICALLY IN THE 1990s. THE  
COMPUTER-INTERNET REVOLUTION DID IT



ARE WE AT  
THE TOP OF  
THE NEW  
HIGHER  
RANGE?



## Market Cap Relative to GDP

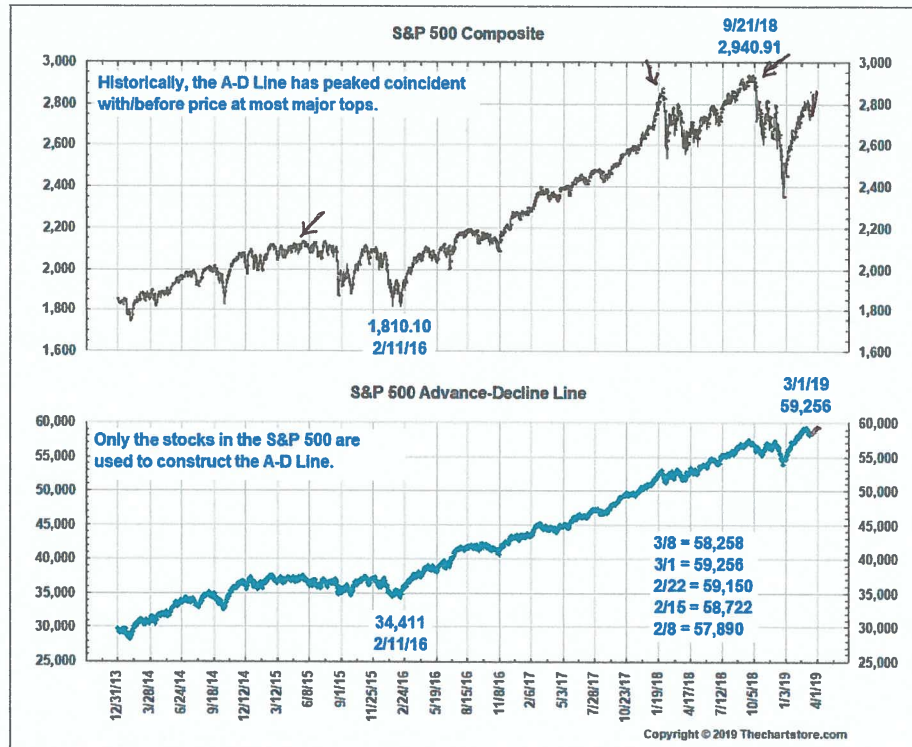
It is interesting to examine the history of this relationship going back over the last 100 years. Market cap relative to GDP reached its first peak in the roaring markets of the late 1920s with 1929 marking the zenith at 88.3%. The subsequent relative valuation peaks remained below this level (70 – 74% at the high) until the mid 1990s. At that point, these valuation parameters took a quantum jump to a peak of 175% by March 2000. This was obviously the internet new issue boom that arose from the anticipation that the computer/internet technology discoveries would usher in the next big growth spurt for the economy.

As usual, the early expectations were way overdone and were corrected in the decade of the 2000s when the Market cap to GDP ratio dropped all the way back to the 70% level in the market crash of 2008.

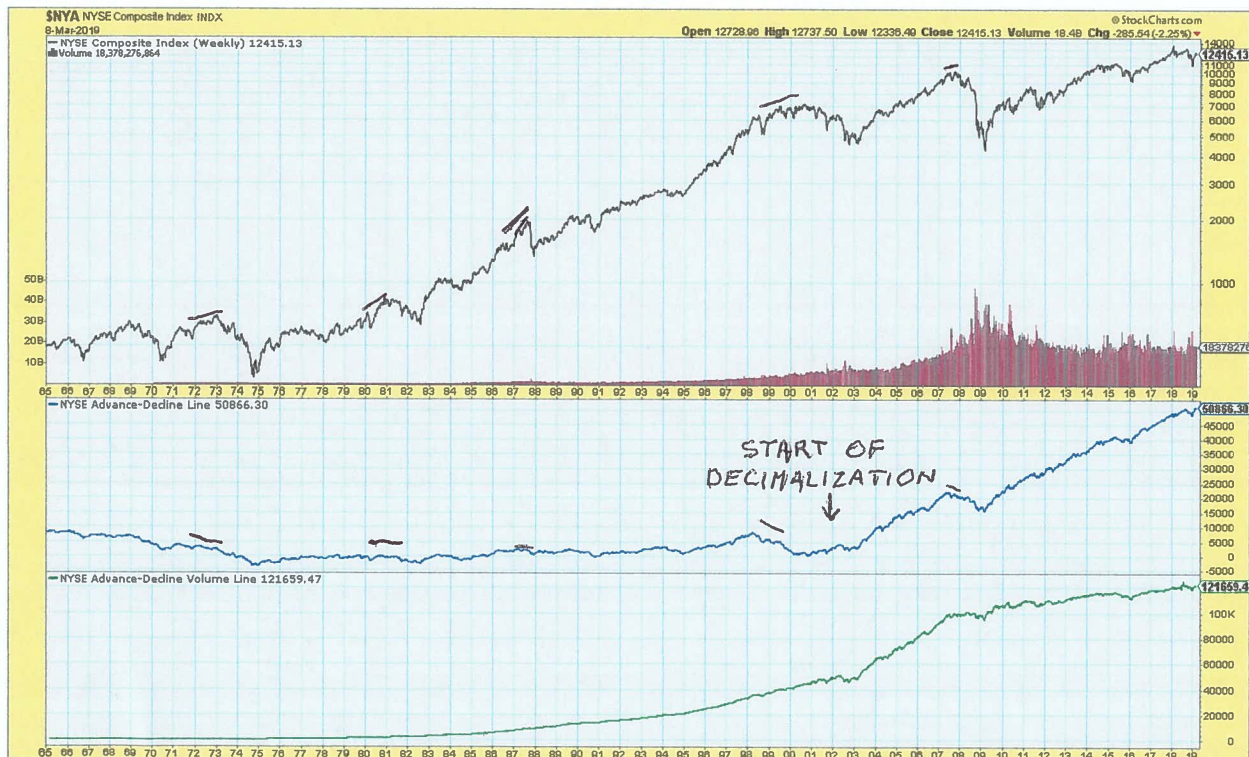
Now low valuation levels have become coincident with the high valuations of the prior 70 years. Thus, it appears that by this measure, we have a new higher range of valuations driven by the realization that the new technologies have resulted in higher valuations for equities and increased growth expectations. More importantly, however, the valuation peak of 175% was reached in September 2018. This may put a limit on market upside expectation going forward in this cycle.



# ARE BREADTH DIVERGENCES NO LONGER RELEVANT



NO DIVERGENCE  
WARNINGS IN  
JULY 2015  
JAN 2018  
SEPT 2018

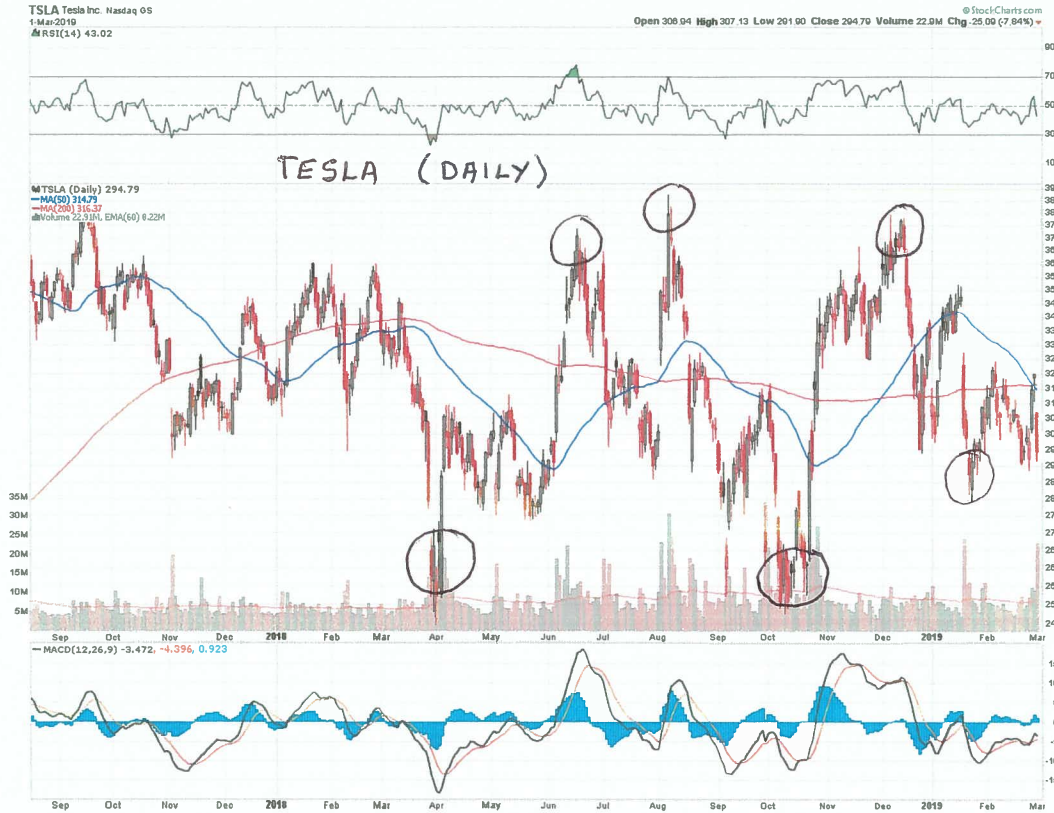


## HOW MANY NEW HEADQUARTERS DOES IT TAKE FOR A STOCK TO MAKE A TOP?

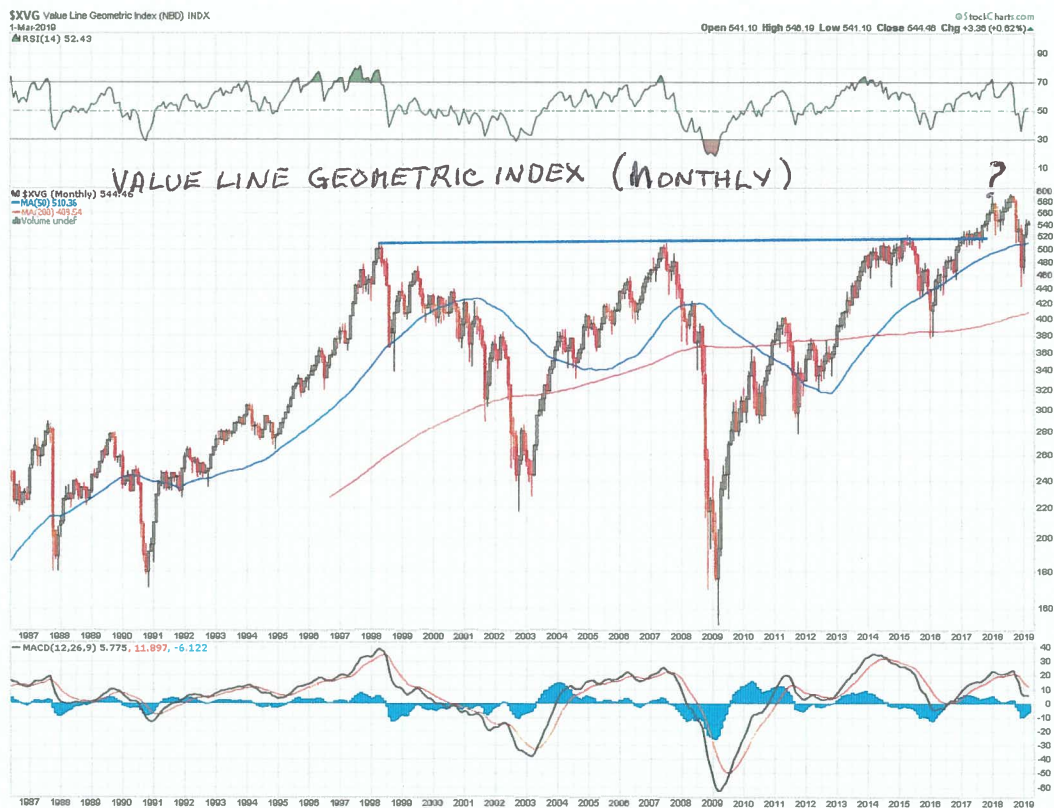
OVER THE YEARS, WHEN COMPANY STOCKS ARE IN THE LATE STAGES OF A TOPPING OUT PROCESS, ONE COMMON CHARACTERISTIC IS THAT THE COMPANY MANAGEMENT DECIDES TO BUILD A NEW HEADQUARTERS BUILDING OR COMPLEX. (IN OTHER WORDS, A MONUMENT TO THEIR SUCCESS). CHRYSLER DID IT IN 1928 CONSTRUCTING THE TALLEST BUILDING IN NEW YORK CITY. SEARS ROEBUCK DID IT IN 1973., ERRECTING THE SEARS TOWER, THE TALLEST BUILDING IN CHICAGO. MANY OTHERS COULD BE CITED AS EXAMPLES OF LATE STAGE HUBRIS. TODAY WE HAVE MOST OF THE FANGS AND SOME OTHER LARGE TECH COMPANIES NOT ONLY BUILDING HUGE NEW HEADQUARTER BUILDINGS, BUT ALSO MULTIPLE COMPLEXES, AS IN THE CASE OF APPLE AND AMAZON. THIS EDIFICE COMPLEX TENDS TO BREAK OUT WHEN COMPANIES ARE FLUSH WITH SUCCESS AND EXPECTATIONS ARE LIMITLESS. IT ALSO CORRESPONDS WITH UNUSUALLY HIGH STOCK VALUATIONS. INTERESTINGLY, BOTH APPLE AND AMAZON LAST YEAR ALSO BECAME THE FIRST TRILLION DOLLAR STOCK CAPITALIZATION COMPANIES IN HISTORY WHICH SUGGESTS THAT INVESTORS AGREE THAT CONTINUED SUCCESS IS ASSURED, A POSSIBLY DANGEROUS ASSUMPTION.

MAYBE THESE COMPANIES WILL BE THE EXCEPTION TO THE HEADQUARTERS INDICATOR, BUT BEWARE. EACH HAS HAD A 30 PERCENT OR MORE DECLINE SINCE MAKING ALL TIME HIGHS IN SEPTEMBER 2018 AND SINCE THEN HAVE UNDERPERFORMED THE S&P 500 BY THE GREATEST MARGIN SINCE 2012. THEY ALSO HAVE NOT BEEN LEADERSHIP STOCKS IN THE CURRENT 2019 RECOVERY TO DATE. THIS CONCERN MAY BE PREMATURE BUT THERE IS ANOTHER HISTORICAL CONTEXT WORTH KEEPING IN MIND. NAPOLEON INVADED RUSSIA IN 1812 WITH THE LARGEST MOST SUCCESSFUL ARMY EVR ASSEMBLED UP TO THAT TIME. THEY REACHED A MOSTLY DESTROYED MOSCOW LATER THAN EXPECTED AS WINTER WAS MAKING ITSELF FELT IN THE MONTH OF DECEMBER. NAPOLEON LOOKED AT HIS GREAT CONQUEST KNOWING HE FACED THE BRUTAL RUSSIAN WINTER AND DWINDLING SUPPLIES AND FAMOUSLY SAID, "ALL WAS NOT LOST UNTIL ALL HAD SUCCEEDED". SUCCESS CAN ALSO HAVE UNINTENDED CONSEQUENCES.

# THE BREAKOUT-BREAKDOWN TRAP NEW HIGHS AIN'T WHAT IT USED TO BE



LOTS OF  
TRAPS



IS THIS LONG  
TERM BREAKOUT  
ALSO A TRAP  
OR JUST A  
PULLBACK TO  
THE BREAKOUT  
POINT IN AN  
EXTENDED  
UPTREND?



# THE SHORT AND LONG OF TREASURY YIELDS

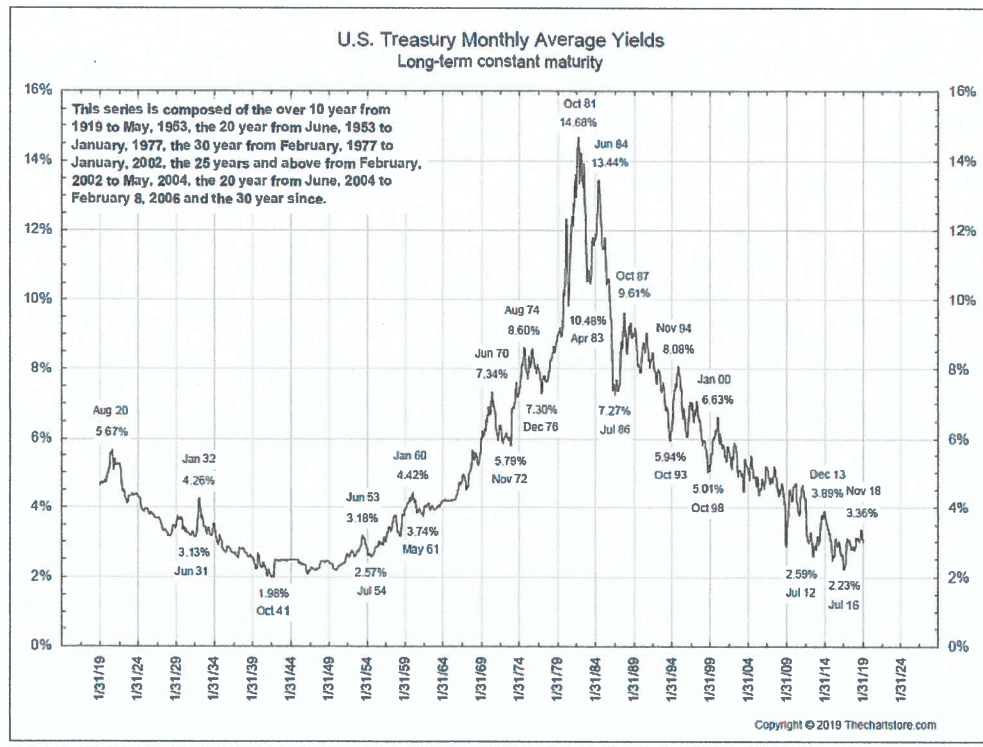
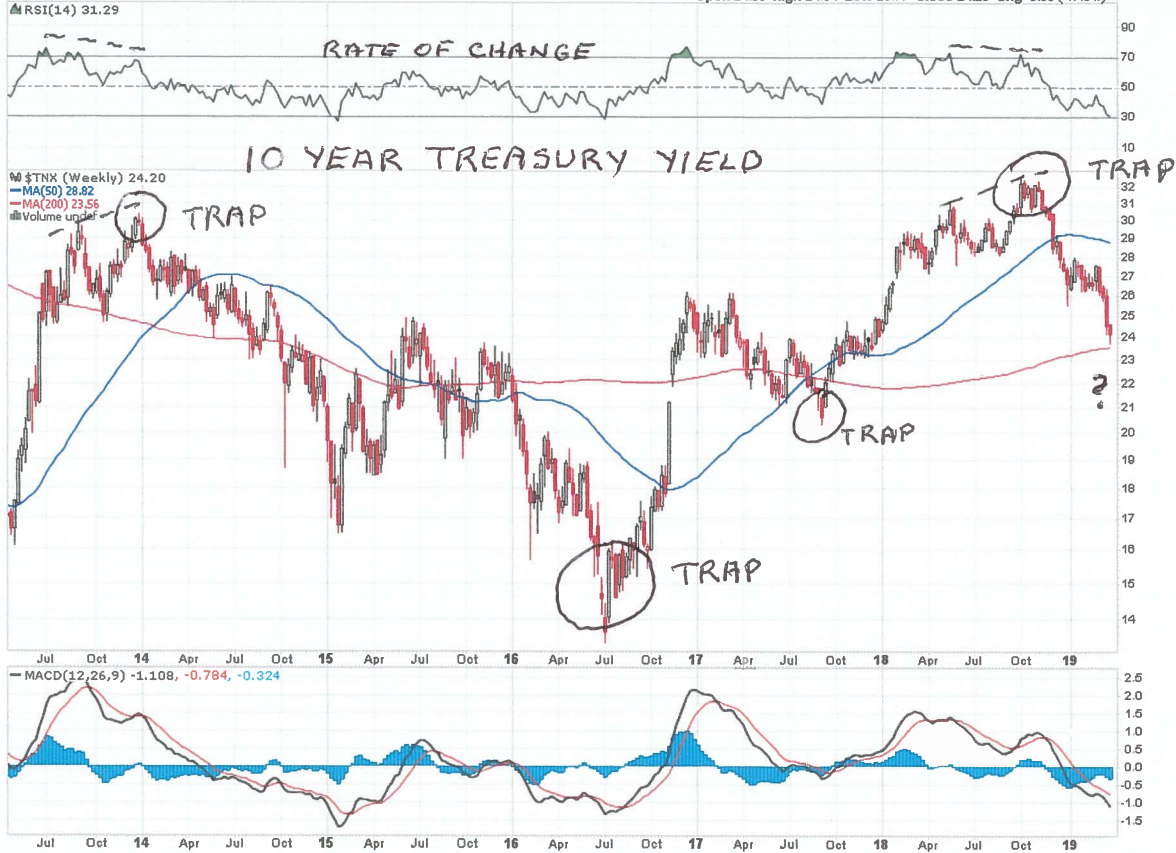
\$TNX CBOE 10-Year US Treasury Yield INDX

25-Mar-2019

RSI(14) 31.29

Open 24.60 High 24.84 Low 23.77 Close 24.20 Chg -0.35 (-1.43%)

© StockCharts.com

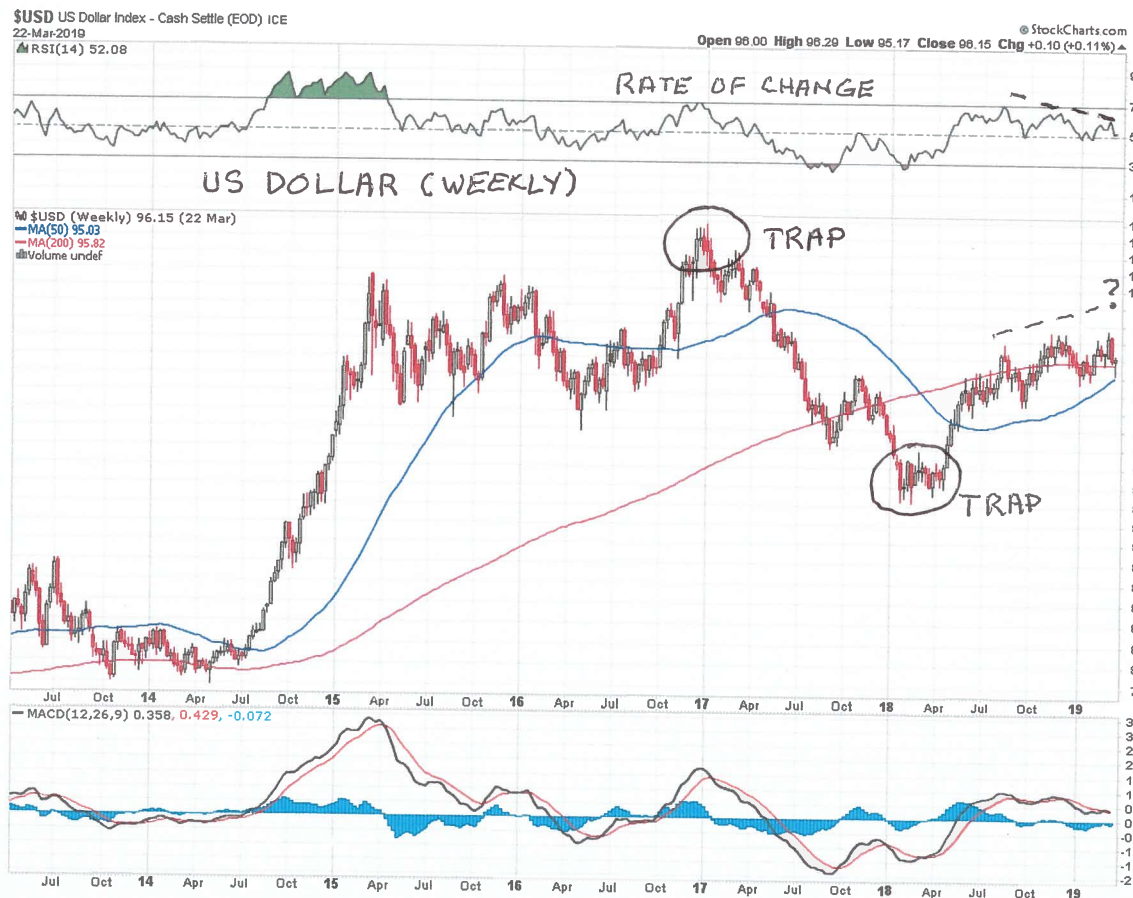
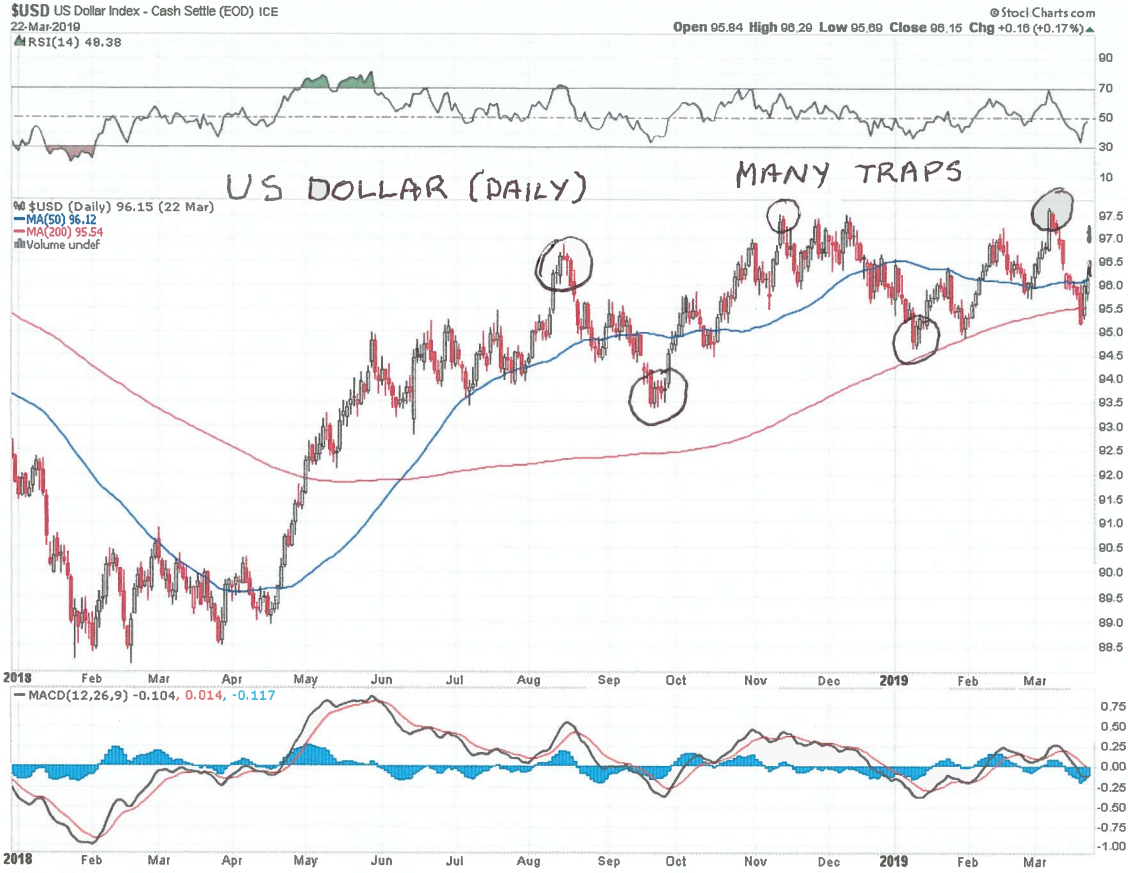


BOND YIELD CYCLES TEND TO BE LONG

THE LAST TWO HAVE BEEN 35 YEARS UP AND ABOUT 35 YEARS DOWN

A NEW BUT DRAWN OUT UP CYCLE SHOULD BE EMERGING

# THE SHORT AND LONG OF THE DOLLAR



IS A NEW  
ONE TO  
DEVELOPIN



# GOLD SETTING UP POSITIVELY LONGER TERM

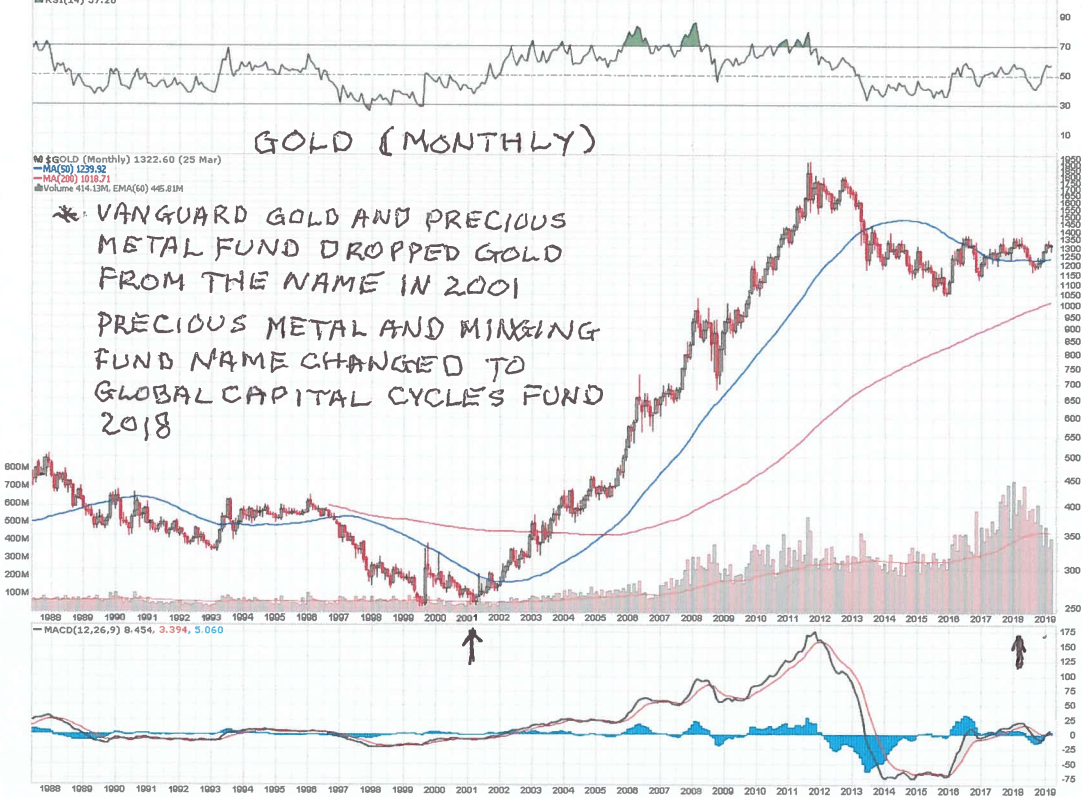
GOLD SPDR Gold Shares NYSE + BATS  
25-Mar-2019 10:20am  
RSI(14) 61.77

Open 124.50 High 125.11 Low 124.08 Last 124.24 Volume 8.2M Chg +0.27 (+0.22%)



\$GOLD Gold - Continuous Contract (EOD) CME  
25-Mar-2019  
RSI(14) 57.20

Open 1315.50 High 1324.50 Low 1280.80 Close 1322.50 Volume 414.1M Chg +6.50 (+0.49%)



\* SOURCE:  
JARED DILLIAN

## What to Expect

Expect changes in market price patterns of behavior. Don't rely on recent historical precedent as a guide to the future.

Fear and greed will still help create extremes in volatility, but machine learning and interaction will either extend or limit the extremes.

Price behavior, sentiment extremes and FRB policy will continue to influence investment profitability but likely in different ways than in the past.

Since markets tend to return to the mean over time, expect underperformance to follow periods of high returns (and visa-versa). After 10 years of higher than average returns from stocks (17.7% compared to the historical average of 9.3%) and with valuation extended, the decade ahead is likely to have below average returns. This will be disappointing for passive ETF index investors and more positive for active stock selection.

Expect sector performance to remain divergent as we experience risk-on and risk-off alternating periods, growth versus value leadership changes, large cap versus small cap cycles and alternating international and domestic preferences. Stock picking will be more important even within sectors

# FINAL FARRELL ADVISORY COMMENT

## Not Your Grandfather's Market

by

Bob Farrell

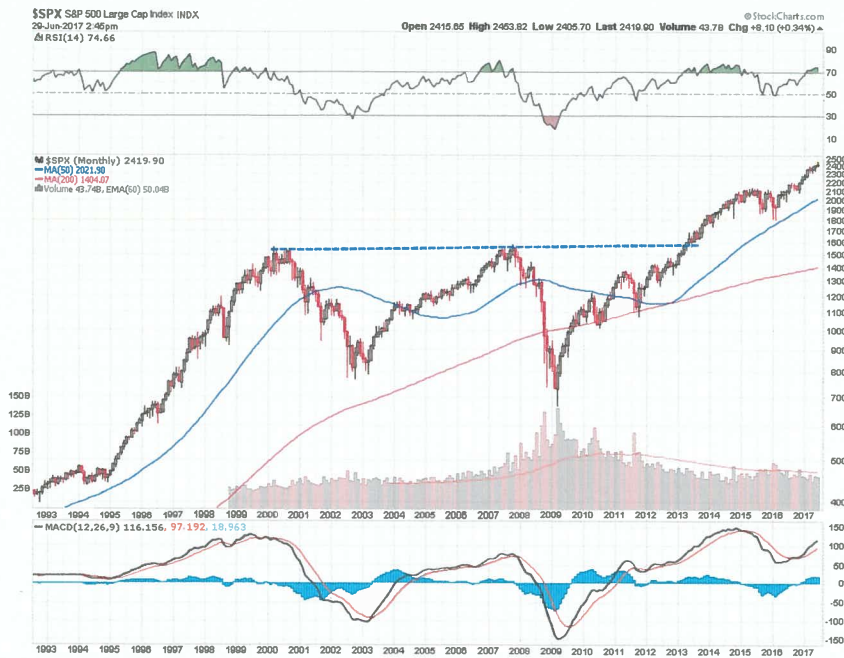
7/1/17

Debt excesses have proved to be the downfall of many bull markets. Sometimes it has been as simple as the over extension of security credit (margin debt) while at others, extreme consumer, corporate or mortgage debt levels have been triggers. From a long-term perspective, our concern today is the record level of sovereign debt and the increasing levels of other government indebtedness. The discipline necessary to reduce it or prevent it from reaching crisis proportions continues to be absent. In a world replete with anomalies arising out of grand monetary experiments such as quantitative easing by many central banks, zero interest rate policies and even negative rates, unintended negative consequences are an increasing risk.

The hope is that we and the rest of the world will grow our way out of the problem whereas the risk is that when interest rates ultimately rise, the needed growth will be hindered or turn negative. The other alternatives for coping with out of control sovereign debt are deflation leading to default or inflation leading to currency debasement. Either of these alternatives can lead to chaotic markets. This is one of the reasons we think markets will become more unstable as they are hit by periodic crises. We have felt for some time that using the market and economic guidelines based on past performance will not be as reliable as a predictor of the future as they have in the past. The world is changing and markets are changing. The long secular trends of the past may be supplanted by cyclical movements of varying duration periodically interrupted by larger than average crisis induced corrective periods. Only human emotions and psychology reflecting the extremes of fear and greed will not change. And, as much as human emotions contribute to extreme behavior of markets, machine driven quantitative decision making, which is greater than ever before, is likely to add to, rather than ameliorate extreme market behavior. 1987 and 1998 are two past examples of quantitative failures that contributed to exaggerated reactions in stocks.

This may sound heretical since we have often referred to secular and cyclical trends in stocks and bonds. Maybe this time is not different but we at least should consider that it might be. Many, using the S&P500 as a guide, have assumed that the market is in a new secular bull market since 2013 when it bettered its 2000 and 2007 peaks. (See chart.) This could be valid but we could just as well be in a series of wide cyclical movements as the Value Line Geometric index suggests. (See chart). Or we could be dealing with what Japan's stock market has faced over the past 27 years. (See chart.)





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The point is that after over eight years of rising stock markets and declining volatility, markets are contributing to a false sense of security about owning stocks (and ETFs) no matter what the valuations. The same could be said of bonds, only the rising price cycle is a far more extended 27 year. Bond holdings are still setting records despite yields at historically low levels. "Goldilocks" economic assumptions or not, the current period of low and boring volatility (the extreme opposite of 2008) will be the set-up for future much less boring volatility. The "when" is still elusive but we should be alert for change. Our approach over the years has been that it is most important to recognize when markets or stocks are reaching extremes in popularity or unpopularity, which is usually reflected in price acceleration (speculation), valuation, ownership levels and media coverage. Being too early can also be costly (as we know) but reversion to the mean is inevitable.

#### What is Different About Markets Today

- A. Decisions are increasingly being made by machines and models. Algorithmic trading, high frequency trading, the passive investing ETF surge and its attendant rebalancing all substitute machine made decision making for personal interaction and accountability. Sixty percent of volume can now be attributed to computer driven trading.
- B. The ETF binge is changing the investment landscape. Who needs security analysts to do research when you can buy a sector with low transaction costs instead. Why buy a single stock when you can invest in a sector? Lots of reasons.
  - a. You buy a lot of companies you otherwise would not touch when you buy an ETF.
  - b. Most sector ETFs are heavily weighted by 5-10 large cap stocks.
  - c. Research is being downgraded in favor of robo investing.
  - d. Investors admit that they do not read through long research reports anyway.
  - e. Then there is the increased dependence on quant models that we consider substitutes for thinking. When quantitative models have failed in the past (1987, 1998), the result has been accelerated forced selling and disorderly markets.
- C. Sector analysis has become more popular than treating the market as a homogenous unit and investing in the broad indexes. Non-correlated markets are not new but the lack of correlation among sectors has grown more extreme at the same time volatility in the major indexes has fallen to record lows. This is beginning to favor stock picking over most passive investing approaches.

- D. Recent studies reveal more than half of all publicly traded companies in the U.S. have become unavailable since the 1997 peak of 7355 stocks. The bulk of the decline to 3600 stocks publically available at the end of 2016 came from shrinkage in small and micro cap stocks. These small often faster growing companies are staying private for a variety of reasons but are also not included in most passive portfolios. Some have conjectured that with only half as many stocks listed today, historical return influences may no longer be valid.
- E. Robo investing is also influencing the charts of stock prices that many investors use as part of their decision making process. We are noticing more anomalies such as more frequent obvious breakout or breakdown failures and pattern recognition traps.

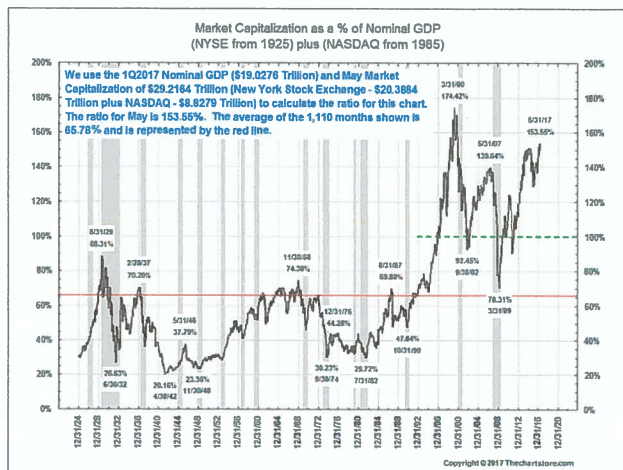
None of this changes the long-term trends in stocks but is likely to alter the average investor's chances of long-term success. More mechanical investing together with less attention to research and less reliability of past precedent are impediments that are likely to lessen returns and increase risks.

#### Other Observations

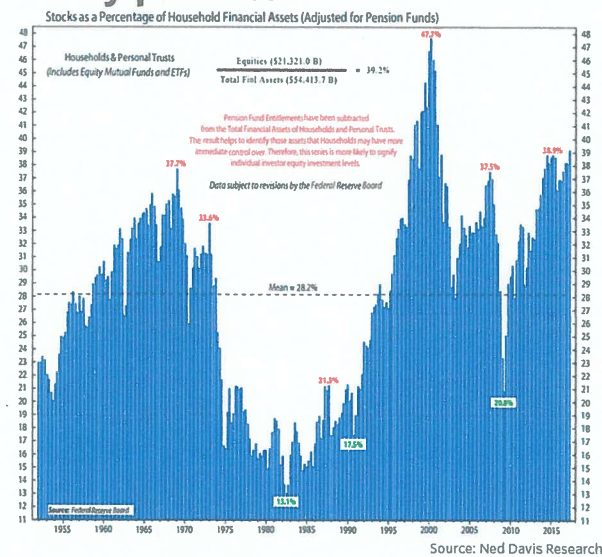
As indicated, the cyclical bull market that has arisen from the March 2009 lows has been supported by FRB policy (QE and ZIRP), record stock buy backs, the huge growth in passive investing (ETFs) and the U.S. market doing better than most foreign markets (large foreign buying to U.S. securities). This is all changing. The FRB is moving to sell off its QE bond portfolio and raising rates. There are also hints that the European central banks are about to become less accommodative. Buy backs have been receding starting in the second quarter of last year. ETF demand may be peaking as active managers performance continues to improve this year. Now foreign markets are outperforming U.S. stocks as the dollar weakens. This is a shifting tide at a time of high valuations and rising ownership levels meaning it will be up to the economy bulls to keep it going. On this point, it is well to keep in mind that markets anticipate economic downturns rather than wait for the monetary authorities to announce one has arrived.

Value and ownership levels are not a timing tool but there is evidence we are at extreme levels. Market cap as a percent of GDP has gone from 70 percent to 154 percent since 2009. This is a high since 2000 when it reached 174 percent in the dot.com boom. Stocks as a percent of household financial assets are up to 39 percent, which is higher than 1968, 1972, 2007 and 2014. The only time it has been higher was in 2000. (See charts).

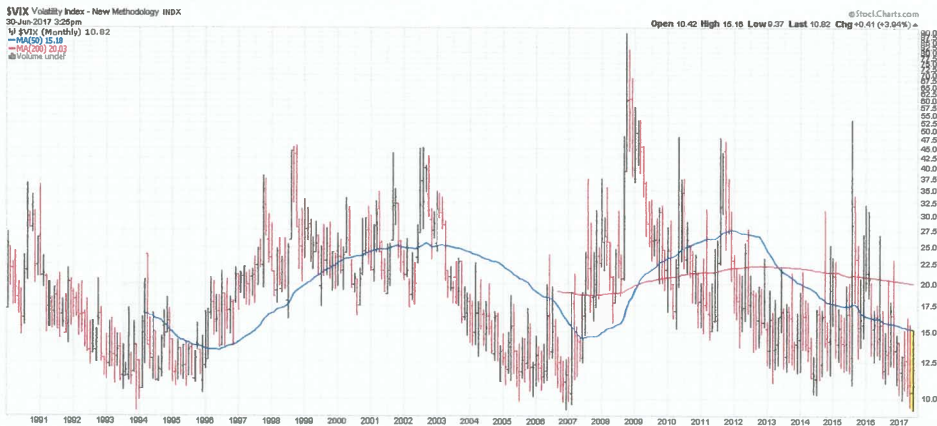




## Scary parallels



Peak volatility in 2008-2009 was the highest in 27 years of VIX option volatility history. Now, almost nine years later, it is at the opposite extreme, the lowest since 1993. (See chart). Mean reversion should be considered.



Professional bullish sentiment about the “Goldilocks” economy and expected highs for stock prices has been hovering around historical extremes. Some recent examples: Janet Yellen suggesting that there may be no new financial crises in our lifetime and Yale professor Robert Shiller indicating that the stock market could go up another 50 percent. Stock price objectives are being raised with each new high in the averages. The boom in passive investing is also a sign of bullishness as a commitment to stocks for the long term. Such optimism is not necessarily fatal but is a reminder of growing risks.

We also look at how many legs make a mature bull market. We are in the third leg up since 2009 with two correction legs in 2011 and 2015-2016. The rise this year is also the fifth leg or third leg up since the 2015-2016 oversold low. Being in the fifth of the fifth does not mean there cannot be additional legs (as even Elliott allows), but at least suggests a corrective leg is overdue and is a reminder of the bull market’s maturity.

This cautionary tale is not meant to imply we face only a bleak future. Everything in its time. Some point out we have yet to have excessive speculative activity in the market. We could still see a wild ending but some bull markets die without such episodes. These are usually cyclical rather than secular peaks. Secular endings such as 1929, 1968-1972 and 1999-2000 have all had very speculative final stages. At present, we have some hints of rising animal spirits in the Bitcoin market and in the romance of the FANGs but it is still more narrow than inclusive. Since breadth is still making new highs and usually leads at peaks, there may, nevertheless, be room for a final run for the roses. Considering the sector rotation between growth and value, large cap and small a rolling sequential top looks more likely. Keep in mind that the currently resurging financials typically peak before a market cycle turns down and energy often has been the last to rally into a cycle ending.

#### Is Intuitive decision-making dead?

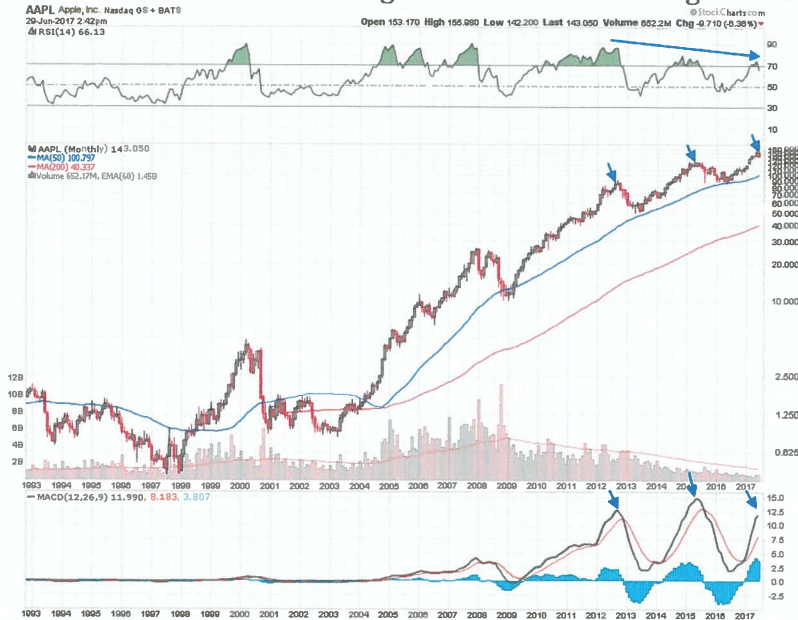
When we first set foot in the Wall Street milieu in the 1950s, quantitative (left brain) skills were much more developed and sought after than intuitive (right brain) skills. We decided that that meant an opportunity for those developing their intuitive or people skills in analyzing markets and stocks. That awareness resulted in our emphasis on market psychology (sentiment as we named it) and going contrary to the crowd to gage the health of markets. With the “robo” markets of today dominated by quantitative and algorithmic decision-making more than ever before, it would be easy to conclude intuitive decision-making is dead. Our view, however, is the opposite. When everybody is depending increasingly on the machines, intuitive common sense contrarily will become more, not less useful. To illustrate, we have included a long-term monthly chart of Apple along with our mostly intuitive reasons for considering it a sale in growth portfolios. Time will tell if the reasoning is correct. (See below).

Meanwhile, as we close these efforts to make sense out of increasingly complex markets, we are going to resist commenting on the short-term outlook. The setup for a correction has not changed. Among the things we have learned is that the shorter your time horizon, the less predictable markets have become. A market seemingly without a day-to-day memory; with “robo” footprints on the price charts; with precedent losing its usefulness; with politics often overshadowing economics; and with increasingly rapid technological change contributing to

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major disruptions in the world as we know it, there is plenty of reason to stay simple and concentrate on underlying long term themes.

1. Find the best companies according to your requirements rather than join the ETF crowd.
2. Stay with your investment style even when it is out of favor for a time rather than switch to the style de jour.
3. Don't abandon market timing because markets have gone one way for 8-9 years.



Apple is the largest cap stock in the world despite reducing shares by 21% since the 2013 peak .

Apple is being touted to be the first \$1 trillion stock (excessive optimism)

Apple has just moved into a lavish new \$5 billion headquarters campus. (corporate hubris).

Apple lost its creative genius Steve Jobs in October 2011.

Apple is now piloted by Tim Cook who seems more concerned with social issues than with creativity.

Apple started to lose momentum as a stock right after being added to the DJIA in March 2015.

Apple is also losing momentum long term and is approaching an overbought peak.

Apple is selling at a 17 times P/E and with \$260 billion in cash abroad is becoming a value stock.

Thanks again for your friendship and support over these past 15 years and longer if you remember our Merrill Lynch offerings.

HAPPY INDEPENDENCE DAY

Charts courtesy of Stockcharts.com