RAYMOND JAMES

Investment Strategy
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Jeffrey D. Saut, Chief Investment Strategist, (727) 567-2644, Jeffrey.Saut@RaymondJames.com

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Investment Strategy

"Merrill Memo"

"We think you should know that, with few exceptions, all the larger companies financed by us today have no funded debt. This situation is not the result of luck but of carefully considered plans on the part of the management and ourselves to place these companies in an impregnable position. The advice we have given important corporations can be followed to advantage by all classes of investors. We do not urge that you sell securities indiscriminately, but we do advise in no uncertain terms that you take advantage of present high prices and put your financial house in order."

. . . Charles Merrill, founder of Merrill Lynch, March 31, 1928

Charles Merrill issued the aforementioned memo to clients on March 31, 1928. At the end of the first quarter in 1928 the D-J Industrial Average was around 240. It subsequently rose to a September 3, 1929 peak of 381.17, which was the price peak for the Industrials that would not be surpassed until 1954, not that we are predicting anything like that here. As Charles Merrill found out back then, calling stock market "tops" in the 1920s bull market, even in a cautious , warning manner, was a hazardous occupation (just like it was with our "top calls" with the Dow Theory sell signals of September 23, 1999 and November 21, 2007). Especially when the roaring Twenties buy-the–dips strategy continued to be successful with investors thoroughly conditioned to buy and hold stocks for the long term and to ignore market fluctuations (sound familiar?).

A case in point in the conditioning process was the December 1928 price breakdown from 296 to 258. The Industrials suffered nearly a 13% correction in just eight trading sessions. Imagine, a 13% dive in just eight trading days! But the market came right back, made new highs again, and rewarded once more those who bought the dips. Indeed, it went on up, overcoming other subsequent dips until it was some 48% higher at the 1929 parabolic peak. Along the way even the biggest bears, and the most determined Doubting Thomases, became bull believers. Virtually everyone grew greedy, fearless, and conditioned to believe that even a sharp market decline was always followed by not only a recovery rally back to the old highs, but to significantly higher highs!

The Great Crash commenced on September 3, 1929 at ~381. By November 13, 1929 the Industrials had collapsed to ~198, a devastating dive of 48% in just over two months. Many speculators were immediately blown out of the market by margin calls. Still, most held on to their stocks, not willing to take such a huge loss, continuing to hope the market would come back yet again. After the Crash, the buy-the-dips crowd was mostly professionals, and the Dow did come back from the November 13th low to 294 by April 17, 1930, but the average stock never really recovered along with the flight-to-quality blue chip Dow. Instead, the bear market resumed. The dreadful fooler was how low the market was ultimately fated to go – down, down, down – to the shocking low of 41.22 on July 8, 1932 with the Dow yielding an astounding 10.3%.

Even veteran Wall Streeters like Benjamin Graham were shocked by their losses. Verily, it was said more money was lost by the buy-the-dip bottom pickers and professionals after the Crash than during it. The pruned public for the most part were said to have sat with their losses all the way down, and didn't really start selling out to salvage what they could until 1935, when the market finally began to rally again. No longer believing in the long term after the horrific bear market, the post-Crash crowd virtually shunned stocks as the Depression wore on and World War II loomed. Moreover, when they did buy equities thereafter, they bought them primarily for yield. Sure, they hoped that their stocks would go up, but no longer greedy and fearlessly like the Roaring Twenties, yield was the first priority. Even as late as 1949, when the post WWII great bull market began, the Dow was still yielding 5%, while bonds were returning only 2.7%. Investors had learned painfully that stocks were inherently riskier than bonds. No longer did they scoff at yield and buy stocks solely in anticipation they would go up, that a greater fool would always buy higher from them as they did during the manic phase of the late 1920s, when Charles Merrill and every Babson-like-bear was discredited, when Charles Dow's advice given at the turn of the century was:

"There is always a disposition in people's minds to think that existing conditions will be permanent . . . when prices are up and the country is prosperous, it is always said that while preceding booms have not lasted, there are circumstances connected with this one which makes it unlike its predecessors and gives assurances of permanency. The one fact pertaining to all conditions is that they will change."

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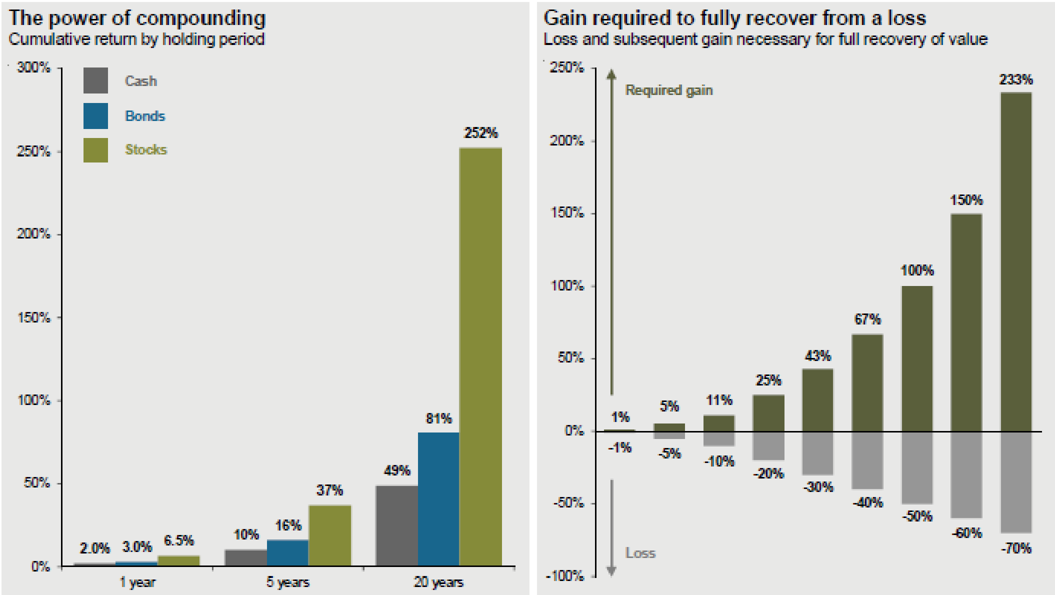
To put it simply, as yet another discredited bear recently said, "You always forget how hot it gets in the summer and how cold it gets in the winter!"

Now we are not saying the current market environment is going to end up like the 1920s, but we do want you to note on a short-term trading basis the momentum monkeys, the buy-the-dips, yield ignoring, always-recovering-to higher-highs, greed-over-fear characteristics continue to suggest caution in the short run. That is consistent with our intermediate-term model that flipped negative in August. More recently there have been other cautionary readings from the Hindenburg Omen and the Titanic Syndrome. Both of those technical indicators have registered sell signals. The first did so last Tuesday (11/14/17) and the second on Wednesday (11/8/17).

Clearly we continue to believe that nobody can consistently "time" the stock market. But, if you listen to the message of the market you can certainly decide whether you should be playing the markets "hard," or not so hard. Indeed, as Benjamin Graham wrote, "The essence of investment management is the management of risks, not the management of returns." To be sure, the concept of "limiting losses" is one of the traits successful investors possess. The importance of staying invested and limiting losses can be seen in the attendant chart (see page 3). Studying the chart, one should think about the fact that the S&P 500 recently broke the record for the longest streak of days without having a 3% pullback. Accordingly, investors and financial advisors are somewhat skittish about committing capital to equities currently. To this point, we met with Cougar Global Investment's portfolio managers, namely Abe Sheikh and Susanne Alexander, last week. Cougar Global is a wholly owned affiliate of Raymond James and has a unique definition of risk, based on the probability of losing money rather than volatility (post Modern Portfolio Theory). They are a global tactical asset allocator with a macroeconomic-driven investment process. We liked their investment model because it tends to be risk adverse. You can see their investment philosophy and portfolios here.

The call for this week: As one savvy seer said a long time ago, "Only fools and liars buy at exact bottoms and sell at exact tops!" So you have to develop a staying-alive, staying-liquid philosophy on Wall Street. Allow yourself to be wrong with your opinion, but don't allow yourself to stay wrong with your money. Manifestly, despite our near/intermediate-term caution we have still been able to find a number of stocks to buy within the Raymond James research universe. We continue to invest and trade accordingly. This morning at 5:00 a.m. the S&P futures are flat (-1.75) despite the bad news out of Germany and China. There is a triple bottom at 2566 and last Wednesday's low of 2557 is important support, while the October low of 2544 is critical support.

Chart 1



Source: J.P. Morgan Asset Management.
*Asset class growth rates are based on synthetic returns using J.P. Morgan's Long Term Capital Markets Assumptions; projected Bond return is based on assumption for U.S. aggregate bonds; projected Stock return is based on an approximation of the average return assumption among small, medium and large cap U.S. stocks.
Guide to the Markets – U.S. Data are as of September 30, 2017.

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Asset Management

J.P. Morgan Asset Management – Risks & disclosures

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Prepared by: Samantha M. Azzarello, Gabriela D. Santos, Alexander W. Dryden, David M. Lebovitz, Abigail D. Yoder, John C. Manley, Jordan K. Jackson, Tyler J. Voigt and David P. Kelly.

Unless otherwise stated, all data are as of September 30, 2017 or most recently available.

Guide to the Markets – U.S.

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* Columns may not add to 100% due to rounding.

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