"Some love is just a lie of the heart The cold remains of what began with a passionate start And they may not want it to end But it will it's just a question of when I've lived long enough to have learned The closer you get to the fire the more you get burned But that won't happen to us Cause it's always been a matter of trust." - Billy Joel, Matter of Trust

---

Why have stocks gotten out to such a strong start in 2018? *(For that matter, why have equities advanced so smartly -- and in an almost uninterrupted manner -- for the last nine months?)* In markets as in life and in Billy Joel songs... it's always just a matter of trust. But optimism (in economic and profit growth) and trust (in policy) only goes so far. Investment vision (and wisdom), as *The Oracle of Omaha* has said, is always 20/20 when seen in the rear view mirror. As I have written, structural changes and the reduced supply of equities have been important contributing factors to the market's near uninterrupted advance in 2017-18.

> *"For many, it will be increasingly difficult to navigate a market dominated by the overly popular ETFs and quant (volatility-trending and risk-parity) strategies that worship at the altar of price momentum. It is also because the "buy the dip" mentality remains indelibly etched on the forehead of most investors and traders that the Pavlovian reaction won't die easily. Favoring the bulls is the diminished number of publicly held companies outstanding (from more than 7,600 in 2000 to 3,800 in 2017), a 17% reduction in the float of the remaining companies via corporate buybacks, and still-abundant liquidity. And on top of this, as previously mentioned, is the market's participants confidence in buying the dips."* - Kass Diary, *The Bull Wont Die Easily* *(November, 2017)*

These words were underscored in Jim "El Capitan" Cramer's "Four Reasons Stocks Keep Going Up" written in early January, 2018 -- in which he discusses the important structural changes that have led to the popularity of passive investing (ETFs) and in the share count drop caused by a near decade of aggressive corporate buybacks. Of course there are numerous other reasons (some Jim details further) like the employment of large liquidity infusions from central bankers around the world, optimism about the cut in corporate taxes, the reductions of business regulations (around the fringe), sustained lower interest rates, etc. But why have we witnessed a combustible rise in stock prices over the first three weeks of 2018? From my perch, the **reduced supply** of stocks (discussed above) when combined with still plentiful central bank liquidity and a recently enacted tax bill have been fueled by trust -- and the following record and **expanded demand** fueled by a massive inflow (of over $55 billion) into domestic equity funds**.** Moreover, and this is important, the reduced supply of equities and the expanded demand (inflows) has occurred in a backdrop of a much lower level of overall trading activity over the last six months (and into early 2018) -- an observation I have not seen from Wall Street's sell side. In other words:

> ** The supply of equities has been reduced because of a lower number of shares available due to a diminished supply of publicly traded stocks (halved in the last decade), the impact of buybacks (on the remaining companies), etc. * The demand for equities is rising as expanding confidence has translated into record inflows into domestic equity funds in January. * Aggregate trading volume has been recently trending markedly lower - exacerbating the aforementioned favorable supply and demand equation.*

These past observations don't really help us project the future -- though I did touch on some of my concerns in a missive during the first week of this year, *"Blinded By a Sense of History"* (with some updates in parentheses):

> ***"It is a mania shared by philosophers of all ages to deny what exists and to explain what does not exist."*** *-- Jean-Jacques Rousseau*

I have no clue how long it will continue:

> ** What I am certain about is that liquidity, which has buoyed our markets for years, is starting to be reduced. (Central Bankers are reversing course and beginning to contract their balance sheets) * What I am fairly certain about is that we are at sentiment and valuation extremes -- at least based on history. (And every day these measures grow more stretched) * Interest rates are likely headed higher, posing -- at some point -- a potential risk and alternative to stocks. (The ten year US note yield touched 2.65% this morning) * I expect no further major legislative initiatives coming out of Washington, D.C. -- specifically on the infrastructure front -- and a further deterioration in the relationship between the Republicans and Democrats as we move toward key midterm elections. (My expectation is that the House goes Democrat while the Senate stays Republican.) * As to the Administration, their belief appears to be that the benefit of*

*world leadership is not worth the costs -- which runs the risk of a policy mistake in the year ahead. * As well, though markets have not been yet unnerved even with the White House having gotten bitten by a Wolff this past week, there exists the possibility that the Special Counsel's activities could be market unfriendly. * And I am of the view that the earnings and economic growth expectations will, once again, be disappointing in 2018-19. (Earnings revisions higher have been material -- in large measure from tax cuts -- but I see mid-year as a pivot point of slowing, not accelerating growth).*

The markets seem to be moving back to being one with more concentrated leadership -- as technology and the FAANGs (a large percent of the S&P Index) have regained their strength. Small caps, supposed tax cut beneficiaries, are lagging. Again, historically these are not positive signposts but it can continue, I have learned, far longer than I anticipated.

The speculation in cryptocurrencies and blockchain and penny stocks is yet another thin reed indicator of a mature Bull. And so is the self confidence and hubris seen in the business media. Risk assets, like stocks, are called risk assets because they have risk -- though you wouldn't know it from the recent action in which fear and doubt has left the Exchanges.

... I see few longs that meet my standards of purchase.