OCTOBER 2018

HOUSEHOLD STOCK OWNERSHIP: WHAT CAN IT TELL US?

Stock investors are always casting about for clues to help them judge the attractiveness of the market in the context of the current stage of the business cycle. The business cycle is the path of our economic progress. Its future direction is derived from what has happened in the past. For instance, falling unemployment or corporate tax cuts can impact the future shape of the business cycle trend line in an upward fashion. Since it is better to own stocks during business expansions, can we gage the maturity of a business cycle by observing US households' stock ownership? Part of the evidence can be found in measuring how forcefully households are expressing themselves in their percentage allocation to stocks. There seems to be a relationship between the optimism of households and the high point of the business cycle.

Without trying to tabulate the hundreds of factors that give households confidence to buy stocks, what we find is that households in 2000 and 2007 had their highest allocation to equities since the early 1970s. Many remember the bear markets of 1973-74 as well as 2000 and 2008. The congruence of high household stock allocations prior to a market top and prior to recession seems worth our attention.

The middle panel of the chart below displays the household percentage allocation to stocks. In the current phase of our business cycle, stocks have generally been moving higher since 2009. As investors we want to know when the stock market has fully expressed the expansion phase so that we can reposition portfolios for the down cycle of the economy. Past peaks of household stock ownership have been valid warning signals for timing the business cycle and for insights to future stock market returns. The chart demonstrates that when stock ownership is in the upper range (highest 20%), the total average returns for stocks in the ensuing 10 years has been 3.9%, compared to forward returns of 16% when ownership was in the bottom 20% (see close up box in the bottom left).

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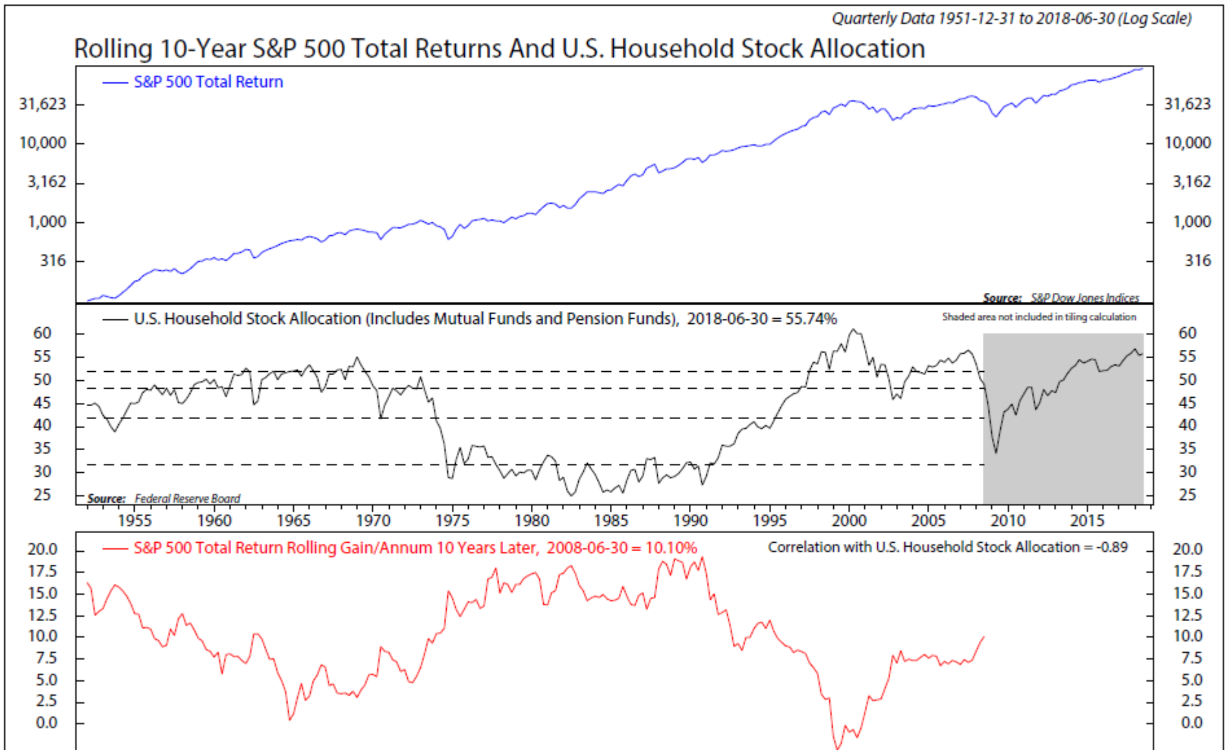

Stock Allocation Quintile	Average Stock Allocation	Low GPA% 10 Years Later	High GPA% 10 Years Later	Average GPA% 10 Years Later
Highest 20%	54.63	-3.03	8.43	3.98
2nd Highest 20%	50.26	0.42	10.87	6.90
3rd Highest 20%	46.07	5.46	16.35	10.18
4th Highest 20%	36.18	8.48	18.13	13.19
Lowest 20%	28.86	13.68	19.36	16.38

Middle Clip: The U.S. household equity allocation as a percent of total equites, bonds, and cash (% invested position).

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The connection between household equity sentiment (high optimism), stock prices and the phase of the business cycle seems more than casual. While most indicators of the economy show current strength, we know in past cycles that stock prices reflected strength before economic and financial conditions began to turn. The Federal Reserve is raising interest rates while Congress has enacted fiscal stimulus (tax cuts). Which will be the more potent factor? Our judgement is that when rates are below potential economic growth, but rising, economic activity should not be under threat. However, when rates rise above potential growth, the economy will face headwinds and recession protection becomes increasingly important. The evidence of historically high household stock exposure suggests that a tipping point will be reached when fading stimulus meets peak employment and output. The contraction phase will mean that for future stock returns to be attractive, stocks will need to become cheaper first.

Investment Implications:

The household allocation to stocks is not a traffic light with an immediate signal to action. It is important to remember that stock market gains can be robust towards the last part of a cycle and de-risking should not happen too soon. The Federal Reserve will be minding wage inflation acceleration in setting monetary policy. History does not present any examples where the Fed has succeeded in returning the unemployment level to normal from high levels of unemployment without a recession ensuing. The post-crisis monetary policy known as quantitative easing has never had practice in exiting. With most stock investors at full allocations to stocks, there is no strong buying power in reserve. The water is moving more swiftly, but we cannot yet hear the sound of the falls. There is still time to plan for a more defensive portfolio, but we have been warned.

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