The Investment Letter

Volume 89, No. 11 November 2018

Stock Market Continues to Climb the "Wall of Worry"

The news media tell us that the world is ending. Headlines announce that, in October, US stocks suffered their worst monthly loss in seven years. The nightly news leads with a story that tech stocks fared even worse, posting their worst month since 2008. That news certainly gets our attention.

Are we seeing the last days of an aging bull market? Is this just an aberration? Just how bad (or how good) are things?

In September, markets made great strides in calming investors' fears about a waning bull market, even posting some record highs. Then October came, and, with it, volatility. The S&P 500 did sink some 7% from its all-time high in September.

Volatility is normal in financial markets. In the 73 years since the end of World War II, S&P 500 stocks have posted negative returns 15 of those years, or more than one of every five. Our current bull market has been abnormally quiet and the S&P 500 has been up each year since 2008. Even this year, amidst all this volatility, the market is still up year-to-date. It's up 7.5% from just one year ago, and more than 60% over the past five.

Data, when viewed annually, tends to have a smoothing effect – helping us see the larger forest despite the individual trees. When viewed monthly, S&P 500 stocks have had off-months – defined as posting a drop of 5% or more – during 34 of the 73 years since 1945, or nearly half of those years. That seems to suggest that, in the last five years, we should have experienced two such drops.

In fact, only once – in August 2015 – when the S&P 500 dropped 6%. The index quickly recovered, however, and in October 2015, the S&P 500 posted a better-than-8% gain. This bull market has been remarkably void of typical volatility.

So, when volatility returns, why does it cause so much concern?

There are factors afoot deserving our analysis and discussion as we live through the longest post-WWII bull market:

Trade War Concerns – Certainly, some market volatility can be traced to trade war concerns. On the day following President Trump's tweet that talks with Chinese leader Xi Jinping were "moving along nicely", Hong Kong's Hang Seng Index gained 4.2% while China's Shanghai Composite and Japan's Nikkei each gained more than 2.5%.

While some details of those talks have emerged, Trump asking cabinet members to draft a trade deal for this month's G20 leaders' summit, there still isn't a lot of fodder for exactly how the US and China will resolve recent trade disputes. This progress came just days after the US banned its companies from exporting parts and software to a Chinese maker of computer chips. To date this year, the US has implemented tariffs totaling some $250 billion on Chinese exports while China has responded with $110 billion in its own tariffs. Meanwhile, the US financial markets watch, fearing the effects of the tariffs on companies, industries, and the bull market in general.

Rising interest rates – The Fed has raised US interest rates eight times since December 2015, from their all-time low of 0.25% to today's 2.25%. These increases do affect financial market performance, the overall economy, and the mechanics of their underlying companies. Rising interest rates rein in consumer spending, slow business growth, and also play a role in currency valuations. They also protect the economy from excessive inflation.

Generally speaking, interest rates express the cost of money. When interest rates change, investors reevaluate which investment vehicle provides the best return for the risk they assume. Current interest rates control the returns on bonds and CDs; and impact stock prices at a macroeconomic level, but also at the micro-company level, since interest rates influence corporate spending, and thus returns, which go on to influence the price of equities.

Midterm Election Results – Midterm election results have seldom garnered as much interest as this year's elections did. US markets expected Republicans to keep the Senate and Democrats to gain control of the House. Investors fretted that this could mean increasing uncertainty about the impact that policy changes may have on the financial markets, economy, and the country itself.

Cuts in Corporate Earnings Forecasts – While companies in the S&P 500 generally reported strong earnings for Q3, a large number of companies cut earnings forecasts for future quarters, generating pessimism in the media, and in the market.

But, every silver lining has its cloud.

Naysayers will find faults in every bull market. And for every fault, there's a reason why it does or does not matter. Even people "in the know" sometimes get it wrong. In February 2016, CNN Business surveyed top investment strategists, who indicated that there was a 50/50 chance that the bull market would turn bear that year. And MarketWatch, a subsidiary of Dow Jones & Company, published a 2014 article titled "4 Signs this Bull Market is on its Last Legs". Obviously, the bull market persisted and the economy kept roaring on.

Why do we embrace the negative?

With panic stories, the media most effectively wrest our attention away from competitors like sports, TV shows, and games. Whether it's caravans of migrants coming north through Mexico, trade war fears, Brexit, oil spills, potential epidemics, or financial reform initiatives, the media have a vested interest in creating division among us. Panic stories generate clicks, likes, shares, and drive traffic to their publications and sites, thereby generating ad revenue and, secondly, subscriptions.

Stories about clear skies and smooth seas under the warm sun of a rosy economy will never garner as much interest as stories of doom, lurking around that proverbial next corner. While the media have been predicting the end of the bull market since its very beginning, the real story is that we have been enjoying and continuing to enjoy better-than-historic-average returns and stability. The US economy is doing well. Unemployment is contained at 3.9%, a 49-year low, and the US economy added 250,000 jobs in October.

You'll never hear this as the overriding message from the news media. No one buys a novel that is without conflict or struggle. The message that everything is fine has never sold newspapers or made people tune into the news. ■

Investment Counsel News

Inside the Office

May the good things of life be yours in abundance not only at Thanksgiving but throughout the coming year.

Happy Thanksgiving!

Outside the Office

Abby & Casey enjoyed a week-end at Grandma Dorothy's house. Pictured here is their mother Andrea, ready to take them home.

Investment Counsel's investment strategies, like all investment strategies, involve risk of loss.
Past performance is not indicative of future results.