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Market Commentary
Fall 2018

We find ourselves in that seasonal time of year when people get spooked by surprises, gripped by uncertainty, and paralyzed by fear. In addition to this, it's Halloween! This quarter we also find ourselves a bit overdue with our commentary. However, in our defense, and given market conditions in October, we waited a bit as we find it easier to predict the future after it passes.

Through October 29th, the month of October is set to be the worst performing month since February 2009, one month before the market bottom of the Great Recession. The S&P 500 and Dow Jones are down 9% and 7%, respectively. Small caps have fallen 12% and are down over 15% since its peak in September; mid cap stocks are down 11% for the month, and over 13% from its peak. The tech heavy Nasdaq 100 and international markets are both down 10%. Despite these drops, the Dow and S&P are back to lows since just early July and May, respectively. In other words, if you are a little worried about the market, just presume it went sideways for six months!

This is not 2008. There are no underlying systemic risks to the market. In our opinion, the markets are pricing in investors' concerns of a slowing economy driven in part by the trade war and the Federal Reserve's rate hike plan. The market's response has been amplified by program selling and exchange traded fund (ETF) liquidations (there are more ETFs than individual stocks). Program selling can result in a snowball effect, as we have seen in the past. Algorithmic trading kicks in based on weakness, and weakness begets more algorithmic trading. Sound familiar? It seems like every correction since 1987 has experienced this. On top of that, twenty years ago, when an investor was nervous, one would sell individual stocks. Now, when one sells an ETF, the underlying holdings are sold and can result in the sale of hundreds or thousands of positions. The down draft in stock prices is worse the deeper you look. While the S&P 500 is not in a bear market, as defined by a 20% drop from a peak, 40% of the S&P constituents are. In fact, the average stock is down just over 20% from its peak as of October 25th. But, are economic fundamentals really that bad?

We are in disbelief at the negative stock price reactions to such strong earnings numbers. According to FactSet, nearly one-half of S&P 500 companies have reported third quarter earnings with a blended growth rate of 22.5% over the prior year, on track for the best performance in 8 years. Yet, the stock price reaction is the worst in 7 years. Investors' most pressing concern is an economic slowdown due to a variety of factors including cost pressures (labor and material), trade issues, higher interest rates and the upcoming election, which is just days away. Yes, the market is a forward looking machine, but how far out is it looking? In addition to strong earnings growth, gross domestic product (GDP) hit 3.5% in the third quarter after a 4.2% increase in the second quarter. We are somewhat surprised by analysts citing a slowing of earnings growth from 2018 to 2019 from over 20% to 10%. This is because one-half of the growth in 2018 was due to the tax cuts that took effect this year. For one to cite concerns about earnings per share growth being cut in half is naïve.

This is no time to panic. So far, most of the declines in the market represent gains given up during the year. Earnings are up over 20% and the market is down. The price earnings multiple of the market has compressed almost two full turns. This is an opportunity. The market is now trading at a discount to its historical valuation. Even some of the FAANG stocks (Facebook, Apple, Amazon, Netflix, Google) are cheap. Facebook is trading at the lowest P/E it has

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ever traded at. Google is trading at 22x 2019 earnings, a 10% discount to its historical valuation. We saw a great line in Barron's a couple of weeks ago, and we echo it; "You've never been rewarded for selling fear." The market direction may be difficult to gauge on a day to day basis, but not as hard when looking beyond a quarter or two.

Interest Rates

One of the biggest culprits to the market is the fear of higher interest rates. In fact, one could argue the market correction started when Federal Reserve Chairman Jerome Powell stated on October 3 that the Fed was set to raise rates in December, and four more times in 2019. This is a different stance than the one taken by former Chairwoman Janet Yellen, where decisions by the Fed were much more data dependent. The US 10-year yield closed at 3.05% on the day before Chairman Powell spoke, rose to 3.26% in early October, and now has settled back to 3.11%. Even so, while the market does not like higher interest rates, Chairman Powell stated his expectation of a slow, gradual increase in rates. So, perhaps it is an overreaction by the market to send yields to new highs for the year following his comments. We believe the Fed will reverse course on the stance promulgated on October 3rd. It may have already happened had President Trump not been so openly critical of Chairman Powell leaving the chairman careful to not appear as being "strong-armed" by the administration. A change by the Fed in its perspective would be a positive catalyst for the market.

Trade

The trade "war" between China and the US also weighs heavily in the minds of investors. In our spring commentary, we predicted the markets would hit new highs again, which they did, but the biggest worry for us was a potential trade war with China, which, on the surface, appears to be escalating. However, behind the scenes, we believe things are different. According to Reuters, China will implement tariff <u>reductions</u> on November 1, and will cut the overall tariff level from 9.8% in 2017 to 7.5% in 2018. How come no one in the media is talking about this? Is China bending to US pressure behind the scenes? It would never do so publicly, of course, and no one can predict the outcome of the trade talks with any certainty. However, any resolution would be a huge catalyst for the markets. President Trump and President Xi are to meet in November. While any outcome presenting a structure to resolve the issue would be taken as a big positive, we had heard that trade may not even make it on the agenda! But then on October 29th, the market reversed course 900 points to the downside, in part, on President Trump's comments that if no progress is made in the November meeting on trade, he would impose more tariffs. So, we have to conclude trade will be discussed, and we believe will set the direction of the market for the rest of 2018.

US Mid-Term Elections

We are surprised at the impact the upcoming elections have allegedly had on the market. The consensus expectation is that the Republicans may pick up a seat or two in the Senate, and lose control of the house to the Democrats. So, to the extent this happens, we would expect no reaction from the markets. However, anything different would cause either a positive or negative reaction, at least initially. In the longer run, over the next two years, a split Congress would guarantee the certainty of nothing getting done in Washington, and the market likes certainty.

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According to First Trust, the S&P 500 has posted a positive total return in each of the calendar years following the previous 18 midterm elections, with returns ranging from 1.4% to 19.1%. We don't think the elections will have any lasting effect on the markets.

Market corrections happen, however, the timing and depth of each one are hard to predict. According to First Trust, since 1980, the average correction has resulted in a 14% decline. If the averages hold true, there is not much more downside to go. We see more positive catalysts than negative ones in the upcoming months. There are few, if any, signs of a recession happening anytime soon. We believe the market correction was an acknowledgment of a higher interest rate environment, and slowing, but still positive, economic growth, and that most of this is completed. While it is always dangerous to predict the short-term, we believe Santa will be finding his way to Wall Street in the not too distant future!