Portfolio Managers Commentary – Q3 2018

“Wealth is freedom. It isn’t a thing, nor is it any accumulation of things. Above all, it isn’t any number of dollars of net worth” – Nick Murray

The legacy of Lehman

September 15th marked an ominous anniversary. Ten years prior, Lehman Brothers declared bankruptcy, sparking a financial crisis that engulfed the global economy.

Lehman’s failure could easily be described as a “systemic event.” That’s financial jargon for an event that triggers severe financial instability and sends shockwaves through the economy.

Economically, we’ve recovered from the downturn. Unemployment is low, and GDP is above pre-crisis levels. Major U.S. market indexes have topped pre-recession highs, but the crisis left an indelible mark on investors. For some, the scars remain.

While today’s bull market pushes higher, some investors fear a repeat. You see it every time the market experiences a correction, or a decline of at least 10%. One day, I believe the memory of the crisis will recede. It may take another downturn that doesn’t lead to severe losses, but I believe it will eventually fade.

Can it happen again?

We cannot unequivocally say “Never.”

Gone are the days when a borrower need only a pulse to obtain a residential mortgage. OK, that’s a bit of an exaggeration, but I think you understand what I’m trying to convey. Whether you blame it on the banks or blame it on borrowers, too many folks jumped into or were placed into loans they couldn’t afford or didn’t understand.

Today, banks are much better capitalized than in 2007. The major U.S. banks have a much bigger cushion to absorb loan losses. And underwriting standards for home loans are more realistic.

During the Fed's quarterly press conference, Fed Chief Jerome Powell was asked about financial conditions.

Powell, said, "The single biggest thing I think that we learned was the importance of maintaining the stability of the financial system." It's something "that was missing" back then.

"We've put in place many, many initiatives to strengthen the financial system through higher capital, and better regulation, more transparency, central clearing, margins on unclear derivatives, all kinds of things like that, which are meant to strengthen the financial system," Powell said.

These measures won't prevent another recession, and systemic risks haven't completely abated, but the financial system is in a much better position to withstand a shock than it was in 2008.

The dreaded month of October

What is it about the month of October? The stock market crash of 1929 ushered in the Great Depression. Black Monday 1987, also October, was driven by computer trading and portfolio insurance, though an economic calamity did not ensue.

During October 2008, the S&P 500 Index lost nearly 17%, the biggest monthly decline of the financial crisis according to the St. Louis Federal Reserve. There is the lesser-known Panic of 1907, which shaved 15% off the Dow Jones Industrials during…yes, October, according to the St. Louis Federal Reserve.

Despite its ghoulish reputation, if we look back as far as 1970, the broad-based index of 500 major U.S. stocks has averaged a gain in October. October ranks number three in performance when using the median return. In case you're wondering, September is the weakest month, on average.

Between 2009 and 2017, we've experienced three declines in October, each losing just under 2%. In the six periods that saw an advance, the S&P 500 averaged a 5.3% advance–impressive.

This year was entirely different. The Dow lost 5.1%, and the S&P 500 Index gave up 6.9%.

So why did this happen?

There isn't a specific catalyst. When investors place sell orders, there isn't a "reason to sell" on the ticket. But, we can reflect on the various themes that cast a shadow on the shares.

1. **Interest rates and a policy mistake**

October started on a soft footing after Fed Chief Jerome Powell said the fed funds rate is "…a long way from neutral at this point (where rates neither stimulate nor restrict growth), probably" (Q&A with Judy Woodruff PBS anchor).

It's a curious remark. The Fed has hiked rates eight times in almost three years and stocks performed admirably, because the rate increases were in response to a firmer economy. Besides, we are only three rate hikes away from neutral using the Fed's own estimate.

Still, his remark suggested a more aggressive posture might be brewing inside the Fed. He has not clarified.

The fear? Raise rates too quickly and the Fed risks throwing the economy into a recession. It would amount to a policy mistake.

Raise rates too slowly, and there is a risk of overheating. You know, an economic boom ensues that may lead to inflation and eventually a bust.

The Fed's gradual approach is designed to thread the needle. While the direction of rates may matter, the level still remains relatively low.

2. **Slowing global growth and trade tensions**

China is slowing down and growth in Europe has softened. For firms doing a significant share of business overseas, the profit outlook has dimmed.

But, as investors look ahead to 2019, they are once again fretting about the impact of U.S. trade policy on earnings. Q3 profits have been quite strong–up 26.2% through November 1 (Refinitiv, formerly Thomson Reuters, 70% of S&P 500 firms reported). Yet, commentary regarding tariffs injected a cautious tone into sentiment. It's especially acute for industrials that rely on China's market.

Simply put, concerns bubbled to the surface that benefits from deregulation and the U.S. tax cuts might be offset by a trade war.

3. The so-called October effect

Let's revisit the initial question–what is it about the month of October?

On September 21, Jason Zweig wrote in the *Wall Street Journal*, "Investors' fear of September and October is based less on evidence and more on what psychologist's call 'availability'—the human tendency to judge how likely an event is by how easily we can recall vivid examples of it."

In other words, dramatic sell-offs are seared into our memories. But, we don't recall the S&P 500's eight percent advance in October 2015?

Zweig adds, "Average returns on U.S. Treasuries appear to be higher in fall than in spring, suggesting that investors seek safety in the darker months. Stock analysts' earnings forecasts are less optimistic in fall and winter than in spring and summer." We receive even less sunlight in November and December!

But the final two months of the year historically finishes strong, at least on average.

These may or may not be reasonable explanations for the so-called October effect. Such explanations aren't rooted in the economic fundamentals but in the behavioral aspects of investors.

It's why I repeatedly emphasize the importance of adhering to the investment plan. It is a long-term roadmap that takes unexpected sell-offs into account. It places a barrier in front of an emotional response.

Final tally and perspective

With all the angst we've seen in the financial press, the S&P 500 lost 9.9% from its closing peak to trough from September 20 to October 29th. It's not quite an official correction, which would be a loss of 10%. While I understand the speed of the pullback may be disquieting, a sell-off of 5%-10% is modest by historical standards.

Since 1980, the average intra-year peak-to-trough dip has been 14% according to LPL Research. Yet, stocks are much higher today than when Ronald Reagan became President. Why? Stocks have a long-term upward bias–average annual gain, including dividends, 12.6% since 1980.

We’ve experienced several sell-offs in recent years. Blame Brexit, the European debt crisis, China worries, the Ebola scare, the Japan earthquake/tsunami/nuclear disaster, U.S. debt downgrade, and much more.

When the risks that jolted short-term traders failed to materially alter the economic outlook, stocks recovered.

We’ve had growth scares before, and they occurred when activity was not as robust as today. Early 2016 comes to mind, when oil prices had collapsed, turmoil appeared in credit markets, and recession fears surfaced.

Today, credit markets are functioning normally, the outlook for the U.S. economy is favorable, and odds of a near-term recession remain low.

Takeaways

It’s not about timing the market. It’s about time in the market, diversification, and the balance between riskier assets (such as stocks) that have long-term potential for appreciation, versus safer, less volatile assets that are less likely to appreciate.

Headlines can create short-term volatility. We saw that earlier this year, and we’ve seen it at various times in recent years. But patient investors who stuck with a disciplined approach were rewarded. Longer term, stocks historically have had an upward bias.

While heading to the safety of cash during volatility may bring short-term comfort, opting for the sidelines can have long-term costs.

A Fidelity study showed that “Investors who stayed in the markets (during 2008) saw their account balances—which reflected the impact of their investment choices and contributions—grow 147%” between Q4 2008 and the end of 2015.

“That's twice the average 74% return for those who moved out of stocks and into cash during the fourth quarter of 2008 or first quarter of 2009.” Even worse, over 25% who sold out of stocks during that downturn never got back into the market.

Yes, the safety of cash during volatility may bring short-term comfort but opting for the sidelines can have long-term costs.

The opposite is also true. Don’t become overconfident when stocks are surging. Some folks feel an aura of invincibility and are tempted to take on too much risk.

That gets them into trouble, too.

I hope you've found this review to be educational and of value. Once again, let me emphasize that it is my job to assist you! If you have any questions or would like to discuss any matters, please feel free to give me or any of my team members a call.

Thank you very much for the trust and confidence you've placed in my team and my firm.

Sincerely,

Brent Woyat, CIM, CMT
Portfolio Manager/Investment Advisor
Canaccord Genuity Wealth Management

www.brentwoyat.com