BAD ATTITUDE

What's the old axiom? If it's too good to be true, it probably is. That might be fitting for how the market performed last year.

By the end of 2017, most forecasts were pretty optimistic. First, you had a tax cut approval, earnings for the year now look like they will come in about 24% higher, GDP saw two quarters of growth over 3% which is pretty rare at this stage of the business cycle. To top it off, unemployment remains very low at 3.7%. How could the market not be higher?

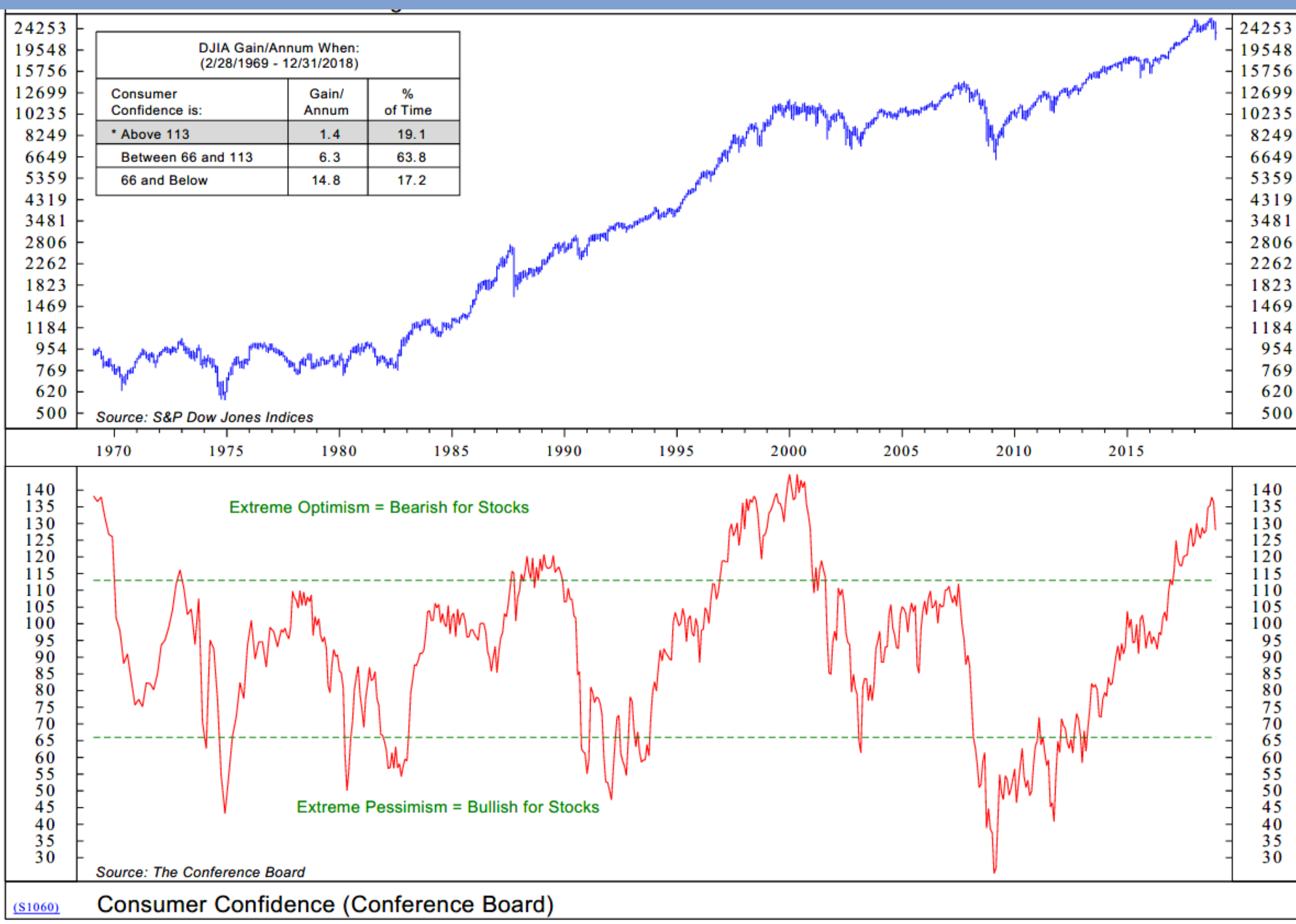
As money managers, we spend a lot of time on what we refer to as the fundamentals, the economy, and company earnings. Over the long-term, companies that grow tend to see their share price increase. However, in the shorter term, let's say over a business cycle, what investors are willing to pay for those earnings can vary pretty significantly, depending on how optimistic they are about the future.

Traditionally, at the bottom of an economic cycle, investors are willing to pay a little more as measured by the price earnings ratio because earnings are down and investors believe things will get better. Conversely, at the top of a cycle, where some feel we are today, investors won't pay-up as they believe business conditions may deteriorate.

I think last year's market sentiment suffered from the "as good as it gets" syndrome.

I only need to show you a few charts to make this point. Let's start with consumer confidence.

Dow Jones Industrial Average

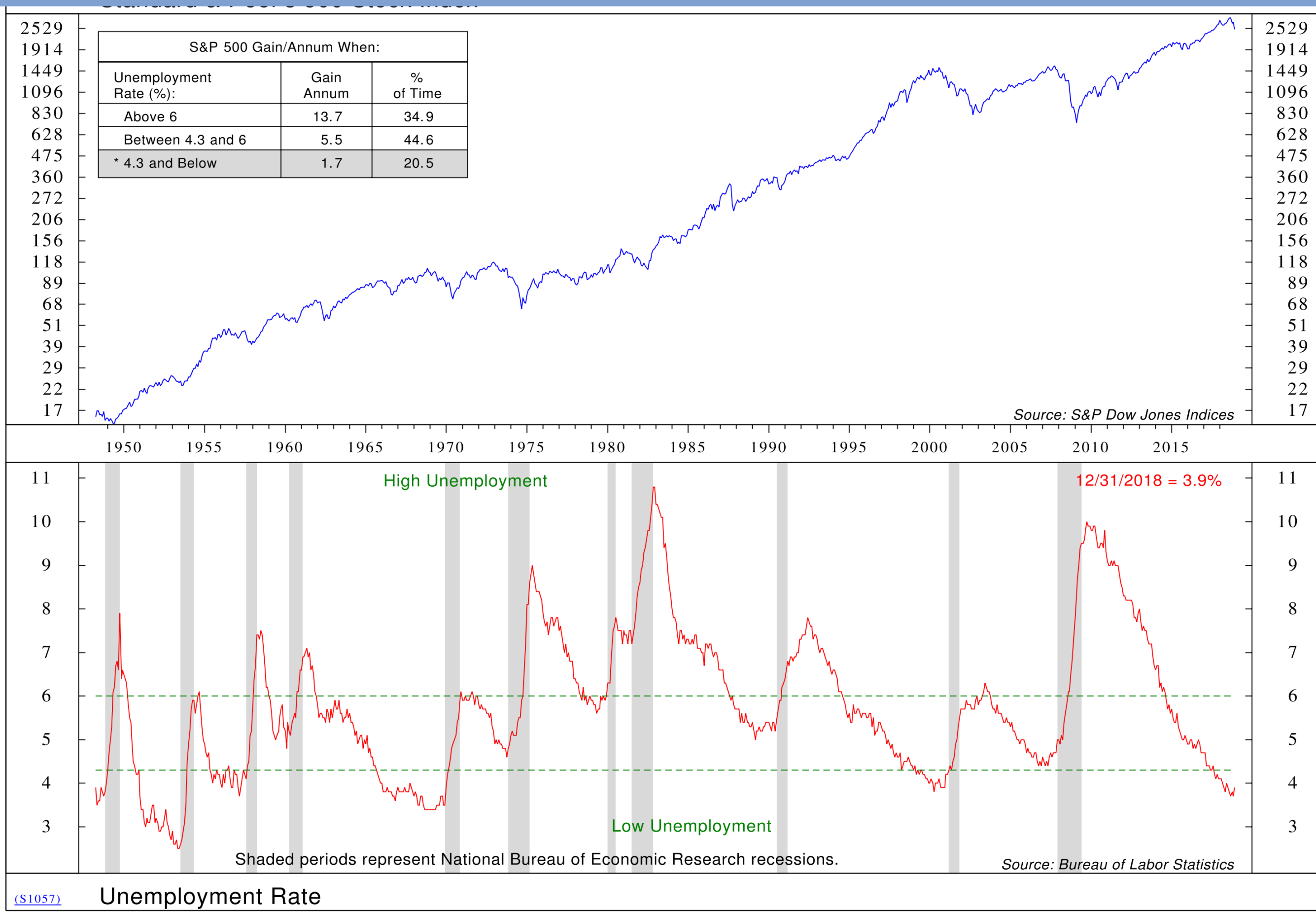


Source: Ned Davis Reaseach Inc.

As you can see in the box on the upper left, there is an inverse correlation. Confidence above 113 correlates to market advances of only 1.4% while confidence below 66 see advances of 14.8%. Markets generally bottom with confidence low as seen at the two lowest levels in February, 2009 and December, 1974. Conversely, we saw peak confidence in January, 2000 and October, 1968. Both were near important market peaks.

Another indicator would be the unemployment rate.

Standard & Poor's 500 Stock Index

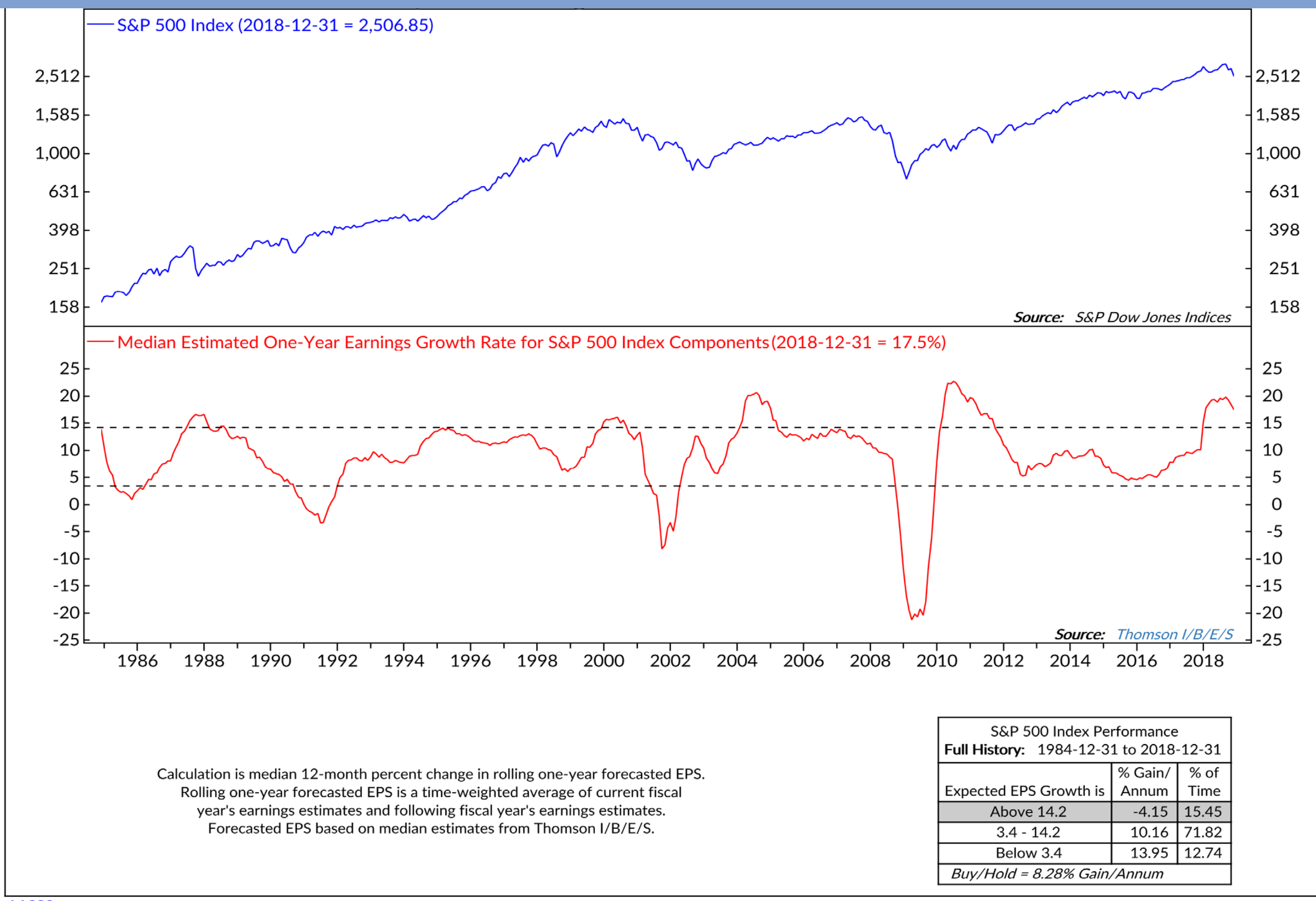


Source: Ned Davis Reaseach Inc.

Again, in the upper left-hand box, you can see that higher unemployment rates correspond to a 13.7% gain in the S&P 500 while unemployment rates below 4.9% correlate with market gains of only 1.7%.

A third indication is earnings growth.

S&P500 Index vs. Median Expected Earnings Growth



Source: Ned Davis Reaseach Inc.

As you can see in the lower right-hand box, earnings growth above 14.2% has correlated with market declines of 4.15% while growth below 3.4% has seen the market rise 13.95%.

Although perverse, sometimes too good to be true is just too good.

So for most of last year, the focus was on trying to predict when the economy would roll over.

It was driven by concerns that the Federal Reserve would tighten monetary policy too much, which traditionally ends economic expansion. There was also a fear that Trump's trade war would cause a global recession. And, when you look at the recent economic releases, the trend isn't encouraging, especially outside of the U.S.

Europe is having its share of problems, with political unrest in France, uncertainty surrounding Brexit, political change in Germany and a standoff between the EU and Italy over their proposed budget. Business activity in Europe is currently the slowest in four years as the Purchasing Manufacturers Index (PMI) has slowed to 51.3 in December from 52.7 the previous month (above 50 signals expansion) and Germany registered an outright contraction in their GDP in the third quarter.

In China, manufacturers continue to move out of this country and their attempt to transition from an export-oriented to a consumer-led economy is fighting ageing demographics. Furthermore, factory orders contracted for the first time in 19 months in December.

In the U.S., certain economic statistics such as housing and auto sales have weakened. However, there is a school of thought that the performance of these industries is less a function of the economy and more influenced by demographics. The millennial generation are more minimalist, live in apartments in the city where they don't need a house or car. At the same time, baby boomers are retiring, downsizing and have no need for a new mini-van.

Nonetheless, employment and retail sales remain exceptionally strong and the leading economic indicators remain positive with 7 of the 10 components increasing. Regardless, there is no question that economic growth rate has passed its peak.

The mental outlook has been that things are going to get worse. The future doesn't look as good as the present and stock markets are leading indicators, anticipating what is to come. So, valuations generally decline, which is exactly what we experienced. Price earnings ratios started the year at over 18x and bottomed in the fourth quarter at under 14x. That's a fair discount provided that the market is right. But as one economist noted, the market has predicted nine of the last five recessions.

Now, we're aware of these trends and cautious but a slowdown is not a contraction. The market is reacting as if the economic growth path is binary, either growing or in recession. We don't buy that. A slowdown that remains positive would be very constructive for the market and valuation levels, especially for value type stocks that have overreacted.

Nonetheless, Fed tightening in the face of a softening domestic economy, faltering foreign economic growth, a flattening yield curve, widening credit spreads and falling commodity prices is considered a prescription for a recession. We understand this and if conditions continue to worsen and increase the odds of a recession, we will become more defensive.

So, that's the backdrop for the decline. Economic trends are softening while the market is discounting a contraction. This will be the 7th time since the bull market started in 2009 that we've seen investors react adversely to choppy economic forecasts. But why so much volatility?

First, let me give you a little history on market volatility before addressing the specifics of the recent decline. Volatility has been with us for quite a while.

- We've seen peak to trough declines of at least 15% in 11 years since 1980 but only 5 coincided with a recession.
- 1974 saw the market fall 33% in 155 days but subsequently rebounded 50% between October 1974 and July 1975.
- In October 1987, the market fell 31% in 15 days. On Black Monday, the market was down 20.5% followed by a 5.32% drop the next day and a 9.1% gain the following day.
- The Dot Com bust saw the S&P 500 lose 35% in two months from March to May 2000.
- The S&P has gained more than 4.5% in a single day 24 times and dropped by that much 29 times in the last 40 years.
- Now, the majority of the swings are grouped over weeks or months. Six months after the Lehman bankruptcy, the S&P fell more than 4.5% on 17 days but rallied that much or more 10 times including two days of advances greater than 10%.
- Between September 2008 and March 2009, there were 27 moves of at least 4.5% in either direction.

So, volatility is nothing new. However, it's different this time because it can be attributed to programmed trading and the use of exchange traded funds (ETFs). Swings of 500 and 600 points aren't generated by traders making buy and sell decisions. They are caused by programmed, algorithm trading that are triggered by certain factors, such as interest rate spreads or volatility and are price indiscriminate.

Nonetheless, swings of this magnitude are frightening and feed on emotions. The normal reaction is to question what is going on? What's causing this? Is there something we don't know? How far down could this go? It's paralyzing and has resulted in a buyer's strike. And, with economic data and earnings forecasts getting generally weaker there doesn't seem to be any reason for this to change.

So, let me be a little more specific on how this algorithmic trading distorts the market:

- December saw the largest outflow of funds from mutual funds and ETFs since 2008, although economic conditions are significantly different from that period. By the way, this is usually a good contrarian indicator.
- Structurally, the market has also changed with more money being managed by passive and systematic strategies which tend to be trend following models. Inflows push stocks higher while outflows push them lower and magnify losses.
- Furthermore, there is an 83% overlap between what is held by passive and active managers. The Vanguard group of funds which has a 50% market share of all index funds, alone owns more than 8% of every public company in the U.S. So, index selling affects every style and every type of manager.

- In addition, the indices themselves are contaminated by cross-over holdings. As an example, the S&P 500 contains 500 companies. However, 300 are classified as growth while 376 are considered value. In the Russell 1000, there are 958 companies with 535 considered growth and 704 value.
- Now, most of the trading strategies are completely rules-based and offer execution through the Exchange-Traded funds. Consequently, one can see the perversity of what happens to a program focused on "Low Volatility" when things reverse. As an example, Investco's High dividend/Low volatility fund lost 11.8% in the fourth quarter. That was a surprise for low volatility investors.
- Consequently, quantitative trading systems have created a tremendous amount of volatility, reduced liquidity and scared the public. They may represent flows into and out of the market, but they do not reflect underlying company fundamentals and I think have amplified the market's reaction to trends that, at this point in time, are inconclusive.
- However, it is easy to see how either generalized selling or redemptions of strategy specific funds can broaden out and side swipe companies that are totally unrelated to a specific strategy. You may own Apple or Amazon in a specific FAANG-related ETF but when you redeem, it affects not only that Fund but all the other growth funds and possibly value funds that hold any of the FAANG stocks. And as those funds decline, they expose others to their selling. As it expands and compounds, investors look for an explanation which unfortunately is not going to be found by looking at company fundamentals. In my estimation, this is not traditional investing which looks at a company's fundamentals and business prospects but instead just playing the market. If there is a positive, it is that many great companies get undeservedly sold and driven to unrealistically low valuations.

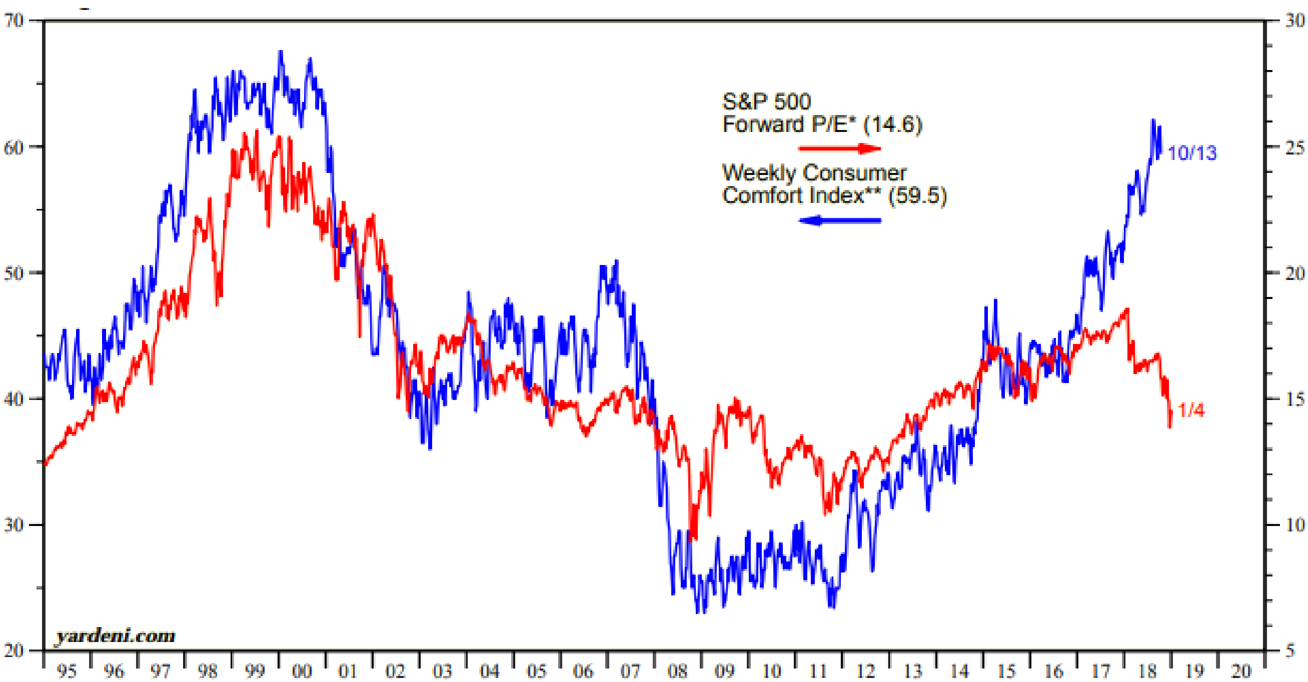
So, where do we go from here?

If we're right and the U.S. is not going into a recession, then the market is a buy. Currently, we are oversold and due for a bounce but there are likely to be some further negative reactions. It isn't unusual for market bottoms to retest the lows. But valuations have improved, especially for the value stocks that have been sideswiped in this setback by programmed trading and ETFs.

So, for the market to improve, investor attitude has to shift from the "as good as it gets" bad attitude to something better. And better will be "things aren't as bad as I feared".

So, maybe this is the best point to reintroduce the chart on consumer confidence.

S&P500 Forward P/E & Consumer Comfort Index



* Average weekly price divided by 52-week forward consensus expected operating earnings per share.
** Index plus 100.

Source: Standard & Poor's, I/B/E/S data by Refinitiv, and Bloomberg

In this case, the confidence level is plotted against the S&P 500 price earnings ratio. As you can see, they decoupled at the end of 2017 which is quite unusual. Although main street might be pretty comfortable with the economy, investors were clearly not comfortable with the market.

In other words, discounting a bad ending started over a year ago. If it happens, a lot of the damage is probably already priced in. However, if things improve and the worst case is taken off the table, there's lots of room for improvement.

Economic statistics are deteriorating and today's fear of continued monetary policy tightening is likely to give way to something more constructive. In China, the poor growth statistics that we have seen are already being met with a more stimulative monetary and fiscal policy response. Hopefully this will also lead to some accommodation in the trade negotiations.

The strength we've seen in the U.S. economy versus the rest of the world has led to higher interest rates and a stronger dollar, which in turn hurts earnings and works against valuation. The Fed recognizes the symptoms of a slow-down and if the U.S. economic numbers continue to slide, we'll see a reversal of these trends.

This fear of the Fed going too far should give way to a more moderate monetary policy, a lower dollar, higher commodity prices and surplus liquidity to support stocks.

What I can tell you about the market with some confidence is that it isn't the concerns we have today that will drive this market. It's the beliefs we have about tomorrow that will determine its direction.

January 12, 2019
GRC/amh

Credits: Barrons
Bloomberg
Ned Davis Research Group
Yardeni