October 10, 2018

Setting up for a (the) fall.

Through August of this year the stock markets have been solidly positive. Here are the returns of the major indices:

Obvious to the casual market observer that the tech-heavy NASDAQ far outpaced the other two major, US indices.

Since the end of August, however, the complexion has changed. The Dow Jones Industrial Average is the clear winner. Shares of technology companies – notably Apple, Amazon, Microsoft, Cisco Systems – have pulled back from recent 52 week highs (all-time highs in some cases).

This dynamic didn't simply occur at the end of August, like a light switch being flipped. It had been developing. There are technical factors which were flashing warning signs (not a complete list):

- More stocks declining to new lows than stocks advancing to new highs. Typically, a sign of waning momentum.
- Low cash balances and high margin balances of individual investors – a sign of near maximum risk
- International markets have been considerably weaker than domestic markets since the start of the year, most posting negative returns on the year
- Stocks trading at premium valuations to their historic price multiples
- Spike in interest rates – I tend to believe this is a convenient excuse as most markets have discounted rates going higher. It is all we have been hearing about for the past year!

Looking forward.
There is an (overused) saying among traders: take the stairs up and the elevator down. That is certainly what occurred today. We've been gradually climbing higher. In fact, there hasn't been more than a 1% move in either direction – higher or lower – in more than 50 trading sessions. That is close to unprecedented. And today we see:

- the Dow down more than 700 points, or 2.7%,
- the S&P 500 down almost 72 points, or 2.8%
- the NASDAQ down 272 points, or 3.5%

I'm willing to think this is not the beginning of the dreaded bear market we keep hearing about. I do think that we will see greater volatility in the coming months and into 2019.

We believe every market presents opportunity and we are seeing that now.

- Value stocks are starting to outperform growth stocks for the first time in many years. As value investors, this is a trend we'd like to see continue.
- Spike in short term interest rates has created a very compelling investment for short term treasuries
- We see the bond market stabilizing and think a rally in bonds will calm investors' nerves
- Today's action is likely more of a panicked sell off than the beginning of a bear market, as equity markets have become extremely oversold and should experience relief from the selling pressure. However, we see some additional volatility in the upcoming days.

Our thesis remains the same: risk management is of paramount importance. You will not be able to avoid the headlines of the "700-point market slide" and some may even use the word "crash". We prefer to ignore the chatter, roll up our sleeves and do the necessary work in finding the best long-term opportunities for our clients.

Jeff