INCISIVE INVESTOR

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WEEK IN REVIEW
GHOSTBUSTERS NOT NEEDED

Review of the week ended October 20, 2017

- **No 1987 ghosts, stocks rise**
- **US Senate budget resolution paves way for tax bill**
- **Fourth round of NAFTA talks wraps up**
- **Spain may impose direct rule on Catalonia**
- **China's National Congress begins**

Thursday marked the anniversary of the 1987 stock market crash (see story following our market report) and some investors have voiced concerns about how sharp stocks have run up since the November 2016 election, ignoring U.S. political and valuation concerns, among others. But no ghosts of 1987 came to haunt the markets this week as it was almost all good news being reported. Late Thursday, the Senate passed a budget blueprint for the next fiscal year, seen as clearing a hurdle to the Trump administration's goal of overhauling the tax code. The rally for stock markets since the election of President Donald Trump has been driven in part by hopes that a Republican-led Congress will introduce lower taxes, seen as stimulating growth. Trump lauded the 51-49 vote on Twitter, saying it would be the "first step toward massive tax cuts for the American people." First-time jobless claims fell to 222,000 in the week ended Oct. 14, marking the lowest level for claims from those seeking employment benefits since March 1973, highlighting continued strength in the labor market. Economists in one published poll had forecast claims to come in at 244,000. U.S. benchmark stock indexes all rose on Friday to close at record levels. The Dow Jones Industrial Average advanced 164 points to 23326, and was up 2.0% for the week. This is the longest stretch of weekly gains for the Dow since a seven-week rally that ended in December. The Dow and the S&P 500 close out their sixth straight weekly gain. The S&P 500 was up 13 points to 2575, and 0.9% for the week. The Nasdaq Composite Index gained 24 points at 6629 and notched its fourth straight positive week.

Tax reform hopes in the United States and record-high equity indices helped fuel a rebound in US Treasury yields, which saw the yield on the 10-year note rise 10 basis points to 2.38% this week. Oil prices held steady, with a barrel of West Texas Intermediate crude oil changing hands at $51.70. Volatility, as measured by the Chicago Board Options Exchange Volatility Index (VIX) was also unchanged, at 9.9.

GLOBAL NEWS

NAFTA talks to extend into 2018

Negotiators from the United States, Canada and Mexico, who recently met to discuss changes to the North American Free Trade Agreement, had aimed to conclude talks by the end of 2018, well in advance of Mexico's July presidential elections and US mid-term congressional elections next fall, but lack of progress has forced them to extend the talks into the first quarter of 2018. Officials from the three nations made clear they are at an impasse and have called for a nearly month-long break in order to regroup. US trade representative Robert Lighthizer said he had seen no indication that the trading partners were willing to make any changes that will result in a reduction in trade deficits.

Spain said to hold January regional elections in Catalonia

The Spanish government is said to have reached agreement with socialist opposition parties to hold regional elections in Catalonia in January. On Saturday, the government is expected to invoke Article 155 of the Spanish constitution, which would allow the central government to impose direct rule over the region in the event of a crisis. Catalonia's leader, Carles Puigdemont, will counter by calling for a formal independence vote in Catalonia's parliament. Spanish authorities hope January's elections will produce a pro-Spanish government, putting an end to the crisis. Some fear that independence backers will boycott the election, calling its legitimacy into question.

China's National Congress begins

China's 19th Communist party congress began this week in Beijing, kicking off with a three and a half hour speech by President Xi Jinping. Economic reform took a back seat to the theme of national rejuvenation in the speech. Xi will be given a second five-year term atop the party at the end of the meeting. Also this week, China reported that its economy grew at a 6.8% annual rate in the third quarter, down a touch from the 6.9% pace registered in the first two quarters of the year.

THE WEEK AHEAD

Date	Country/Area	Release/Event
Sun, Oct 22	Japan	General election
Tue, Oct 24	Global	Flash purchasing managers indices for October
Wed, Oct 25	United Kingdom	Q3 gross domestic product
Wed, Oct 25	United States	Durable goods orders, new home sales
Wed, Oct 25	Canada	Bank of Canada interest rate decision
Thu, Oct 26	Eurozone	European Central Bank rates decision
Fri, Oct 27	US	Q3 gross domestic product

30 years after Black Monday, could the stock market crash again?

On Oct. 19, 1987 the Dow Jones Industrial Average tanked 508 points, a fall of nearly 23%, in a chaotic, daylong selling frenzy that ricocheted around the world. The S&P 500 shed more than 20% of its value. At today's market heights, a percentage fall of that magnitude would knock more than 5,200 points off the DJIA.

The crash was blamed on a number of factors, but at heart, it was the growing complexity of the market that seemed to overwhelm participants and set the stage for the calamity. Computerized trading, then in its infancy, combined with new hedging strategies that used relatively newfangled stock-index futures contracts were all part of the picture.

In 1987, so-called portfolio-insurance products, which were created to protect investors from falling markets, instead, helped exacerbate a breakdown on Wall Street that resulted in the largest one-day, stock-market percentage decline in history. Portfolio insurance, employing computer algorithms, was designed to limit an investor's loss from a plunging market, while preserving upside gains in rising markets. It consisted primarily of derivative bets, and often involved using "stock-index futures in a rising market and selling them in a falling market," according to "A Brief History of the 1987 Stock Market Crash with a Discussion of the Federal Reserve Response" written by Mark Carlson in 2012, then an economist at the Federal Reserve. Carlson said using futures were common because it was cheaper for those firms offering such insurance products.

Portfolio-insurance became popular in the 1980s as institutional investors such as pension funds were increasingly concerned with elevated valuations, that often precede market corrections, defined as declines of 10% or more from a recent peak. During the days leading up to the '87 crash, there were increasing worries that the collective use of these products "could snowball into a stunning rout for stocks" if investors sold stocks and futures simultaneously, Carlson wrote, citing an article written by The Wall Street Journal before the crash in 1987.

Indeed, the week before the crash of 1987, the S&P 500 index dropped 9%, one of the largest weekly declines in decades, which triggered a sell signal for nearly all existing portfolio-insurance models.

Meanwhile, mutual funds were forced to unload shares to meet redemptions, fueling the vicious cycle of selling. Of course, portfolio insurance wasn't the only factor that brought the market to its knees.

Some other contributors to the fall were margin calls that hamstrung liquidity and lack of reliable, real-time information. Since then, financial markets have been transformed by the march of time and technology and regulatory change. "It's a much, much more complex system than it was in 1987. That doesn't mean it is better or worse, but it is certainly infinitely more complex," said Nicholas Colas, co-founder of DataTrek Research.

Among the most profound changes, the stock market has become more fragmented. In 1987, the New York Stock Exchange, along with the Nasdaq, ruled the roost. Now, the human specialists once at the center of trading have been all but displaced by algorithms and computers. Buying and selling equities takes place across a vast ecosystem made up of numerous exchanges, dozens of so-called dark pools, where trading occurs outside of the public eye, and several electronic communication networks, or ECNs. "That should be healthy in that it allows for a lot more computational power and it's also less susceptible to having everything focused in one location and one market," Colas said, in an interview. "It doesn't always work that way but that's the idea." The chief worry is that the current market system has never faced a crisis scenario on par with Black Monday, Colas said. How it would perform is simply unknown.

Wall Street and regulators also instituted a circuit-breaking system for indexes and individual stocks that is designed to slow down a selloff by halting or even stopping trade as heavy losses mount. But while they could mitigate the pace of a decline, it isn't clear that they would be able to significantly temper a 1987-style meltdown, market watchers said. Also, there were no exchange-traded funds in 1987. Since their introduction in 1993, they now hold nearly $4.2 trillion in global assets, according to research firm ETFGI, and accounted for nearly a third of all U.S. trading in terms of value in 2016, according to Credit Suisse. ETFs are securities that track an index or other basket of stocks or securities, much like a mutual fund. But unlike a mutual fund, whose net asset value is calculated at the end of each day, ETFs trade like a stock. The popularity of low-cost, index-tracking ETFs has exploded as investors embrace passive investing.

The rapid growth of exchange-traded funds, which trade like stocks and offer exposure to basically every investible asset class, including major bond categories, commodities, and precious metals, has raised the first issue of how they might perform and secondly, what impact they might have during an intense crash like the one on Oct. 19, 1987, which wiped out 23% in market value in a single day. The urgency of the first issue was underlined in August 2015, when a session with a historic amount of market volatility caused a number of ETFs to break down. The share price of a number funds fell more than the assets that comprise them because market makers—who take on risk to facilitate buy and sell orders—couldn't accurately set fair prices for the individual securities. (The issue was concentrated within stock funds; fixed-income products weren't as affected.) Exchanges bore the brunt of the blame for these issues, and in response the largest U.S. exchanges—including Bats Global Market, Nasdaq, and NYSE Arca—announced joint efforts to improve trading in volatile markets.

Several of the reforms have since been implemented, while others are slated to go into effect later this year. Additional changes have also been discussed, with some recommendations sent to the Securities and Exchange Commission earlier this year. While the market hasn't experienced a session with the same degree of selling as that late-August period two years ago, other volatile events have occurred without similar problems. This speaks to the second issue, of whether ETF trading can have an impact on overall market moves. This has been hotly debated for years because investors essentially buy every stock in an index when they buy a passive fund, if a crash were to result in heavy selling of index funds, the entire basket would be sold regardless of the fundamentals of the individual underlying securities. And because ETFs are a way to make immediate decisions on the overall market (in contrast to mutual funds, which only price and trade at the end of day), selling them could mean the rout becomes more indiscriminate in what is being sold. “If there is a ‘rush to the exit’ an ETF will likely trade to a discount that’s influenced by the volatility and the liquidity of the underlying market,” UBS, the Swiss Bank, wrote in September. However, “despite the growth in ETF assets, we believe the ETF market is better equipped to handle turbulent markets now than in the past.” UBS said funds had been “battle-tested,” and added that the ETF investor base is more diverse than it had been in the past, “as there has been greater adoption among both retail and institutional investors. This means there’s likely to be different investment views, objectives, and time horizons among investors, which helps to balance supply and demand.”

So, could Black Monday repeat? Critics charge that fragmentation and liquidity concerns resulting from market structure changes make an eventual rerun a near certainty. Others feel the changes since then would lessen the damage in any one single day of trading.

I will be glad to show you how I have helped many other area residents plan for a more secure future for themselves and their heirs. Have you done enough to determine that your investments allocated properly for you goals, dreams, and legacy? Call today to schedule your personal appointment date and time.

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