Market Update – December 17, 2018

As is obvious from the current market downturn, markets do not necessarily act in the way logic would dictate. Normally, the best practice is to buy stocks when they're cheaper than they have been and/or are reasonably valued. That's the case now. Market valuations, in some cases, are the best they've been in a decade. However, when it comes to equity markets, the cheaper stocks get, the more investors run away. It usually takes some event or intervention besides current valuations to turn things around. In the current case, a resolution of the China tariffs issue will go a long way towards stabilizing the current situation.

It's not so much the news itself that matters. It's how the news is perceived. Another way to put is, "What's the risk appetite of investors?" Human reactions to the news, rather than the actual content, are the important factors. Interest rates have been rising for a year and a half and tariff threats started in the spring. The markets had no problem rising throughout the summer months.

Algorithms and computerized trading have changed the structure of markets. They control about eighty percent of daily trading and have fundamentally altered the way markets work. This is not your grandfather's market; it is not even comparable to the market of ten years ago. Something often heard today is that there's no reason for this kind of volatility without any recession indicators flashing warnings. Algorithms, high frequency trading, and computers have been programmed to sell and buy at certain supposed resistance and support levels. The problem is that once they get going, humans follow in this supposed herd mentality, and that takes over and continues that trend for much longer than what would have seemed normal among only humans. While this is the current situation, it's also important to understand that markets can create their own reality. If enough selling ensues to make investors feel poor enough, recession can follow despite an otherwise rosy economic situation.

At the moment, there are still many unknowns. Because of the last parabolic move between February 2016 and January 2018 in mega-cap momentum stocks, followed by a final thrust in these same stocks from May 2018 to September 2018, the market still needs time to stabilize and determine its true status. Are we in the early stages of a bear market or is it just a correctional pause in a generational bull market?

In our opinion, the S&P 500 index needs to close about six percent above from where it is now on Dec. 31 to convince investors it's still a bull market. If it closes around where it is now, then there's another seven percent potential downside from here before a more significant bounce. It becomes a self-fulfilling belief. Many, including the machines and their algorithms, are looking at the same levels.

As the markets continues to fluctuate, remember that *cash* is an asset class. Investors don't have to be fully invested in stocks all the time. Bargains have started to appear. Finally, even while the major indexes are declining, other sectors have started to reverse back up. Bonds, gold and precious metals, food commodities, and emerging markets all fall into that category.