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Why has the Stock Market Fallen?
What should we expect in the near term?

The recent volatility and "correction" in the U.S. stock market has created concern for many investors. Let's look at what has happened and what we expect going forward.

▲ Why has the U.S. Stock Market Fallen?

We have anticipated a correction, or a market decline of greater than 10%, in U.S. stocks for some time now. The past nine plus years of an exceptionally strong "bull" market was not going to last forever. This expected retracement in U.S. stock prices was delayed by the large tax cut that went into effect on January 1, 2018 that delivered close to 60% of additional growth to U.S. corporate earnings. This created a positive environment for stocks, which likely could have continued given greater certainty post the mid-term elections in November. Usually following an election, the financial markets rise in response to greater visibility into the political and economic landscape going forward. This has not been the outcome in 2018, however, due to a confluence of factors including heightened uncertainty over U.S. Federal Reserve ("Fed") policy, rising trade tensions, the lack of coherent or consistent political policy out of the White House, and market "technicals."

As expected, the Fed raised interest rates four times this year. Doing so allowed the agency to lift its target for the federal funds rate above the "zero bound" (0.00% to 0.25%) so that it could once again lower rates when the next recession occurs, sometime in 2020 according to the experts we think knowledgeable. The Fed also continued "quantitative tightening" ("QT," "tapering" etc.) or the sale of $50 billion per month of U.S. Treasuries and agency mortgage backed securities that were purchased following the 2008 financial crisis. While the financial markets were anticipating additional interest rate hikes, investors were widely anticipating a slowdown in the pace of hikes in 2019 given headwinds to future economic growth stemming from increasing tariff activity globally and, to a lesser extent, Brexit. This is why Fed Chairman Powell's comments regarding the federal funds rate being "far from neutral" in late September triggered the recent correction in U.S. stocks. (The neutral rate is the level of short-term rates that neither stimulate nor hinder U.S. economic growth.) Stock investors ignored the inference Powell was attempting to make (i.e. a healthy U.S. economy that can tolerate more interest rate hikes) as well as clarifying remarks made by Fed Vice Chairman Richard Clarida, suggesting fewer rate hikes next year, because of the belief that the Fed appears disconnected from reality. Such a disconnect could prematurely trigger the next recession via continued "aggressive" monetary policy tightening.

This view was further validated when the Fed's December meeting perpetuated the slide in stock valuations even though the Fed's Federal Open Market Committee ("FOMC") lowered its expectation for interest rate hikes in 2019 and confirmed that any future rate increase would be “data-dependent.” (Data dependency means adjusting interest rates in response to current macroeconomic data and longer-run trends and forecasts.) The market not only wanted the Fed to coalesce around the prevailing expectation for zero to one quarter point interest rate hikes next year, but it also wanted the FOMC to extend its “data-dependent” mindset to QT, which is estimated to have had an equivalent impact of an additional 0.5% to 1.5% rise in interest rates.

At this point in time, we are not as concerned over Fed policy as the financial markets. Rather, we view Chairman Powell’s inexperience with publicly communicating forward guidance as unfortunate. Such guidance is a key monetary tool used by the Fed to stabilize the capital markets in addition to monetary policy (i.e. adjusting its target for the federal funds rate) and quantitative easing/tightening. Conveying forward guidance through the Chairman’s recurring press conferences, congressional sessions, and written publications is a learned skill that improves over time as evidenced with former Chairwoman Janet Yellen’s early career as head of the Fed. With that said, Yellen’s “learning curve” will likely be viewed as less “steep” as compared to Powell’s given her prior experience as head of the Federal Reserve Bank of San Francisco. The Fed is also in the precarious position of wanting to raise interest rates as high as possible while continuing to reduce its balance sheet so as to shore up its monetary toolkit for the next time the Fed needs to ease financial conditions. We expect the Fed to continue to be a source of volatility over the short-term as Fed Chairman Powell fine-tunes his communication style. This will likely be the case with Treasury Secretary Steven Mnuchin as well given his recent maladroit assurance to the markets regarding the soundness of U.S. banks even though public evidence, including the Fed’s latest bank stress tests, clearly indicate otherwise.

Another source of uncertainty that has roiled the markets over the past three months was the increase in global trade tensions. The fights with our trading partners that have resulted in tariffs was not perceived as positive news by the financial markets here in the U.S. or globally. Like U.S. stocks, foreign securities, both developed international and emerging markets (countries with less than $25,000 per capita income) fell on these fears. Numerically, the total value of tariffs currently enacted or planned to be enacted if U.S.-China trade talks deteriorate should not cause an immediate recession in the U.S. or globally. These tariffs do present headwinds to economic growth, which otherwise would have helped to extend the current business cycle. Increased trade tensions also could lead to a worst-case scenario of an all-out currency war, which we think is highly unlikely given China’s desire for continued Yuan-stability as a means to increase the currency’s weighting within the International Monetary Fund’s (“IMF”) basket of Special Drawing Right (“SDR”) currencies. The SDR is a supplementary international reserve asset used in lieu of gold or the U.S. Dollar and is currently comprised of a basket of 5 currencies – the U.S. Dollar, the Euro, the Chinese Renminbi/Yuan, the Japanese Yen, and the British Pound Sterling.

The chaos in Washington and lack of consistency interacting with our allies overseas, both economically and politically, has further elevated market anxiety. The results caused by the

President seeking an extra five billion dollars for a border wall after he had agreed with Congress on a short-term funding plan through early February further increased concerns leading to another leg down in stock prices as a result of the government shutdown. Sudden resignations by senior officials in the Administration as a protest of the President's impulsive actions, in addition to rumors of the President's desire to fire both Treasury Secretary Mnuchin and Fed Chairman Powell, also contributed to the Standard & Poor's 500 Total Return Index's near "bear market" drop. (A "bear market" is defined as a 20% or greater drop in stock prices.) As of December 24, 2018, the U.S. stock market, as defined by the S&P 500 Total Return Index, had fallen by almost 19.3% from its peak on September 21, 2018. This Bah Humbug response has created the worst December in the U.S. Stock Market since the Great Depression. Today, December 26, the largest one-day gain in the history of the U.S. stock market occurred with the Dow Jones Industrial Average rising over 1,000 points or 5%.

Lastly, it is important to note that over the past 38 years, the S&P 500 typically experienced an average "intra-year" decline (i.e. the largest market drop from a peak to a trough during a calendar year) of nearly 14%. Over the past 7 years, the market has gone through an extended period of low volatility with no intra-year decline exceeding 14% since 2011. As 2018 is reminding us, the market has a penchant for reverting to a mean tendency (i.e. "normalize") especially as interest rates also continue to "normalize."

Other market "technicals" that have precipitated the current downdraft in stocks include excessive selling volumes due to end-of-year tax loss harvesting activities and the increasing influence of programmatic trading. The change in tax law earlier this year has increased the need to offset large gains with losses as compared to prior years given the removal of key tax deductions for many high income earners. This has a transient impact on the market though as most tax loss harvested positions are repurchased 31 days later so as to avoid violating IRS "wash sale" rules. Programmatic trading, however, represents a structural change to the markets that will persist given the rise of "passively" managed fund strategies. A large portion of these funds rely upon algorithmically-driven "buy" and "sell" decisions based on underlying market trends and signals. While these trading technologies do not impact the underlying mid-to-long term fundamentals of any one asset or asset class, they do impact the breadth and frequency of short-term price fluctuations. Ultimately, this means investors should expect daily market volatility and "intra-year" declines to become more capricious given the propensity for these trading algorithms to overreact to changing market dynamics both to the upside and downside.

▲ What Should We Expect in the Near-Term?

Much of this correction in the U.S. stock market has occurred due to factors that are not related to the fundamental data measures of U.S. companies. Typically the current quarter, the eighth in a presidential cycle, is the best in the U.S. stock market returns, followed by the next two in succession.

We anticipate that the market will once again follow historical patterns and recover some of these losses. Whether this happens before the government reopens is unknown.

Most of our client portfolios have had their allocation to U.S. stocks reduced to about 50% of what would be normal over the past year. We facilitated this adjustment in anticipation of a market correction that was long overdue. We certainly did not expect that the combination of factors noted above would happen all at once.

The negotiations for a “soft landing” with Great Britain leaving the European Union (“EU”) or “Brexit” are likely to end badly. The EU cannot let England leave easily enough to encourage other members to consider doing so. The experts we have consulted do not project any positive outcome based on the current negotiations between England and the EU. Whether a deal can be struck is unknown at this time. What we do know is that companies based in Europe are profitable and their stock values are suppressed due to the fears about Brexit. As a result, we are generally not recommending adding to developed international stocks. Trailing results through September 30, 2018 for the past five and ten years reflect average annual compounded returns that are 40% less than normal per-year returns for this sector. The emerging markets (“EM”) sector has also experienced trailing returns of less than 35% of long-term averages during the past decade. The EM sector is expected to recover sooner than the developed countries, mainly due to the Brexit issue and an expectation for a decline in the value of the U.S. dollar as other Central Banks begin to raise interest rates (thereby increasing the competitiveness, thus demand for, local market yields as compared to U.S. yields).

▲ What Should You Do Now?

What we know is that investing long-term in a diversified portfolio helps clients attain their goals with lower risk than other strategies. We expect the U.S. Stock Market to recover from the sell-off that began in late September and accelerated over the past couple of weeks. We anticipate the EM sector will recover sooner than international developed stocks. Long term, being invested prudently in the financial markets is the best way to protect principal and grow the value of a portfolio so distributions can rise to keep pace with inflation. This is usually necessary in retirement when inflation does not stop working when our clients do and our clients are living longer.

The question we have been asked a few times recently is “Should we sell some stocks and go to cash now?” Based on long-term research, we do not recommend this strategy. Trying to “time” the markets by going to cash is a strategy that has not worked for investors. Research confirms that those investors who go to cash “until the markets recover” generally do not reinvest until the financial markets have risen 50% of their next total increase in value. Unfortunately, this means that investors tend to “lock in” losses in their desire to “protect principal” in the near term.

We employ a disciplined strategy to support the portfolio distributions our clients need to receive, especially for those who are retired. We always retain sufficient cash balances and exposure to conservative bond funds so we do not need to have clients reduce distributions during periods of turbulence in the financial markets by selling stocks. This means we do not need to sell stocks to support regular (monthly or quarterly) distributions for our clients for many years. Typically, we retain no less than six to eight years of regular distribution capital in conservative instruments such as cash, bonds and other assets that deliver income distributions.

What we do know is that the recent volatility in the markets has caused investors to become concerned. We can report that free capital markets are desired by most consumers in the world who hope to improve the quality of their lives. We know from experience that investing wisely is the most effective way to help clients reach their financial and personal goals.

As always, please let us know if you have any questions about your financial portfolio, or any other issue that may have a financial impact on your life.

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