Building & Preserving Wealth by Design - Not by Chance

QUALITY FINANCIAL CONCEPTS

QFC's Insights

Date: December 24, 2018
Category: Investment Markets
By: Doug Horn, CFP®

Market Insights and Update

"The Correction by Tweet and Headline"

First and foremost, Merry Christmas and Happy New Year! Happy Holidays! Wishing everyone joyful times and safety in your travels.

The markets appear to be acting more like Grinch than Santa these days, and it has not gone unnoticed. Depending upon how the markets move the last few days of the year, investment statements could reflect these low values. There are times when the markets become irrational, moving either direction which cannot be explained by data. In 1996 Alan Greenspan, then Federal Reserve Chairman, included in a speech a question wherein he asked if 'irrational exuberance' had begun to play a role in asset prices. If not data, what else can play a part in this move? Since markets often move in anticipation, could this be signaling more ominous times ahead? Or as I suspect, the market is in an oversold position driven by computer trading and reaction to media sound bites and short-term issues. In thirty-two years of watching markets and managing investments, I have not found anyone who successfully timed the markets and consistently avoided short-term corrections.

In my last market update, August 2018, I touched on the roller coaster ride I was expecting as well as the new market highs which were experienced the first week of October. You can review this 'Insight' on our site, http://www.qualityfinancial.com/Dougs-Insights.17.htm. Since this market high, the Dow's path has had more turns, curves, and bumps than we have seen in years.

Markets in an oversold position, lower than they should be, are expected to recover and return to a reasonable valuation. Oversold conditions occur when many investors throw in the towel and sell to get out of the markets regardless of the price. Other contributing factors can be computer trading by hedge funds and other institutional traders, which can exacerbate market moves in either direction. When this happens on high volume days, it is often called 'capitulation'. Despite favorable economic conditions, consumer sentiment, low energy costs, and increasing corporate profits, investor fear has been on the rise due to the many headlines in the media. When there is a lot of fear in the markets, many investors often sell into the gains which defeats the rally and drives the markets lower. Once this type of seller is washed out of the markets, then rallies can occur with far less headwinds.

Doug Horn, CFP®, Registered Principal. Securities offered through Crown Capital Securities L.P., Member of FINRA & SIPC. Advisory and Tax services offered through QUALITY FINANCIAL CONCEPTS. *CCS and QFC are not affiliated.*

Insights Continued:

New highs are always met with doubt and wonder if the trend higher will continue or succumb to deteriorating data, news, or some other event resulting with the markets pausing, entering into a correction or falling into a bear market. Unlike 2017, where the Dow rose from 19,762.60 at the start of the year, to end the year at 24,719.22, a 4,956 point rise or a 25% move up with few periods of declines, 2018 has struggled to hold the highs reached during the year and most recently has given it all back during the second correction of the year.

During 2018, it is one of the rare years where two market corrections have occurred. A correction is where the markets drop to a point where it is at least 10% lower than its last high. From January 26th to February 8th, the Dow dropped 2,756.25 points representing a 10.3% decline. In a brief nine day move, the Dow fell to a value it had last held on November 28, 2017. This is not unusual for a correction to erase months of gains. But, corrections have always been followed by new highs. It was not until the start of July did the markets break out of a trading range and reach a new high late in September. This was followed by several more new highs, reaching a top in early October.

The second correction for 2018 was not like the first. While the first dropped quickly, reaching the definition of a correction in only nine trading days, the market lows were not reached until late March. On December 19th, the Dow closed at a value of 23,323.66, representing a 13% decline from its last high and had reached the 10% decline in 18 trading days. Once again, this value represented one last held on November 15, 2017. Over the weekend, I was reviewing an article written by Paul Davidson and posted by *USA Today,* and he was asking if the sell-off is forecasting a recession? Within the article Davidson states, "A market correction (a drop of 10 percent or more) is often a leading indicator to a recession six months or so down the road…" This cannot be farther from the truth. This is like saying if you sneeze, you will get a cold. It is true that most people who catch a cold did sneeze prior to catching the cold. But, not everyone one who sneezes catches a cold. It is not uncommon for a correction to occur almost annually; in the last 50 years there have been 30 corrections according to Yardeni Research which was included in a Motley Fool article. For the same 50 years, there have only been seven recessions according to the *National Bureau of Economic Research* (www.nber.org). Clearly, not even most corrections have led to a recession. Those making investment decisions based upon headlines may find themselves missing opportunities.

The question becomes, is this still a correction to be followed by new highs or possibly the start of a new downward trend? The quantity of news topics potentially impacting the market are numerous. They include the Federal Reserve and the current higher interest rate moves, the Mueller investigation of the Presidential campaign and other political activities, the trade negotiations with China, the new Democrat controlled House, and the potential budget and government funding discussion. While each has the opportunity to move the market, those appearing to provide the most impact are the rise of interest rates, budget, and trade talks with China. Some of these have been in the news for months and will remain in the headlines, but others like the budget talks may fade within a week or so. Headlines can move the markets but have never created a recession. With economic data still favorable and in some cases strong, it is my view this is still a classic correction. Reports thus far for consumer spending with most retailers is high and better than preceding years. MasterCard® just reported an increase in spending by 5% this Christmas season, and this is following two prior seasons with increased spending. The growth in Internet purchases by many of the larger retailers, such as Target and Macy's, is growing at double digit rates. Recessions are not created when unemployment rates are low and not increasing, wages are increasing, and consumer and government spending are on the rise.

Insights Continued:

The last time the markets experienced a period of increasing interest rates was July 2004 through August 2006, where the Federal Funds rate moved from 1.0% to 5.25%. This is more than a decade ago, and how the markets reacted during this time period most likely has been forgotten. In a mere 25 months, this rate moved from its low to its peak rate. The markets are always concerned the increasing interest rates will reach a point where they impact the economy and slow the growth, potentially causing a recession. It appears this Reserve Board is moving with more caution, taking 35 months to move the rate from 0.10% to its new value of 2.5% announced on the 19th. This current rate is still 50% lower than the last peak value, but that does not imply the Federal Reserve is expecting to move the rates to the same peak value as the last time they were raising rates. The comments by Chairman Powell during his most recent report of the committee's meeting was more dovish than past reports, meaning the need for aggressive action to combat inflation (rate hikes) is unlikely, though it was not as dovish as the markets wanted.

The consensus of the move in the market this December is that the markets are pricing in bad news, which most are saying the data does not support and may not materialize. It is also contrary to the actual data and the financial report by Chairman Powell. The Board is expecting the rate of the gross domestic product (GDP) for 2019 to be 2.3%, which reflects an expanding economy; and thus, the Board is not expecting a recession. They did lower their expected growth rate from 2.5% but also reduced the number of future interest rate hikes they are expecting for the year. To make it clear they are not on a preset course, Chairman Powell stated they are dependant on the data as it is received and therefore will act accordingly, if the data suggests future rate hikes are not needed. Investors and managers are still learning the communication style of Chairman Powell. There have already been a couple of missteps where the markets reacted negatively to his comments only to have a follow-up statement from the Chairman to elaborate or clarify.

Long-term investors should continue to look past this storm and take advantage of opportunities currently being presented. Every investment manager is adding to key positions and is able to do so at values 10 to 20 percent or more lower now than earlier in the year. Weathering this storm, while frustrating, appears to be the best long-term option.

Mutual Fund Dividend Distributions:
Please remember, December is the month most mutual funds distribute and reinvest their annual distributions. Many of the equity funds are paying high capital gain distributions. For those who have brokerage accounts, there is generally a one day delay between the drop in value due to the distribution, which is then followed by the increase in value due to the purchase of additional shares with the amount distributed. If you have any questions, please reach out to our office.

December 2018 © By J.D. Horn Maryville, TN