Fourth Quarter 2018 - The Year When Nothing Worked

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2018 will be broadly remembered as a year when nothing worked and daily stock market volatility spiked. This contrasted with 2017 where seemingly everything pushed higher, and volatility was low. But in 2018, nearly every single asset class and all but one major stock market index (Brazil) around the globe posted negative returns.

International markets sagged earlier in the year and U.S. equity markets finally felt the pain in the fourth quarter. After hitting an all-time high on Sept. 20, 2018 and then coming within a whisker of that record intraday on Oct. 3, 2018; the S&P 500 began a sharp move lower that eventually reached a 19.4 percent total decline on Christmas Eve. The index then reversed course and staged a stunning 5 percent rally on the day after Christmas and inched higher, finishing the quarter with a 13.52 percent loss. For the entirety of 2018, the index fell 4.4 percent. But that masked the widespread damage as only 3 of the 11 sectors produced positive returns, with cumulatively five down more than 12.5 percent. U.S. mid-cap and small-cap stocks fared worse, falling 11.1 and 8.5 percent respectively. This downward move was swift, and it was the 10th worst quarterly return for the S&P 500 dating back to 1950.

Interestingly, in all but one of the other nine downturns, investors who held steady experienced positive outcomes one year later. And for those who believe this market downturn is a good forecaster of a looming recession — in all but one, they occurred during or after the end of recessions, not before.

We believe this downturn is largely self-induced and not fueled purely by economic forces. Indeed, the U.S.-China trade war, Brexit uncertainty, the Italian-European Union budget stand-off, the U.S. government shutdown and the Federal Reserve's confusing monetary policy messaging have provided ample opportunity for humans — and more likely computers — to react to potential happenings. "Fix" these and you likely fix the markets.

A Brief Review of Our 2018 Outlook

We entered 2018 expressing our belief that monetary policy normalization and rising inflation would lead to a bond market and subsequently equity market correction in 2018. While it's been lost in the shuffle, keep in mind that the S&P 500 fell 10 percent at the beginning of the year — longer-dated U.S. Treasuries spiked, and stock markets shuddered due to Federal Reserve rate hike fears. These fears eventually dissipated, and markets moved higher through the summer only to once again be spooked by a rise in U.S. Treasuries early this fall.

Indeed, on Oct. 3, 2018, Federal Reserve Chair Jerome Powell famously uttered, "Monetary policy may be a long way from neutral." No matter Powell's intent, both the bond and equity markets worried that more interest rate hikes were on the horizon – too many, perhaps. This fear was again on display in mid-December as Powell's confusing comments continued during his post Fed-meeting press conference. Once again, the market fell precipitously after Powell took to the podium.

The Fed's communication has been messy, but we continue to believe its rate hike strategy will prove to be prudent. As stated throughout the year, we don't believe the Federal Reserve's intent is to over-tighten the U.S. economy into an economic recession. We expect the Fed to clarify its message in 2019 and to act with extreme caution with its rate hike strategy. The recent pullback in inflation gives the central bank additional reason to stay on the sidelines.

Given our belief that the Federal Reserve gets to put the final bullet in economic cycles by tightening too much, and given our analysis of the Fed's intention, we don't believe a recession is likely in 2019. We believe that sustained bear markets require recessions. Therefore, we believe the latest market dip will be shorter lived as the stock market will eventually be tugged higher by an economy that continues pushing forward.

The Geopolitical Amplifier

While we believed a correction was likely in 2018, the magnitude of the drop exceeded our forecast. In our opinion this resulted from geopolitical discord, especially the U.S.-China trade war, which impacted market sentiment more than we

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expected. This was on display in the aftermath of the U.S.-China meeting at the G-20 in early December. After a seemingly positive Dec. 1, 2018 meeting between U.S. and Chinese officials, U.S. equity markets looked to be stabilizing and moving higher. The momentum quickly lost steam as we learned more about what occurred and whether the two sides were any nearer to an agreement.

While we believe the market has overreacted to the trade war threats, the saving grace is that we believe the recent economic and market soft patch in both China and the U.S. increases the odds that both administrations will be strongly incented to find a sufficient path forward to appease markets. Chinese policymakers need economic stability to remain in power. This U.S. administration measures its success based upon economic and stock market growth. However, risks are rising as these worries are beginning to seep into confidence — which is critical to future economic growth.

The Economic Foundation Appears Firm

We believe economic growth will continue in 2019. The U.S economic foundation — upon which this market shaking is occurring — is solid. While corporate and government debt are growing, consumer debt has moderated, and the U.S. banking system remains well capitalized. While each crisis is unique, we note that it’s often the latter two that wobble in the lead up to recessions. And while global growth has weakened, Chinese policy-makers have recently shifted gears and are now working to stimulate rather than slow their economy.

Panic and Negativism Is Often the Predecessor to Positive Returns

While investors profess they will adhere to long-term investing principles and not panic during extreme market movements, it’s tempting to change course rather than stick to the plan in a year when nothing seems to be working. The desire to staunch the bleeding grows as the market dip intensifies. However, historically investors who stuck with their investing strategy during times of market stress usually saw positive returns.

Perversely, extreme market volatility is often the precursor for better future returns. A review of the equity market’s panic indictor — the VIX Volatility index — sheds some light on what happens after periods of extreme volatility. Just as the Richter scale measures the intensity of earthquakes, the VIX measures the magnitude of volatility the markets seem to imply. During the month of December, the VIX hit an extreme level of 36.07. Based on data going back to the VIX inception in 1990, there are only 256 out of total of 7,012 days when the VIX has resided at this level or higher. Of those 256 observations, when you buy S&P stocks at the close of that day and hold for the next 250 trading days (one year), 244 of these are positive (only 4.7 percent negative) with an average return of 29.9 percent. And of the 244 positive observations, 240 of them produced double digit returns. This compares to any one randomly chosen year producing an average return of 11.43 percent with a 17 percent chance of a negative outcome.

Accelerating Leading Economic Indicators

Not only were people nervous, but they were pessimistic about the future, which has historically preceded positive future returns. The American Association of Individual Investors weekly bullish sentiment survey on Dec. 13, 2018 found that only 20.9 percent of respondents stated they were bullish about equity market prospects, the worst sentiment since 2016. In reviewing the history of this indicator going back to 1987, there have only been 55 observations when sentiment was at 21 percent or below. Those who bought into a fund that tracked the S&P 500 index at the close of business on the next day and held for the next 52 weeks, 53 out of the 55 times have produced positive returns; 3.6 percent are negative versus 17 percent that were positive of all observations in any random 52-week time period. In these observations, the average forward returns were 19.5 percent vs. 11.7 percent for any random 52 week-time periods. We caution that the two negatives were large and recorded by those who bought in early 2008 as the Great Financial Crisis was unfolding. However, we don’t believe we are sitting on the precipice of another financial crisis. In other words, sticking with an investment plan through market volatility and periods of high pessimism can help produce more positive longer-term outcomes.

And finally, 2018 proved to be a tough year for stock-pickers and active mutual fund managers. One must imagine that trade war fears overly impacted some stocks which may quickly reverse when the trade war subsides. While it’s difficult to quantify the opportunity, one can’t help but believe there’s an opportunity for patient, talented and highly convicted stock pickers to add value in the future.

We note that a growing amount of academic research suggests that high-conviction managers who buy and then maintain their conviction to hold those stocks for longer periods — often three to five years — are the ones who provide a better opportunity to succeed. Unfortunately, these longer holding periods often lead to periods of short-term underperformance as they wait for their investment thesis to bear fruit. Perhaps the seeds of these funds’ future outperformance are being sewn right now as impatient investors overreact to current market conditions.

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While research suggests the underperforming funds noted above give investors the best opportunity for added performance in the intermediate to long-term, these periods of short-term underperformance often compel investors to sell them at exactly the wrong time. Put simply, for one to be "right" in the intermediate- to longer-term, they often must be willing to be wrong in the shorter term; there is no strategy that outperforms in all measured periods.

While it is always tempting to "do something" when markets gyrate in the short-term, we believe those who stick to their plan have the best chance to win in the intermediate to long-term.

Disclosures

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