Corrections Happen

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By now, everybody watching equity markets knows that February was a tough month with the S&P 500 Index dropping about 3.8%. March has come in like a lion as well. February 2018 was the first down month since March 2017, which should hardly count since the S&P only dropped one point. You have to go back to October 2016, one month prior to the presidential election, to find a bigger drop – 1.8%. With February's drop and the plunge in late January, we have entered "correction" territory for the first time in several years. A market correction is a drop of 10% from the prior peak, in this case the 2872.87 close on January 26th. We saw a drop of 11% in the S&P 500 and a like drop in other indices (Dow Jones Industrials down 10.2%, small cap S&P 600 – 10.4%). People have somewhat forgotten that February followed an incredibly strong January and that markets were still up year-to-date, albeit slightly when February ended.

We have gotten a fair number of questions about what went on in equity markets in the past few months. They generally center around four thoughts as to what caused the correction.

They are….

A: A market that was somewhat overvalued.
B: Rising interest rates
C: A strong economy
D: Political turmoil
E: All of the above

I'd vote for "E," all of the above. We had an S&P 500 selling for about 20x estimated 2018 earnings of $150 at the peak. This is 3-4 multiple points ahead of the norm. Yields on 10 year U.S. treasuries went from 2.40% to 2.90%, a move that both makes bonds more attractive to investors and affects the numbers analysts use to value future corporate earnings. Meanwhile, the U.S. economy continued to be strong – employment growth rose and unemployment rates fell. Wages have started rising a bit faster than previously. This, of course, prompts fears of higher inflation which fed into the rising interest rates. Lastly, after successful passage of tax reform legislation late last year, the likelihood of further economy-helping legislation seems slim and growing budget deficits going forward have become a significant possibility as have tariffs on aluminum and steel, something also inflationary.

It is somewhat hard to believe, but in a few months, we will start reading stories about the 10-year anniversary of the market collapse in the fall of 2008 and the demise and/or collapse of many leading financial institutions of that day – Bear Stearns, Lehman Brothers, Fannie Mae, Freddie Mac, AIG, etc. This will serve to point out two things: the stock market is up more than 250% since the fall of 08 and that the expansion of the economy since the 2008-09 trough has been long and will raise fears that it might be ending.

It is important to note that the sky is not falling. Markets historically have risen in rising interest rate cycles. The following table came from Marketwatch and the St. Louis Federal Reserve Bank. Basically it shows that rising rates have not been terrible for the stock market. Admittedly it only goes back to 1971. The red line is the yield on 10-year U.S. Treasury Bonds. The shaded areas represent periods of rising rates while the unshaded areas represent periods of falling rates. In the nine periods of rising rates since 1971, the market has gained an average of 20%.

(over)

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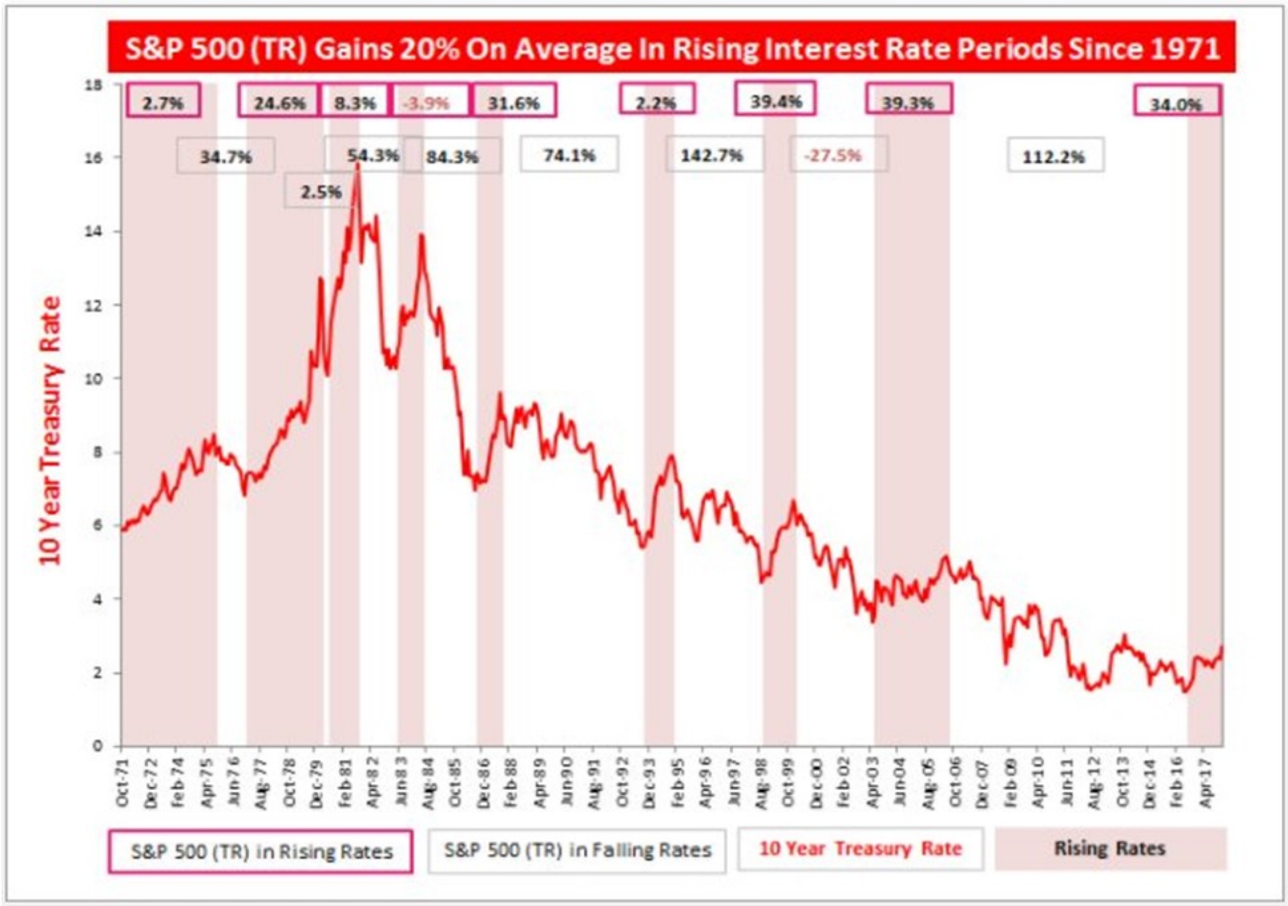

Source: S&P Dow Jones Indices and Federal Reserve Economic Data, Economic Research Division, Federal Reserve Bank of St. Louis. https://fred.stlouisfed.org

The obvious question facing most investors these days is how to prepare for an environment ahead that will likely be less conducive to stocks than the one for the past decade. The phrase from legendary Green Bay Packers coach Vince Lombardi comes to mind – "The best defense is a good offense." To us this means several things. If you believe you have too much exposure in equities now, do something about it yourself rather than let the market do it for you. Secondly, be more selective with the equities you own. The rising tide we had for the past several years has lifted all boats but we believe going forward companies with the ability to pass along rising costs should be able to maintain earnings growth better than companies that can't do so.

Regards,

Peter

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The S&P 500® Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general.

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The S&P 600® Index measures the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable.

The Dow Jones Industrial Average is an unmanaged index of common stocks comprised of major industrial companies and assumes reinvestment of dividends.

You cannot invest directly in an index.

A basis point is equal to 1/100th of 1%.

Yield is the income return on an investment, such as the interest or dividends received from holding a particular security.

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