The Fall of 2018

350 Old Ivy Way, Suite 100
Charlottesville, Va 22903-4897
Phone: 800-293-9104
Fax: 434-293-9002

Peter W. Tuz, CFA, CFP®
President & Director
Portfolio Manager

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With Labor Day here and gone, it is hard to believe the fall of 2018 is upon us. It is also hard to believe this fall marks the 10th anniversary of the 2008-2009 collapse of U.S. equity markets. You will soon see a barrage of articles about this as you are already starting to read articles on the record length of the current bull market now that many indices have reached record levels again.

Markets have come a long way since the crash. The S&P 500 index peaked at 1576 on October 11, 2007. By September 30, 2008, it had fallen 26% to 1166 and fell further to 748 in November 2008 before making an ultimate bottom of 667 on March 6, 2009. Through August 31, 2018, in price alone, the index is up 335%, or about 16% on an annualized basis. Dividends added about 2% to each year's return. From the October 2007 peak, the S&P 500 index is up about 85% on a price only basis, or about 6% per year, again boosted about 2% annually by dividends. The moral of the story is that it has generally paid to be in, or at least mostly in, equity markets through thick and thin, but it is difficult and painful to do so.

Think back again to the 2007-2009 market peak to bottom cycle. Some of the nation's major financial institutions collapsed and were either closed or rescued by other institutions. This includes:

Bear Stearns, rescued by J.P. Morgan on March 16, 2008.
California based Indy Mac Bank, a big mortgage lender, failed on July 11, 2008.
Mortgage giants Fannie Mae and Freddie Mac, placed in receivership on September 6, 2008.
Merrill Lynch, taken over cheaply by Bank of America on September 15, 2008.
Insurance giant AIG, placed in receivership on September 16, 2008.
Lehman Brothers, the venerable investment bank, collapsed on September 16, 2008.

Investors were scared. Troubles weren't limited to equity markets. Corporate profits plunged with S&P 500 earnings falling from $82.54 to $49.51 between 2007 and 2008. Real estate prices fell dramatically, with a drop of 23% for the average house price in the U.S. Unemployment climbed from about 5% to about 10% during the crisis.

After significant government intervention like the $475 billion TARP program (troubled asset relief program) and to time itself, markets began to heal. Every year since has been up. Although, in price only, the S&P 500 index was flat in 2011 and fell 0.7% in 2014, dividends made those years slightly positive.

And now we're at record levels again.

As of August 31, 2018, markets were near all-time highs with the S&P 500 index peaking at 2916.5 on August 29th, and the NASDAQ Composite Index peaking at 8133.3 that same date. Only the Dow Jones Industrial Average remained about 2.5% below its January 29, 2018 peak. Markets are ultimately driven by earnings and earnings have been great, in no small part due to the reduced corporate tax rates enacted in 2017. S&P Capital IQ estimates for S&P 500 earnings for 2018 are now $159.22, up 23% over 2017 levels. The 2019 estimate is now $175.38. While tax rates accounted for much of 2017-2018 growth, the 10% growth for 2019 should come from fundamentals like revenue growth, higher profit margins and share buy-backs.

Once you start thinking about 2008-2009, the obvious question is "Will it happen again?"

Could markets fall again 50% from peak to trough? Will major U.S. financial institutions fail or become wards of the state? Unfortunately, history says yes to the former and probably yes to the latter as well.

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As with many times in the past, complacency grows as markets rise. It's a tough thing to measure. One way to gauge it is to look at the "Fear & Greed Index" copied from Dennis Gartman's August 30th newsletter below. We've just entered "Extreme Greed" territory. The AAII survey of individual investors weekly survey paints a similar/different picture.

According to AAII, as of August 29th, 2018, 43.5% of investors in the survey were bullish – the markets will be up in six months; 24.4% were bearish – markets will fall, and 32.1% were neutral, expecting no major change in markets. Usually, about 38.5% of investors are bullish. 30.5% are bearish and 31.0% are neutral.

It's important to remember, these are contrary indicators – the higher the bullishness, the more likely the market is to fall, the higher the bearishness, the more likely the market is to rise. Yet it is difficult to see what would make U.S. equity markets fall substantially any time soon.

Most economic indicators are good, although there are warning signs in housing. If estimates are correct, the S&P 500 index is valued at 16.6x next year's earnings, high but not excessively so. In general, interest rates are still low with 10-year U.S. Treasury rates at 2.87% and inflation remains tame.

There are worries about tariffs, China slowing down, Italy, Turkey and Argentina are having serious economic issues. But these are well-known and discussed in the media on a regular basis. Generally, it takes a big negative surprise to upset markets significantly. The terrorist attacks of 9/11/2001 caused markets to plunge and ultimately caused a recession. Since then, we've seen frequent, albeit much smaller, terrorist incidents over the past decade with no long-lasting market impact.

Former Secretary of State Don Rumsfeld summed up the conundrum well with the famous quote:
"There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we don't know. But there are also unknown unknowns. There are things we don't know we don't know."

How can one prepare for the next downturn? Asset allocation has always been a good risk mitigating strategy. Hold liquid assets for significant expenditures expected in the next year or two. Have access to some cash to take advantage of bargains if a market downturn presents them and feel free to call us here at Chase Investment Counsel if you want to discuss anything further.

Best wishes for a good fall.

Regards,

Peter

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The S&P 500® Index is a broad based unmanaged index of 505 stocks, which is widely recognized as representative of the equity market in general.

The Nasdaq Composite Index is the market capitalization-weighted index of over 3,300 common equities listed on the Nasdaq stock exchange.

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

The Fear and Greed Index was developed and used by *CNNMoney* to measure the primary emotions that drive investors: fear and greed. The Fear and Greed Index is based on seven indicators: stock price momentum, stock price strength, stock price breadth, put and call options, junk bond demand, market volatility, and safehaven demand. Each of these seven indicators is measured on a scale from 0 to 100, with 50 denoting a neutral reading, and a higher reading signaling more greed. The index is then computed by taking an equal-weighted average of the seven indicators.

You cannot invest directly in an index.

Index performance is not indicative of fund's performance.
Past performance does not guarantee future results. Current performance can be obtained by calling 888-861-7556.

The funds' investment objectives, risks, charges and expenses must be considered carefully before investing. The Statutory and Summary prospectuses (CHASX/CHAIX or CHAMX/CHIMX) contain this and other important information about the investment company, and may be obtained by calling (888) 861- 7556. Read carefully before investing.

Earnings growth is not representative of the fund's future performance.

EPS=Earnings Per Share.

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