EPIC INVESTMENT MANAGEMENT

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Chicken Little

October brought a familiar autumn chill to equity markets, justifying the month's reputation as the most volatile period of the calendar. From the stock market crash of 1929, to Black Monday of 1987, to current conditions, October surprises tend to loom large not just in elections, but in the more important matters of our nation's financial system.

The most recent sell-off sent most US stocks, and many high-profile indices – from the S&P 500, to the NASDAQ, to the Russell 2000 small caps -- down 10 percent and more, firmly into correction territory. On the global stage, conditions are worse, with emerging market equities in a bear market and developed international markets not far behind.

The proximate cause of this setback -- including concerns over trade wars, rising interest rates, a decelerating economy, and slowing profit growth -- represent the same conditions present in late September, when our equity market reached all-time highs. If this leaves you scratching your head in confusion, join the crowd. As is often the case, the market's collective interpretation of events vacillates far more than the events themselves.

This leaves us for the second time this year, and the umpteenth time since this bull market began, facing an uncomfortable choice: declare a state of emergency and evacuate a sinking market ship; or defend the market and its unpredictable behavior as just another occasional hiccup, a spasm certain to recur, if impossible to time. And once again, fully aware that one day a full-blown bear market will hit, we side with the latter.

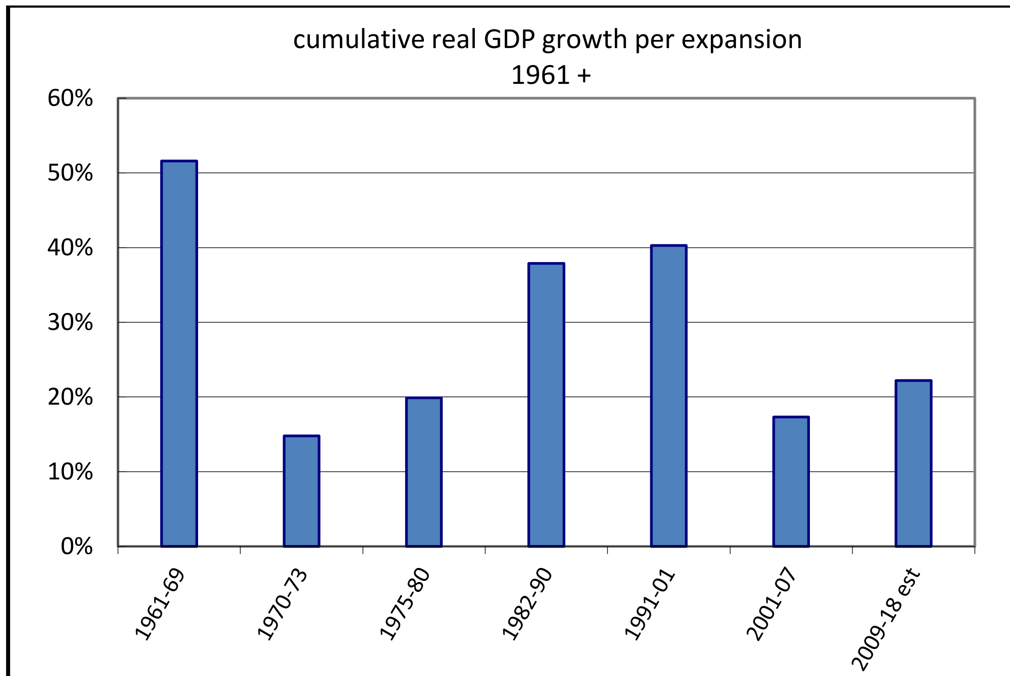
The reasons are numerous, if not definitive:

It's Not The Economy

Naysayers will acknowledge that expansions do not die of old age; and in the next breath will tell us the current expansion is already among the longest in US history, its demise therefore imminent. This is nonsense. A better way to gauge the 'age' of an economic upcycle is to measure the size, rather than duration, of its overall advance. On this basis, if nothing gets in the way of our economy, its progress should continue for years. As shown below, for the current expansion to match the real growth of the 1980s and 1990s booms, it would need to almost double the GDP growth produced since its 2009 bottom. If that occurs, we should all be worried about the expansion dying of something; right after we offer a toast in celebration.

Moreover, the index of leading economic indicators, a reliable barometer of our economy's prospects, recently reached an all-time high. Of note, no recession has begun within eight months of this index reaching its cycle peak. That alone should put us comfortably into mid-2019 without a hint of recession. More likely, the timeframe is 2020 or beyond.

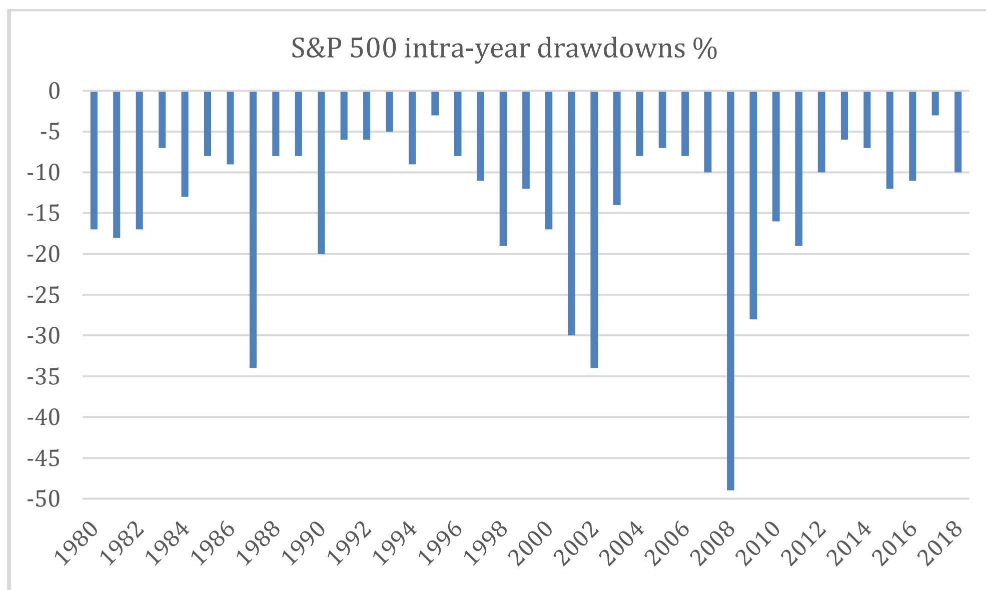
Growth will slow after 2018s acceleration, and that's a good thing. It lessens the chance of over-heating, of a spike in inflation and interest rates; and it raises the chance of a Goldilocks economy -- not too hot, not too cold. Investors love Goldilocks, almost as much as they love counting their money. Trade wars could prove to be a wildcard in this analysis, as we have no base case for what to expect. Still, a struggling economy remains an unlikely risk.



Volatility, It Is What It Is

The two most worn-out investment clichés are that times are uncertain, and equity markets are volatile. Current and future conditions are always uncertain, until the passage of time provides the clarity of a rear-view window. Likewise, stock markets are by nature volatile, sometimes less so and other times more so. Last year was the former, by our measure the second calmest market in nearly a century. Investors made money with little fuss. What to expect as an encore? Reversion to the mean, meaning rising volatility.

As shown below, the average intra-year drawdown for the S&P 500 since 1980 has been 14 percent. Excluding bear market declines, the number falls to 10 percent. Last year the largest drop was only three percent. This year, February's pullback measured 10 percent, and the current decline is right at that level. In the heat of the moment, it is hard to label any correction as 'ordinary'. It's just that no other term is so applicable at this time.



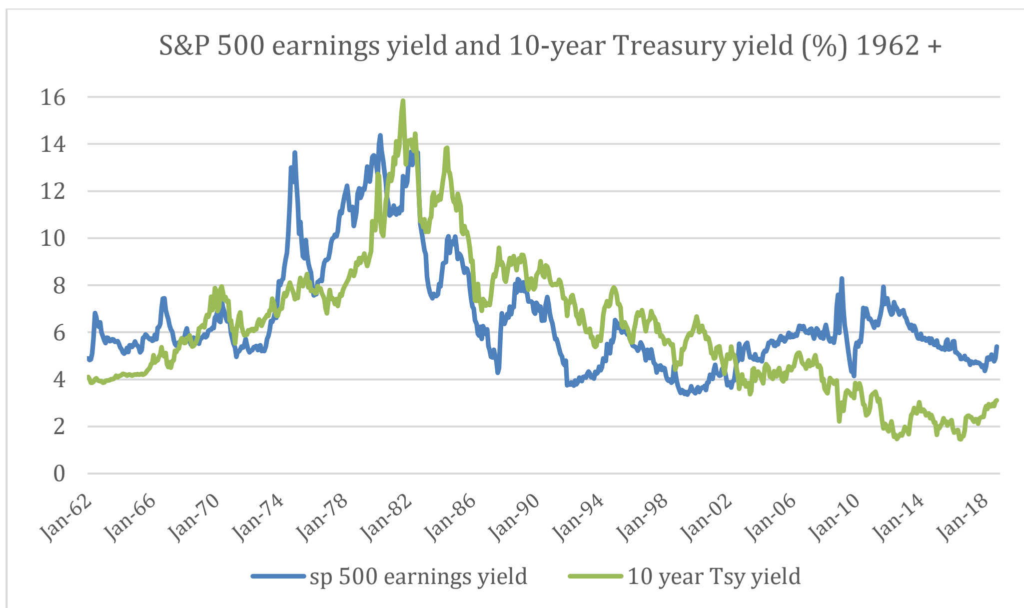
data source: J.P. Morgan Asset Management

Somethings Doesn't Seem Quite Right

As we study history, we might as well learn something from it, with a focus not on what is possible at the extremes, but what is likely. The past three decades and more of stock market history reveal that no bull market has ended, no bear market has begun, with any of these conditions present:

1. The Equity Risk Premium so high, at 166 basis points
2. Real Fed Funds rate so low, at -70 basis points
3. Individual Investors so cautious, with bulls-minus-bears survey at +9
4. Composite Put-to-Call ratio so high, at 0.94
5. Bloomberg Financial Conditions index so strong, at 1.08
6. VIX and MOVE volatility indices reflecting such calm, 12 and 49 respectively
7. NYSE Cumulative Advance-Decline line at its all-time high

What is noteworthy is that these conditions, each indicating a continuing bull run, were all in place at the September market peak. Some may be coincidental, but all seven at once?



No Joy Ride

Equity markets are not a roller coaster, taking us on a brief if exhilarating trip up, down, around, and back to where we started. It is not a joy ride to nowhere. If it were, we would still be quoting prices from 1792 and the signing of the Buttonwood Agreement. Stocks are more akin to a network of escalators, each of varying length and slope, most ascending and a few descending. When we start down, moving in the wrong direction, it is tempting to jump off, lest it carry us to unfathomable depths. And with a few notable historic exceptions, jumping off, bailing out, is the wrong move.

In the context of the current decline, there are three possibilities to consider. First, the correction could resolve itself at or near current levels, down 10 to 15 percent on most indices. Second, the decline may accelerate into a deeper correction or a mild bear market, defined as a 20 percent drawdown from the market's peak. Third, a severe bear market could develop, similar to the downturns of 2000-2002 and 2008-2009. Sure, there is always a worst-case scenario, but here is the critical point: the first two possibilities are far more likely, and represent buying opportunities, just as they did in five of the past eight years. The third scenario, financial Armageddon, is simply not in the cards at this juncture.

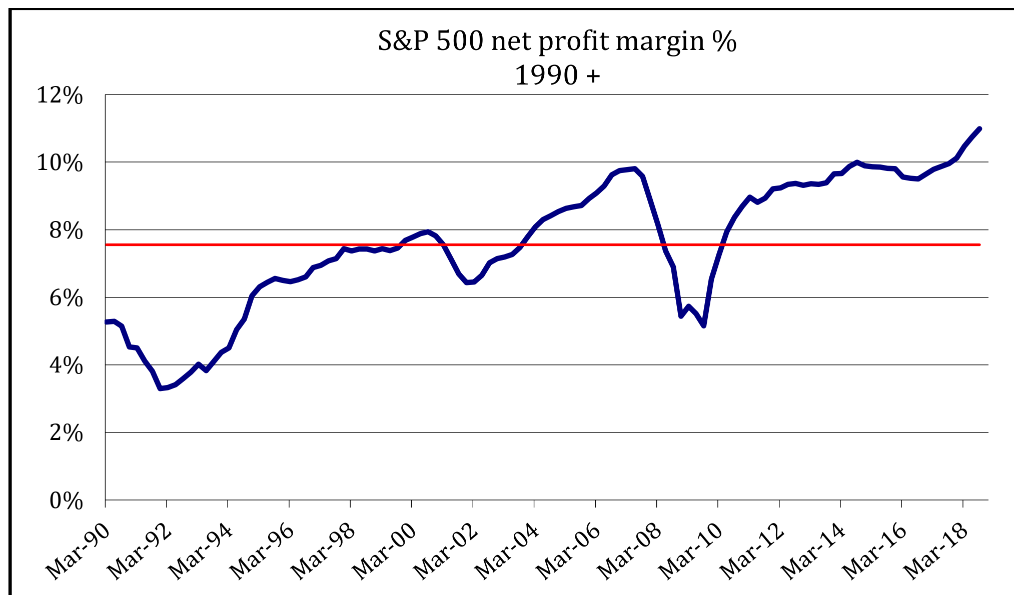
S&P 500 index 1980-present, log scale with regression line

What Could Go Wrong?
Plenty, as always. The immediate concern is not fundamentals as investors typically view them, but trading anomalies. It should be lost on no one that equity markets repeatedly hit 'air pockets' where buying interest dries up and sellers are left to create short-term mayhem. Just as in February of this year, in January 2016, and in earlier setbacks, passive investing combined with risk arbitrage strategies, multiplied by algorithmic trading activity, set the stage for rapid and otherwise inexplicable market declines. It's complicated, and if anyone truly understands the complexity of it all, they are not sharing their secret.

Infamously, in 1987, investors had a general knowledge of portfolio insurance and its quirks; but seemingly no one, regulators included, had a deep understanding of its dangers until a market melt-down arrived. Similar pressures seem to be building in today's equity markets, with rapid declines unattached to fundamentals. For now, our expectation is "this too shall pass", until it re-emerges at a future date.

From an intermediate-term perspective, earnings are a concern, or will be. This seems counter-intuitive at a time of robust profitability, but follow the logic. Corporate profits have been super-charged by an oddly-timed fiscal stimulus, right in the heart of a robust expansion; and by a historic corporate tax cut. It is no surprise then, that earnings growth has accelerated to a double-digit rate, with after-tax profit margins reaching record highs. The worry is, what's next? At some point, operating margins will peak, in fact they may have already. Rising interest costs, higher wages, or competition will pinch business profits, even without a recession. Tax rate cuts are a real and lasting benefit that cannot be repeated.

Stock prices do not seem expensive on current or projected earnings, especially when adjusted for today's low interest rates. Yet one day profitability will take a tumble, and we will discover just how expensive some stocks really are. And then it may seem that the sky is falling.



Tidbits...

International Monetary Fund cuts 2018 global growth forecast to 3.7 percent, cites "disruptions in trade polices" as cause of slowdown.
US unemployment rate, at 3.7 percent, drops to lowest level since 1969.
US economy expands 3.5 percent in third quarter, continuing run of above-trend growth.
Federal Reserve raises target interest rate by 25 basis points, eighth hike in this cycle.
World Economic Forum ranks US as most competitive country in the world, citing entrepreneurial culture, strong labor market, and financial system as key assets.

Right where we should be.

Trade war escalates as US imposes tariffs on additional 200 billion dollars of Chinese goods, China responds in kind.
Chinese-embedded spy-chip creates hacking device, infiltrates corporate US server systems.
US reaches tentative trade deal with Canada, Mexico to revise, rename, decades-old NAFTA pact.

Coca Cola to acquire Costa, UK's largest coffee shop chain, in further diversification away from traditional soft drinks.
Final frontier: Starbucks begins rolling out coffee shops in Italy, original inspiration for the now ubiquitous chain.
Volkswagen to cease production of iconic Beetle in 2019, after 80-year run.
Theranos, once-billion-dollar blood testing company built on fraud, set to dissolve.

California legislation targets state-wide carbon-free electricity by year 2045.

Good luck with that.

Tesla founder and chief executive Elon Musk loses board Chair position in settlement with Securities and Exchange Commission over market manipulation claims.
General Electric, mired in a decade-long slump, replaces chief executive after 14 months at helm.
CBS chief executive is ousted amid sexual assault allegations from numerous women.

Amazon raises minimum pay for US employees to 15 dollars per hour.
Sears Holdings, owner of Sears and Kmart stores, unprofitable since 2011, files bankruptcy.
Store vacancies at US shopping malls reach highest level in seven years.

Traditional retail under relentless attack from e-commerce.

US budget deficit rises to 779 billion dollars in 2018, up from 666 billion dollars in prior year.

No one in Washington really cares about fiscal discipline.

United Kingdom proposes "Digital Services Tax" based on revenues of technology companies seen avoiding taxes.

Avoiding taxes can get too clever; taxing revenues is downright dangerous.

Source:
Bloomberg
J.P. Morgan Asset Management
The Wall Street Journal