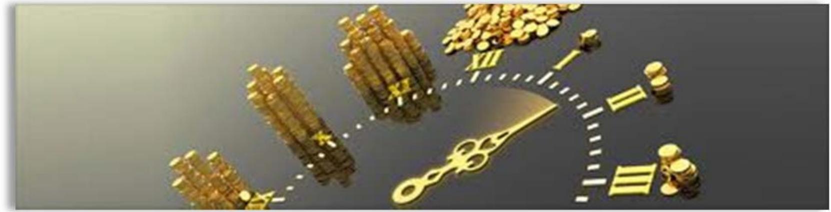

Investors Quarterly

Timely Insights into Markets and the Economy

Christopher P. Shea, CFP®

Fourth Quarter, 2018

Equities

- While it is tempting to blame the last few month's volatility and losses on the Grinch, the reality is that stocks had gotten too far ahead of valuations and the headline headwinds finally took the wind out of the market's sails. If you don't like the nautical reference, the time-tested phrase that "trees don't grow to the sky" will suffice.

- If you can remember 2017, you'll recall that stock prices performed a "melt-up" in the fourth quarter that extended into January of 2018, before experiencing a correction in February and March. The way we measure things, it appeared that all of 2018's expected growth got shoved into the fourth quarter; and so I'm not entirely surprised by what happened in the last few months. For a visual, visit the chart on our website (Relative Value).

- The graphic goes back to 1988 and measures the actual annual performance of the Dow Jones Industrial Average to the cumulative average return of the index over the same period. The "model" price is where the Dow should be given its long term average return. You can see periods where the market was over-valued (late '90's) and periods where prices lagged (post 2008).

- On the numbers front, fourth quarter earnings continued to improve, moving up another percentage point in December and notching a 7+% gain for the quarter. For the year, earnings advanced more than 28% and still failing to get any love from investors.

- It's all about earnings... say and repeat. The markets can and will pull back or correct. Eventually, we'll see another bear market. To put 2018 into perspective, large cap stocks gave up around 4% for the year, but since 2009, they have gained over 250%. That's not a bad trade-off when you think about it. Earnings reports in the next few weeks will tell the story for the first half of 2019.

Fixed Income

- Fed Chair Jay Powell pulled the trigger on another rate hike going into the Christmas break and even though it was expected, investors lost their collective minds over this, not to mention the government shutdown. That political drama is being played out as this is being typed.

- While some think it is late in the business cycle to be raising rates (it is), we also need to remember that the Fed is attempting to navigate the economy back to "normal." The policies implemented after the Great Recession, took us into unknown territory first with TARP and then the QE's. Both of these programs have ended; therefore, the Fed's action makes sense (to them).

- The major concern triggered by the latest rate hike was when the 5 and 7 Year Treasury yields actually inverted, creating most of the fire storm equities endured through the end of the year. Just for the record, most of the academic research surrounding the shape of the yield curve focuses on the relationship between the 10 Year T-Note and the 3 Month T-Bill (or the Fed Funds Rate).

- Obviously, the recent hike by the Fed further narrows the spread between the two securities. At the close of the year, spread on the respective yields, reported on the CBOE was 26 basis points. This raises our calculation of the probability of recession to approximately 35% and the Yield Curve Score to about 90%. If you add the two together and average them out, we estimate the odds of recession at 62.5% and rising. When it gets to 100%, we've got about 8-9 months to get defensive.

Conclusions

- The main take-away for the quarter is that the return of volatility is, unfortunately, part of "return to normal" and we should expect more of it (up and down) in the coming year. As I noted in the November memo, a lot of the recent volatility appears to be driven by robotic trading that often makes holding a stock over the weekend look like a long-term investment!

- The markets continue their search for a bottom. We want the Dow to stay above the recent low just below 22000 and then we'll have a better idea of where we go next. It's interesting to note that in the past, with the exception of 2008-09 (which was a panic), whenever the market gets down below its 500 day-moving-average, it usually marks a bottom. We are there now. Let see what comes next.

- Finally, we still need to contend with the prospect of more Fed tightening, ongoing trade tensions (China is going to be a problem moving forward) and ever increasing debt. Continued economic growth can solve the last problem, if it continues. Valuations aren't necessarily the problem at this point. Panicky investors are. I've heard it said that panic is not an investment strategy. Believe it.

Disclosures:

Opinions expressed are as of the current date and subject to change without notice. Intrinsic Investors, LLC shall not be responsible for any trading decisions, damages, or other losses resulting from, or related to, the information, data, analyses or opinions contained herein or their use, which do not constitute investment advice, are provided as of the date written, are provided solely for informational purposes and therefore are not an offer to buy or sell a security.

This commentary is for informational purposes only and has not been tailored to suit any individual. References to specific securities or investment options should not be considered an offer to purchase or sell that specific investment.