Market Volatility: Risks and Opportunities

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October turned out to be a difficult month with domestic stocks down nearly 7% and international stocks down a little over 8% (measured by the S&P 500 index and the MSCI EAFE Index). With such a significant monthly drop, and worries about stretched market valuations, there seems to be an increasing fear that this is "The Big One"; that will take us down by a much larger percentage reminiscent of the 2008 "Great Recession". As such, I thought this would be a good time to send out a market commentary.

Historically, extreme market declines, which I define as a decrease of 30% or more, occur when the economy is going into recession. Third quarter GDP (a measure of economic activity) just came in at 3.5%, which is lower than the quarter before (at 4.2%), but still extremely strong and not historically the environment for "The Big One."

Looking forward, we can use the Index of Leading Economic Indicators (LEI), which is comprised of 10 components (the stock market being one of them) and is designed to signal peaks and troughs in the business cycle. Historically, the Index spends a few months "rolling over", and then a few more months in decline before a recession occurs. Currently, the LEI is advancing, which indicates the economy will grow well into 2019.

My conclusion is that we are not in an economic environment that can be compared to 2007-2008, or for that matter 2000-2002, or 1990 when we witnessed significant market declines due to recession. A better comparison would be the years 2004, or 1994, or 1987. In those years, the economy was humming along quite nicely. In fact, the economy was strong enough that the Federal Reserve raised rates to slow it down.

Because it has been so many years since we've been in that type of environment, I thought I'd offer an abbreviated detail of the mechanics involved. It goes as follows:

One of the Federal Reserve's mandates is to "stabilize prices" – in other words control inflation. High inflation is an issue that can result from an economy that is too strong (referred to as overheating). When the Federal Reserve thinks the economy may overheat, they move to slow it by adjusting the Federal Funds Rate. By moving the Fed Funds Rate upwards, they are trying to influence long term rates upwards. As long term rates increase, borrowing money becomes more expensive and a decrease in economic activity results due to an overall decrease in spending.

However, long rates "float" and have a tendency to move in fits and spurts. It is not a smooth process and a sudden move can scare the markets. Recently, the 10 year treasury yield made a significant move, and closed above the 3% level for the first time since 2011. I believe it is the primary cause for the recent stock market volatility.

As mentioned there are several points in time we can use as a reference – in 2004 when the Federal Reserve was increasing rates, ensuing bond market volatility caused an 8.2% stock market correction over a 6 month period. The market then recovered and ended up earning 10.8% for the year. In 1994, there was an 8.9% decline over a 2 month period. For the rest of 1994 the markets recovered and ended up earning 1.3% (which is basically a sideways market), but then it went on to earn 37% in 1995.

1987 however, was a year that went down in history due to extreme volatility. On October 19, 1987, a day a lot of us remember even though it was over three decades ago, the market declined more than 20% in one day. Funny thing however, we are always reminded about October 19th, but never of October 20th and 21st when the market rebounded over 14%! For the year, the market was up nearly 6% and went on to earn over 16% in 1988.

Considering the current level of economic growth, I do not see any reason why the stock market would not recover from October and advance above and beyond its recent highs before this business cycle ends. However, I do see above average volatility, and it may be volatility more closely resembling 1987 than 1994 or 2004. The reason – High Stock Market Valuations as measured by average rolling returns.

There are many ways to measure the value of the stock market, most of which use ratios, and because the ratios rarely agree there is always a raging debate over whether the market is overvalued or undervalued.

I have found over the years a reliable indicator that doesn't use ratios. It uses rolling returns and it is based on the premise that average annual returns eventually revert to their long term mean. (Note: a rolling return is an average annual return ending with the listed year. I consider many rolling periods, but pay special attention to 3, 5, and 10 year periods. I consider 1 year periods to be random.)

As an example, the 90 year average annual return for the S&P 500 index is 9.8%. The current 10 year average annual return ending October 31, 2018 is 13.24%. That's high. It's important to note that part of the reason it's so high is because the 10 year takes us back to "The Great Recession" when the market was extremely low (In October 2008, the 10 year average was a little over 1%, and by February 2009 it was negative). So, to compensate, it's worth looking at the current 3 year average, which was 11.52%, and 5 year average, which was 11.34% as of October 31st 2018. All higher than the 90 year average. That tells me that the eventual mean reversion is downward, and because the 3 and 5 year were higher a few months ago and have passed downward through the 10 year, the mean reversion back to the long term average may be occurring as we speak.

It is important to note that downward reversions are not all down. They include both ups and downs, which is why I mentioned earlier that market indices can reach even higher levels over the next few months. However, downward mean reversions do involve above average volatility, which means this is a great time to review your portfolio with an eye not just on potential risk, but also on potential opportunity.

To use the S&P 500 as an example, the index can be broken down into 11 subsectors. The largest subsector is the technology sector, which accounts for nearly 23% of the total index. Over the past 10 years, Morningstar reports the average Technology Investment Company earned nearly 17% per year, which is significantly above its long term average. In October, the average Tech Investment Company lost almost 11% - significantly more than the S&P 500 Index (at -6.84). In addition, the 3 and 5 year averages recently passed downward through the 10 year. Going forward, the sector may be subject to significantly more volatility than average; so to lower portfolio risk, it may be a good time to take profits.

On the other end of the spectrum is the energy sector, which I categorize as a subsector of the commodity sector. Over the past 10 years, Morningstar reports the average Commodity Investment Company lost -4.9% per year, which means it is below the long term average by a significant amount. It is extremely rare to see any sector with a negative 10 year average, but it happens. To use the Technology sector as an example, the 10 year average return was negative in 2010, and as mentioned its now 17%. Historically, a sector with a low or negative 10 year average has been an opportunity for the long term investor because the mean reversion, whenever it occurs, is upwards; and the upwards movement can be significant (considering the level of US Government Debt, I can make a strong case for a reversion in the commodity sector - more on that in a future commentary). In addition, for the month of October, the Commodity category was down -3.08, which was less than the overall market at -6.84. I think it's interesting that a category that is normally more volatile than the overall market was down less. It may indicate that it is starting to show a non-correlation to the broader market, which may make it a good portfolio diversifier. The bottom line is the category may be an opportunity for the long term, but you should know it can be a volatile sector; so moving into the sector over a period of time as opposed to all at once may be the best strategy. Also, an important note; Natural Resources, Energy, Precious Metals, and Emerging Markets are all sectors highly correlated with the commodity sector, and are exhibiting similar characteristics.

For the more conservative investor, or those with a shorter term time horizon, there are a set of sectors that have a low correlation, or no correlation with both the stock or bond markets, and may be an opportunity at this time. The categories are Bank Certificates of Deposit (CD's), Market Neutral, Long-Short, and Multialternative strategies.

I track over 50 equity sectors and 25 fixed income sectors, and not only analyze them on an absolute basis, but also how they are moving versus the S&P 500 (regression analysis). On an absolute basis, the 10 year average returns on all the above mentioned sectors "bottomed" over the past couple of years and have been advancing. Versus the S&P 500, the 3 and 5 year average returns have advanced through the 10 year over the past few months. I believe these sectors are now worthwhile portfolio diversifiers, but there are pluses and minuses as follows:

Bank CD's: Also, short ***individual*** bonds can be included in this category (the key is individual bonds, as opposed to "packaged" bond investment companies). The biggest issue with the category is historically it has not kept up with inflation. Currently, 18 month maturities or longer are equal to, or above, the inflation rate; so this is the time period we are most focused on. Also, going forward, the highest rated banks and bonds should be more of a focus versus yields.

Market Neutral, Long/Short, and Multialternative: Don't worry if you don't recognize the categories, most people don't. The key feature of the group is that they are designed to have a low correlation, or no correlation, to the stock and/or bond markets. Although the three categories have slightly different techniques from one another, they all manage risk by holding long **and** short positions, and have historically prospered during times of stock and bond market turmoil. I believe they will be an important portfolio diversifier going forward.

In closing, rest assured we have been preparing for this type of volatility for quite some time. Even so, we will be monitoring all positions and your accounts with an eye on reducing excess risks as well as potential opportunities. In the meantime, should you feel the need to get together personally, please know we are always available and thank you for the trust and confidence you have placed in us.