4Q 2018: A "Glitch"Down the Stretch

"We had a little glitch in the stock market last month, but we're still up about 30 percent from the time I got elected."

— President Donald Trump, 1/2/19

Love him or hate him, our President does not typically display a penchant for understatement. So, we were a bit surprised to hear Mr. Trump dismiss the recent stock market decline as a "little glitch." We do not necessarily disagree with the notion that the correction represents a "glitch," but forgive us if we take issue with describing it as "little." We note that the S&P 500 fell 9% last month, logging its most painful December since 1931. The benchmark index's -13.52% return in the 4th quarter of 2018 was the largest such pullback since late in the 3rd quarter of 2011. From 9/20/18 through the close of trading on Christmas Eve the S&P 500 fell 19.8%, slightly overshooting a 19.4% draw-down that occurred back in 2011. There is a silver lining to this sort of market experience. Outside of global recessions, big market "glitches" tend to pave the way for better returns. The aftermath of the 2011 correction is as good as an example of this tendency as any. As bad as that volatility felt at the time, the S&P 500 returned more than 30% in the subsequent 12 months. Read on for some more detailed thoughts on our outlook.

"The market was volatile."

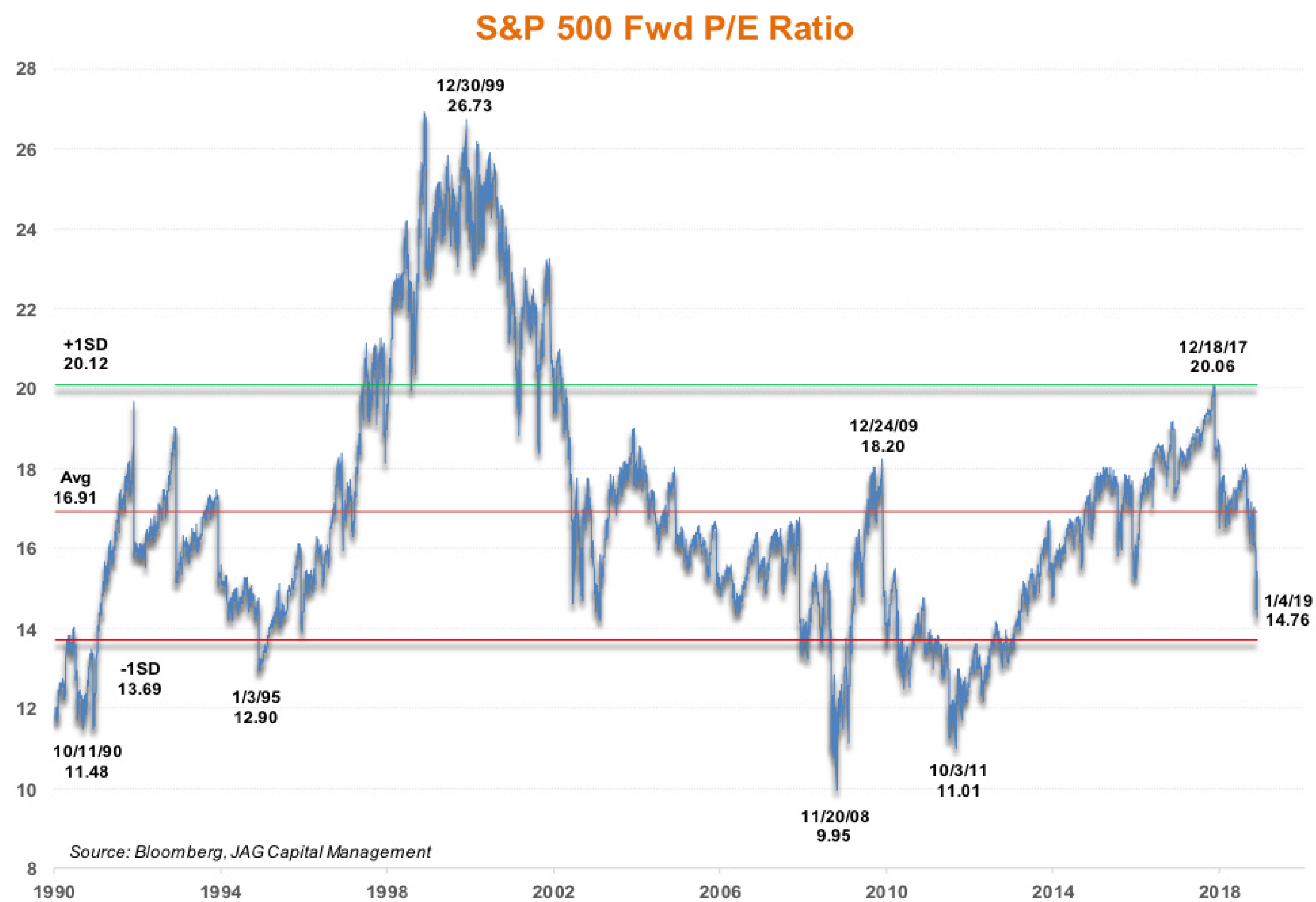
We did not foresee the rough ride in 2018's final stretch. Entering the last stanza of the year, corporate earnings were setting record highs, stocks were fairly valued relative to bonds, investors did not appear to be overly ebullient, and the domestic economy was robust. Historically, these sorts of conditions have not been the typical harbingers of a big correction or bear market. As if we needed it, this is yet another reminder of how fickle Mr. Market can be. In the short term, markets will do whatever they wish to do, for any reason or even for no reason. Lots of our fellow investment professionals are publicly searching for "the" cause or causes for lower stock prices over the past several months. We admit that we have done our fair share of hypothesizing. Various pundits have blamed the US/China trade dispute, our Twitter-crazy President, an intransigent Federal Reserve, hedge fund forced liquidations, or the rise of rapid-fire algorithmic trading. Each of these issues probably has contributed in some way to the drop in stock prices, but it is impossible to know to what extent. For our part, we think investors have suddenly recognized that trade tensions have made the global economy more fragile, while at the same time central bankers worldwide are tentatively beginning to tighten monetary policy. This is causing investors to fear that the Federal Reserve and foreign central bankers are making a policy mistake by tightening too much, too fast. Rising levels of fear, in turn, have compelled investors to require higher returns to compensate them for greater perceived or actual risks. All of the factors join forces to compress valuation multiples and push down prices on risk assets like stocks and corporate bonds.

Market pullbacks are both emotionally painful and intellectually fascinating. From an intellectual perspective, stocks tend to provide higher long-term returns than bonds or cash precisely because they are volatile on a short-term basis. To borrow a phrase from the world of computer programming, risk is a feature, not a bug, of investing. The fact that stock prices fluctuate so much on a day-to-day or quarter-to-quarter basis is exactly why there is such a thing as the Equity Risk Premium. Stated another way, if stocks were not risky over short time horizons, they would not be able to produce higher returns over longer time periods. The fact that this concept – embodied in the saying, "no risk, no reward" - is relatively easy to understand does nothing to make it easy to execute in practice. Quite simply, corrections – which by definition involve temporal declines in portfolio values – are painful. In fact, researchers tell us that we tend to dislike a given amount of loss more than 2x as much as we like a similar amount of gain. When it comes to successful investing, our evolutionary and behavioral wiring is quite literally working against us.

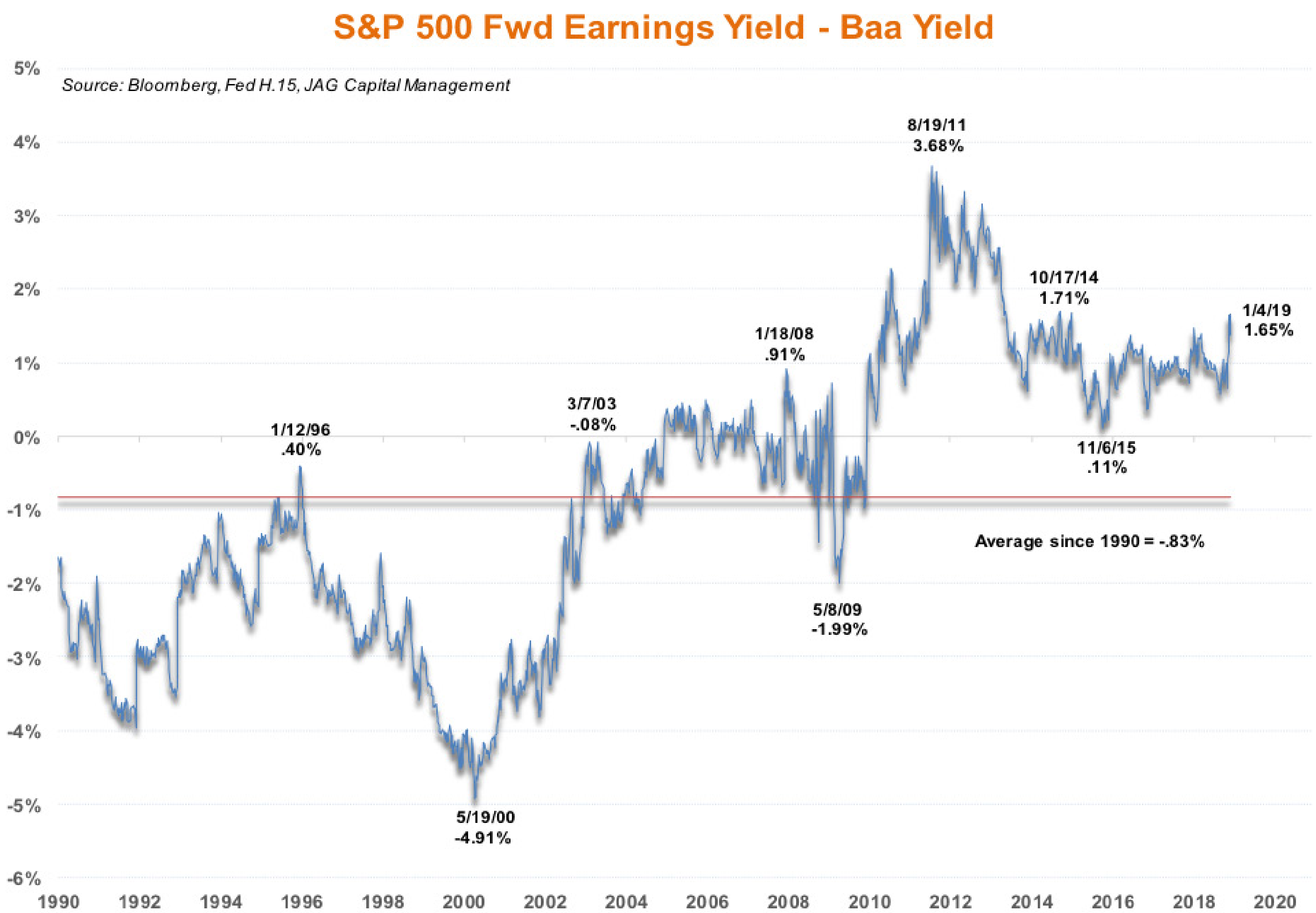
In any event, once corrections begin, they tend to feed on themselves as more investors grow increasingly fearful of more losses. Eventually – sooner or later, and to a lesser or greater extent, stock prices fall too far relative to their earnings power and intrinsic value. This inevitably leads to stabilization, in which prices bottom out and begin to move higher again. The problem arises when one attempts to precisely time this "turning point." Just as we did not predict the current correction, we cannot claim clairvoyance on the timing of a recovery. However, we can say that stocks have discounted a significant amount of bad news to come in 2019, and that valuations have become quite undemanding.

As our longtime clients and friends are aware, we tend to be optimistic most of the time. However, the fact that optimism has historically been the correct stance for long-term U.S. stock investors does not give us any special insight into how stocks will behave in the coming weeks or months. In fact, it is impossible for anyone to reliably predict the short-term path of financial markets. It follows, therefore, that successfully timing the market is a fool's errand (although we are certain that some investors will never stop trying, almost always to the detriment of their results). All we can do is assess probabilities, which we think favor more fruitful returns over the next year.

We believe the recent near-20% pullback for the major averages has set the table for better stock returns looking forward. Fundamentally, we think equity valuations are once again relatively attractive. The S&P 500's forward P/E of 14.8x implies stocks are as cheap as they have been since October 2011.

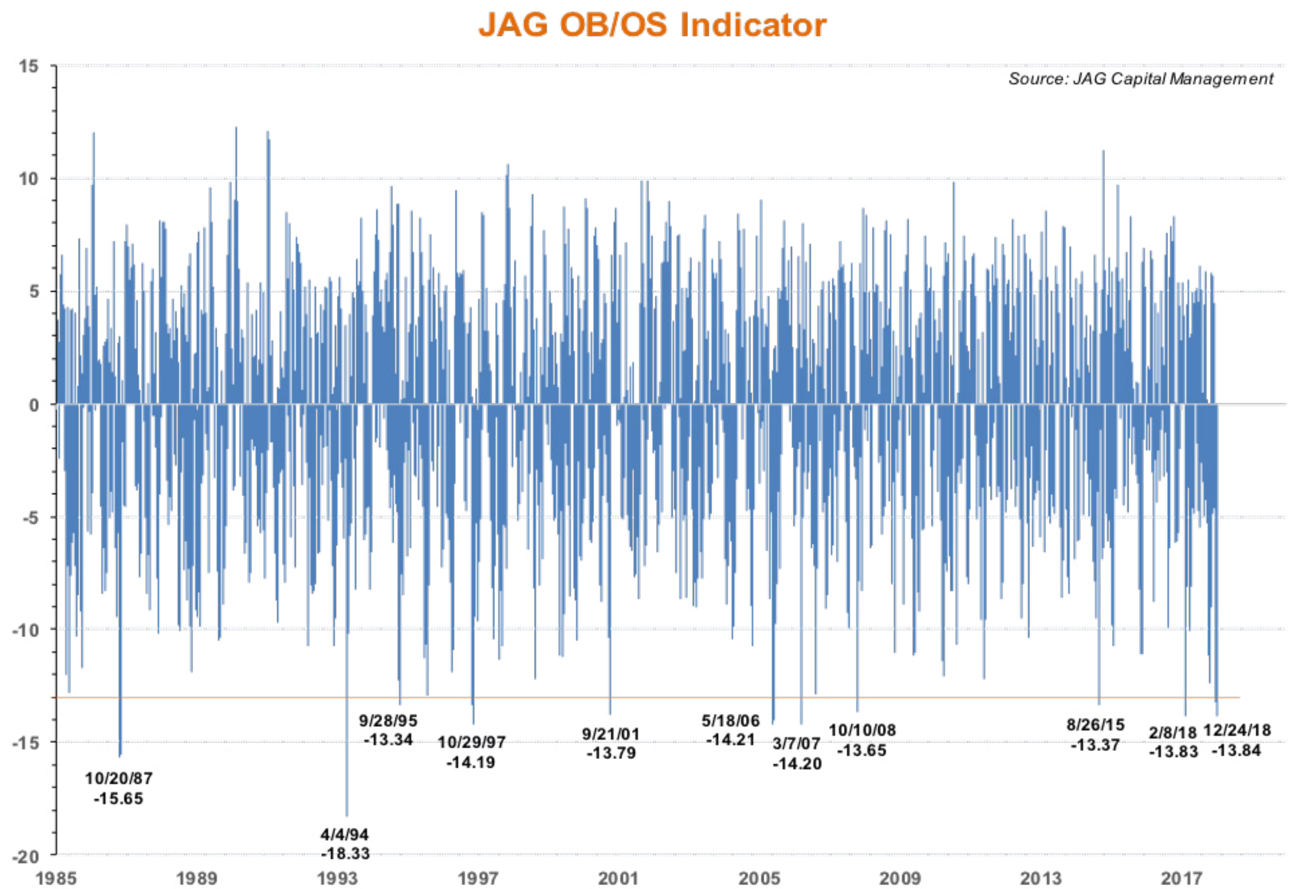


When we invert this equation to solve for earnings yield, we find that the S&P 500's forward earnings yield of 6.8% is the highest such figure since 2013. Given the fact that Baa-rated corporate bonds yield an average of 5.1%, the S&P 500 currently offers a 1.7% earnings yield premium to bonds - the biggest since late 2014.



While it is true that current S&P 500 earnings estimates of roughly $171 could prove to be too optimistic, it is likely that the markets have already substantially discounted this potentiality. Barring a truly calamitous collapse in earnings or a very significant increase in interest rates, valuations appear to offer a decent tailwind for equity investors.

From a technical perspective, there are a variety of signs that the stock market sell-off reached a climactic crescendo in late December 2018. For example, at the close of trading on Christmas Eve, only 10.8% of S&P 500 and 9.3% of Nasdaq Composite constituents were trading above their 200 day moving averages. These were the lowest such figures since 2008 and 2011, respectively. Both of those previous occurrences took place at or near important market bottoms. Similarly, JAG's proprietary Overbought/Oversold Indicator reached an 11-year oversold extreme on December 24th. Since 1985, the S&P 500 has produced a median twelve-month gain of 17.1% following the nine previous instances in which this indicator reached similarly oversold levels. The average one-year gain after reaching such deeply oversold conditions has been 11.1%, and that includes two "failed" signals in September 2001 and March 2007.



JAG OB/OS Indicator					
S&P 500 Performance # of days after oversold reading					
Date	10	20	63	126	252
10/20/1987	5.9%	2.6%	2.4%	8.1%	18.0%
4/4/1994	0.8%	3.2%	1.7%	5.2%	14.3%
9/28/1995	-0.5%	-1.6%	4.8%	10.8%	17.1%
10/29/1997	-1.4%	3.5%	6.6%	22.0%	18.1%
9/21/2001	10.9%	11.1%	18.0%	17.2%	-13.7%
5/18/2006	2.1%	-0.8%	2.8%	10.7%	20.9%
3/7/2007	3.1%	3.4%	9.0%	5.8%	-6.3%
10/10/2008	-2.5%	3.5%	-3.2%	-6.4%	19.7%
8/26/2015	0.6%	-0.4%	7.7%	0.4%	12.0%
2/8/2018	6.4%	8.0%	5.5%	10.6%	
12/24/2018					
Average	2.5%	3.3%	5.5%	8.4%	11.1%
Median	1.4%	3.3%	5.2%	9.4%	17.1%
Max	10.9%	11.1%	18.0%	22.0%	20.9%
Min	-2.5%	-1.6%	-3.2%	-6.4%	-13.7%
% > 0	70.0%	70.0%	90.0%	90.0%	77.8%
Source: JAG Capital Management					

Both of those dates coincided with global recessions and resulted in stock losses of -13.7% (2001) and -6.3% (2007) in the ensuing twelve months. Therefore, the wild-card looking forward (yes, in investing there is always a wild-card) is the risk of a full-blown recession beginning within the next 12 months. Such a near-term recession appears to be highly unlikely, but it is far from impossible. In any event, when we weave the fundamental and technical pictures together, we think the odds favor solid gains for stocks over the next several quarters.

Norm Conley
CEO & CIO

Disclosures

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