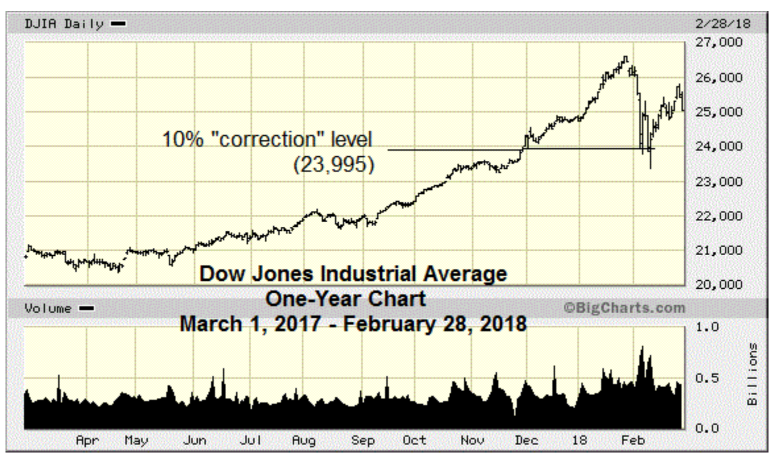
American Heritage Financial

March Update **March 2, 2018**

Market Madness

Ok, that title is a bit dramatic. A better choice might have been *"Market Turbulence"* or *"Return of Volatility"* but we couldn't resist tying the market's wild volatility in with college basketball's big month!

However, a touch of madness has overtaken the market. Since the peak on January 26, stocks have taken a dramatic turn from one of amazingly smooth, ever-ascending new highs and market bliss to a wild and wooly, unpredictable market that plunges and soars on a daily basis—no, make that hourly! It all began with a 362 point plunge on January 30; shocking at the time since the market had not seen that kind of drop since a 372 slide back in May 2017. The Dow lost 7.5% in the next five trading days and by February 9 it had touched 23,360, or a full 12% lower than the January 26 peak. A volatile, near 2,000 point rebound followed but, as we enter March, a new down-leg seems to be developing.



Typical of markets, the initial carnage came out of the blue. The market had been humming along amazingly smoothly and positively for two years. Yes, investors knew the long steady ascent felt too good to be true and **the acceleration in volatility, price appreciation and risk appetite in the last months of 2017 was a giant red flag.** But still, the dramatic shift to wild volatility and plunging stock prices has been hard to comprehend.

Unfortunately, there is no simple answer as to what caused this change in market character. The cynical reply would be to say that this is just ***"markets being markets"*** and there definitely is a lot of wisdom within that adage. A more rational answer is that the selloff is the ***response to an overheating economy weighting on an expensive stock market.***

Concerns which emerged just before and in the initial days of the selloff, in general, all relate to the strengthening economy and include rising interest rates, Fed hints of tighter credit, strong economic data and new indications of an uptick in inflation. Those concerns surfaced fairly suddenly against a benign environment which had stretched stock prices. Remember, the Dow rose 25% in 2017, plus the benefits of the new tax law and strong corporate earnings added fuel to the fire in January 2018. Many investors were looking for an excuse; they had been waiting for a reason to sell for months.

The volatility went far beyond what even the skeptics expected. Some blame the dramatic price swings on hi-tech trading, ETF's or exotic trading such as "shorting volatility"—whatever that is. Or, we can simply say it was a normal reaction to the abnormally benign market conditions of the past few years.

The question for investors is: ***Now that the market has changed character—what does it mean for the future*?** With the caveat that absolutely no one can predict how long this will last or if the bull market will resume or if a bear market emerges, we would first say we **expect** the volatility and wild price swings to continue—at least for the next few months. It would be highly unusual for the market to return to a calm, steady ascent after this kind of jolt. In fact, the **calm** markets of the recent past were the true aberration; markets are normally fairly volatile and unpredictable.

Market analysts use a simplified rule of thumb that says a decline of 10% is a "correction" and a decline of 20% is a "bear market." The recent plunge met the criteria for a correction within the first week although it quickly recovered above that magical 10% point. But a correction normally takes much longer than a week to resolve, so expect this process to continue for an indefinite period. Three things could help the correction return to a bull market. First would be more favorable valuation levels. Lower prices help improve fundamental factors like price/earnings ratios, dividend yields, etc. Continued growth in corporate earnings would also contribute favorably to the valuation metric. Second, corrections provide an "adjustment" to investor psychology. In late 2017 there was a fairly dramatic up-turn in investor sentiment. It is the concept of, once everyone is bullishly buying stocks, there is less available "dry powder" to continue to push stocks higher. It is hard to measure investor psychology but once there is a sufficient "shake-out," the markets will be better positioned to move higher. Last, the market will need at least one significant positive catalyst to regain its upward momentum. The most likely source of that catalyst would be strong earnings growth in the first or second quarter releases. But, usually these catalysts are ***unanticipated*** surprises, just as the election of Donald Trump was a totally unexpected positive catalyst for the market in late 2016.

More important than the near-term gyrations which will continue as this correction plays out, ***Should investors expect the correction to develop into a bear market (the 20% decline)?*** While the correct answer is, **No one knows**, it is highly unlikely the current decline will develop into a bear market. This is because, as discussed above, the decline was precipitated by the strengthening economy. Our economy is rapidly gathering momentum which should drive further economic activity and greater corporate profits (plus, the tax cuts are benefiting profits and the economy). It would be highly unusual to go into a bear market with such a strong economic outlook. The caveat here is that overheated economies eventually cool because high interest rates and/or high inflation eventually stifle growth.

If you accept our reasoning, there still is the question: ***What, if anything, should an investor do?*** First, an ***investor*** should not need to do much of anything. An ***investor*** holds high quality companies for the long-term in a diversified portfolio which is allocated to meet their needs and objectives. An ***investor*** understands the limited value of trying to time the market by buying and/or selling in reaction to market volatility. An actual bear market might call for a more proactive approach; but that still assumes one can correctly time the market.

We do urge everyone to review their long-term objectives and appetite for risk as well as the contents of their portfolios to be sure investments match their risk parameters (another great challenge for anyone). ***It is times like this that underscore the value of the simple strategy of owning great companies for the long term.*** That may sound like over-simplification or taking the easy way out—but it certainly works for Warren Buffett—not to mention many, many examples we have encountered over the years in our dealings with wise mom and pop investors.

Best regards,

Ted Ingraham

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Questions or comments?
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