

MARKET UPDATE

October 12, 2018



 **ASHTON
THOMAS**
PRIVATE WEALTH

Dear Clients and Friends,

Several of you have reached out to our team the past two days to ask our opinions about the market volatility we've seen Wednesday and Thursday, and what it means for markets going forward, and by extension, what it means for their portfolios. We thought it appropriate to "e-blast" a quick message as to our sense of the markets' near term directions.

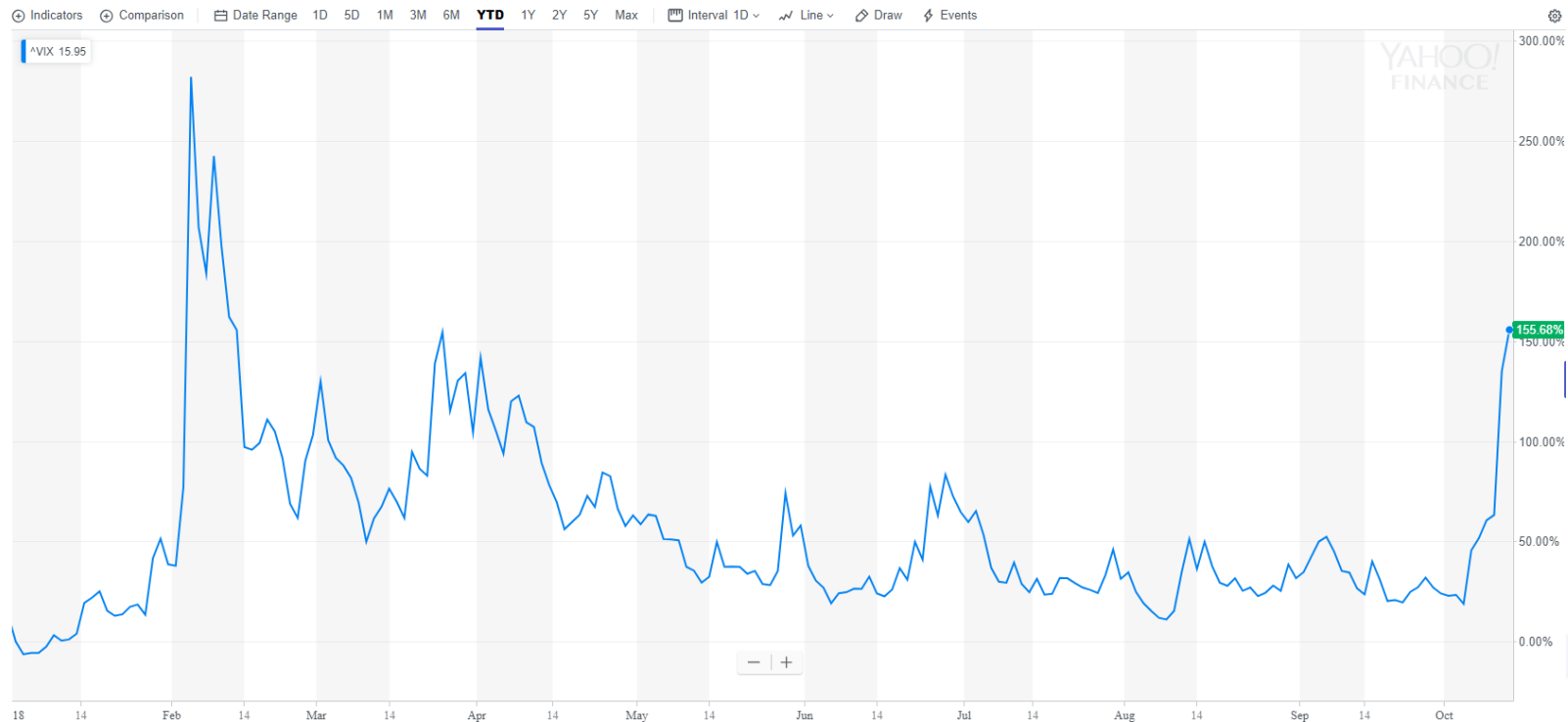
Let's take a quick look at a year-to-date (2018) chart of the most widely known domestic (U.S.) stock market index through last night, the S&P 500 Index (**GSPC – Blue line**), the most widely known foreign (non-U.S.) stock market index, the MSCI E.A.F.E. Index (**EFA – Green Line**), and the most widely known domestic (U.S.) bond market Index, the Bloomberg Barclays Aggregate U.S. Bond Index (**AGG – Red Line**). I'll make a couple of fairly obvious observations about these markets' movements this year before going into some of our (and our money managers') thoughts as to where this is all headed.



Chart Source: Yahoo Finance

- First, you'll note that the U.S. Bond Market (**AGG – Red Line**) has been is a fairly steady decline all year long, as interest rates all along the yield curve have risen. In recent weeks (September-October), we've seen some sudden "spikes" in the intermediate-term section of the yield curve. The Ten-Year U.S. Treasury Bond yield, which recorded an all-time low yield of 1.37% as recently as July 8th, 2016, began this year paying investors 2.46%, and they closed on Friday of last week with a yield of 3.23%. The 35-year "bull market" in bonds is officially over. The Federal Reserve Bank (more on them in a moment), which kept the Fed Funds Rate in the 0% - 0.25% range from 2008 until December 2017, has raised it eight times since, to its current 2.25%. A 2% move upward in interest rates on bonds with Ten Years to maturity will typically take (-15%) to (-18%) of the bond's principal value, and not unexpectedly, the **red line in the chart** shows the "slow bleed" in bond prices that started last year continuing into this year. Fed Chairman Jay Powell has made it clear that these rate hikes will continue, with another quarter-point rate hike in the Fed Funds Rate expected to be announced in December, and with two more quarter-point rate hikes expected in 2019, bringing that Rate to 3%. The decade of unprecedented monetary policy accommodation is over.
- The second point I'd make about the chart above is to bring your attention to the divergence in the path and direction the U.S. equity markets (**GSPC – Blue Line**), and the foreign (non-U.S.) equity markets (**EFA – Green Line**) that began in late June of this year. Until June, the global equity markets were rising in relative sync with one another, but have completely separated since, with the U.S market appreciated to as much as +8% YTD (thru September 20th), when on the same date, the foreign stock index was down about (-3%). Over the last eight or ten trading days however, you'll note that both U.S. and foreign stock markets have "re-converged" in terms of their directions, with both indices declining about (-7%) over the last week or two. Last night, the S&P 500 Index remained slightly positive, holding on to a small +0.6% year-to-date gain, while the E.A.F.E index was down (-10.6%) year-to-date. The markets are strongly positive today, lending credence to the argument that the stock market's volatility this week is much like January's decline into February, a "natural correction" (as Treasury Secretary Mnuchin said today), and not the beginning of an extended decline.
- The final point is that though it's never comfortable watching markets sell off to the downside, we have seen this level of volatility earlier in the year. You may recall that the S&P 500 Index and the E.A.F.E. (foreign stocks) indices started the year on a continuation of the upward momentum calendar-year 2017 ended with. The S&P 500 rose +6.6% from January 1st until the 26th of January, before it declined sharply by (-10.9%) over the next nine trading days (February 8th). On January 26th, the E.A.F.E Index was also up +6.2% year-to-date, before falling by (-9.8%) over the next nine trading days. The VIX Index, a

measure of market volatility, began the year at an extremely low level of 9.22. On February 5th, as the markets declined rapidly, the VIX Index “spiked” to 33.46, a +263% increase in volatility in just a couple of weeks. As the chart of the VIX Index (below) reveals, the VIX is again “spiking”, having closed yesterday at 24.98, just six trading days from its close at 11.61 on October 3rd. Investors who were lulled into complacency by 2017, the year with the lowest volatility in the VIX Index’ history, have been reminded twice this year that equity markets can be quite volatile.



Small-cap and Technology stocks, which led the market’s gains early in the year, have been hit hardest in this recent decline, and are now in, or are very close to formal “correction” territory. The NASDAQ Composite Index is now down (-9.63%) from its all-time closing high on August 29th, and the Russell 2000 Index is now down (-11.22%) from its closing high on August 31st. We’ve reached

out to most of our money managers to get their take on this, and for the most part, they tell us that they believe that this decline looks very much like the late-January to early-February decline. **Most believe that the U.S. economy is far too strong, and corporate earnings are far too good, for any market correction to be sustained.** There are a number of other “positive” factors I outlined in a Special Report to clients we published on September 19th of this year, a link to which is attached here: www.ashtonthomaspw.com/2018/09/19/sep-2018-special-report-weighing-evidence-2/. Many of the “Pros” we listed in that piece *remain in place*, despite this week’s market volatility. Along with the aforementioned economic strength, we have cyclically low unemployment, and interest rates and inflation remain reasonably low, all of which would argue that this decline may be a buying opportunity. Several of our managers believe that the selling we’ve seen accelerating in recent days really began a couple of months ago, is “profit taking”, as savvy investors took profits off the table in advance of what may be a contentious U.S. election.

On the negative side, many of the “Cons” we outlined in our Special Report last month remain as well. Stocks remain “expensive” by *any* fundamental measurement, even after the recent declines. Inflation is rising due to wage pressures. Geopolitical Risks and the Political Polarization we mentioned in the Report certainly remain potential impediments to economic growth. A potential “trade war” with China would be incredibly disruptive to corporate earnings, and has the potential to increase inflation in the U.S. economy to very undesirable levels. **But by far the biggest reason for the recent “panic” is the belief that the Federal Reserve will push rates too high and too quickly, possibly “inverting” the yield curve.** Generally speaking, rising interest rates are a “headwind” to market advances, as higher interest rates mean higher corporate, governmental and household debt servicing costs, and lower corporate earnings. Market participants are starting to recognize that the Fed has, indeed, pulled the punchbowl from the party, and are particularly concerned that if the Fed follows through with its pronouncements relative to raising the Fed Funds Rate three more times over the next year, it could, as it has many times before, put the brakes on a growing economy too quickly, and actually cause a recession.

Market prognosticators are all over the board, with several calling for a full-fledged “bear” market correction (>20% decline), while others see this as another buying opportunity that will be rewarded as it was after the February decline. Which camp (“bulls” or “bears”) is right about the next ten percent movement in the market is anyone’s guess. That said, the recent sell-off looks an awful lot to us like a temporary disruption, one that is unlikely to accelerate into a “2008-like” crash. Though its early in the market day as I type this, today’s market rebound is a sign that a “crash” isn’t coming in the near-term. In our opinion, the underlying U.S. economy is simply too strong today for a decline to be sustained past (-20%) or more.

We'd remind the reader, however, that we don't allow our "gut" or our "instincts" to determine when and where we allocate assets. Our tactically defensive money managers have historically employed their investment disciplines in all types of markets, working to "participate" in market advances, but with a mandate to avoid large losses, and we expect them to do so today. We stay in close contact with all of them and have been assured that their "defense is on the field". If the last two trading days' results are any indication, they are doing far better than the markets during the recent "storm". Feel free to call us directly, should you have any questions or wish to discuss your portfolio with us.

Respectfully,



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