BEING "RIGHT" AND THE DANGERS OF BEING "WRONG"

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Yesterday, November 20th, 2018, the U.S. Stock markets joined overseas stock markets in completely erasing their 2018 gains. The S&P 500 Index, the Russell 2000 Index, and the NASDAQ Composite Index all finished the year-to-date in negative territory.

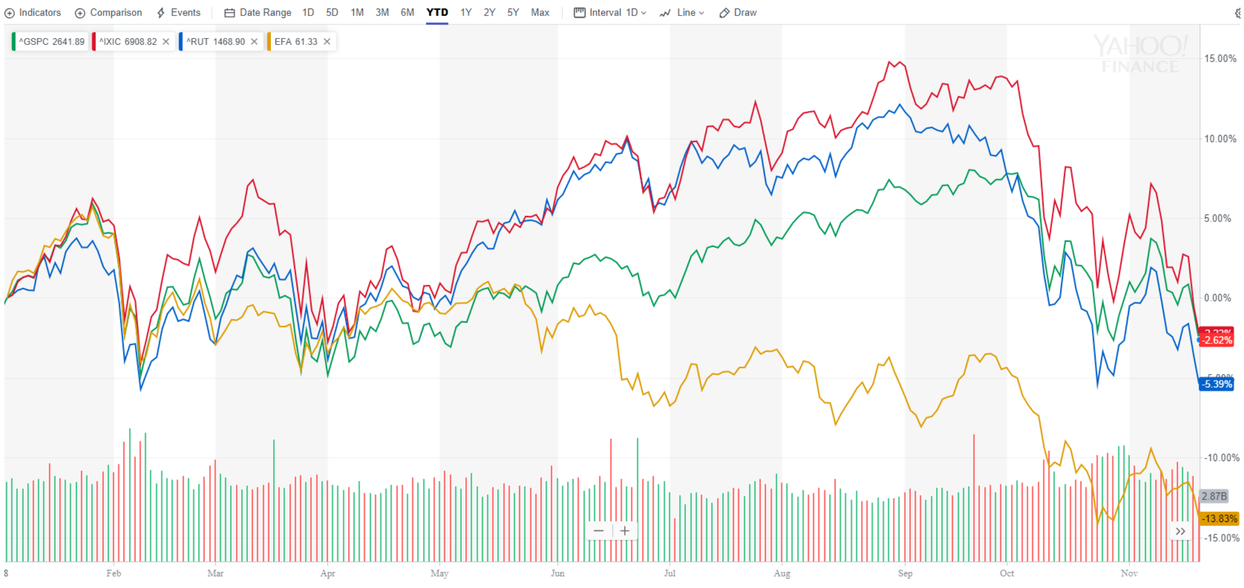

Chart Source: Yahoo Finance 11/20/2018 market close

S&P 500 Index (Large-Cap U.S. Stocks) = Green line = (-2.62%)

Russell 2000 Index (Small-Cap U.S. Stocks) = Blue Line = (-5.39%)

NASDAQ Composite Index (Information Technology Stocks) = Red Line = (-2.20%)

MSCI E.A.F.E. Index (Foreign Developed Countries' Stocks) = Yellow Line = (-13.83%)

On Monday morning, Goldman Sachs long-time Chief Economist, Jan Hatzius, someone rarely accused of being a "bear", warned that economic growth in the U.S. "*is likely to slow significantly next year, from a recent pace of 3.5%-plus to roughly 1.75% estimate of potential by end – 2019*". The Dow shed 375 points in response. Yesterday, continuing concerns over global trade tariffs and slowing demand for technology drove the markets lower again. The "FAANG" stocks (Facebook, Amazon, Apple, Google & Netflix) that led the equity markets' advance through August, have been crushed in recent weeks on weak results and disappointing "guidance", losing (collectively) close to $1 Trillion in market capitalization in these five names alone.(1) Here are the declines of each FAANG stock (and the S&P 500 Index) for just the last two days, and since their closing market "peak" values:

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	% decline November 19th & 20th	% decline from market closing high (and date)
Facebook:	(-5.09%)	(-39.11%) - July 25th
Amazon:	(-6.15%)	(-26.68%) – September 4th
Apple:	(-8.55%)	(-23.74%) – October 3rd
Netflix:	(-6.72%)	(-36.28%) – July 9th
Google:	(-3.37%)	(-19.13%) – July 21st
S&P 500 Index	(-3.45%)	(-9.86%) – September 20th

Data Source: Yahoo Finance 11/20/2018

While there is a long list of things the markets are concerned about today, there are really three "primary" fears that are front and center in market participants' psyches, **Trade**, the **Fed**, and **Economic Slowdown**.

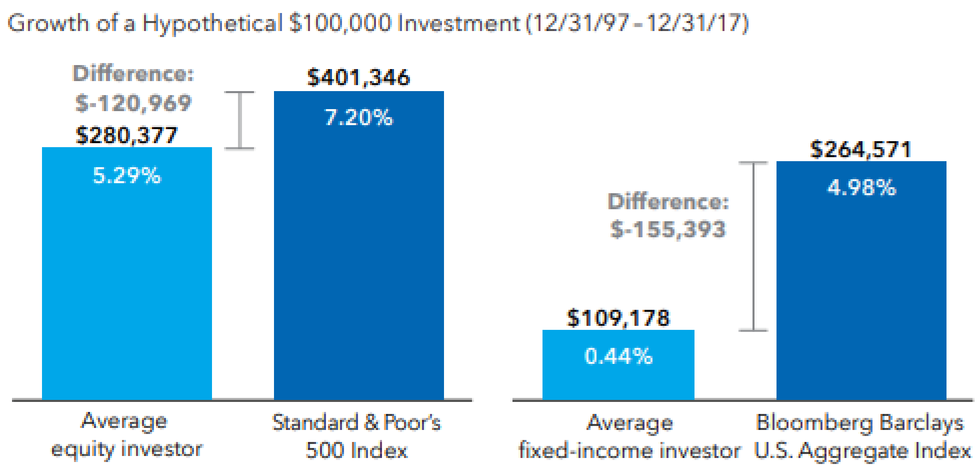
Lacking a policy reversal or delay, the Trump Administration will increase the 10% trade tariffs on Chinese imports to the U.S. to 25% at year's end. If the Chinese retaliate and raise tariffs on U.S. exports to China, hopes for year-over-year growth in corporate earnings may be dashed. In my unscientific observations, fears over this escalating "trade war" have risen to the top of the list of things markets are worried about today. The President is betting his Chinese counterparts will recognize that with such a large trade surplus with the U.S. ($301 Billion through September YTD) [(2)], they certainly have more to lose than we do with a disruption in bilateral trade, and will "blink" first. We can only hope he is proven right, and soon, as this gamble could prove to be an extremely expensive game of "chicken".

Also, near the top of market concerns is the fear that the U.S. Federal Reserve Bank (the "Fed") will push interest rates too high, and too quickly, and cause a bear market here in the U.S. The Fed's attempts at "Rate Normalization" following nine years of ultra-accommodative monetary policy, has many fearful that the new Fed Chairman, Jay Powell, is less "data dependent" (read: willing to acquiesce to market fluctuation and downturns) than his predecessors have been, and is far more resolute in removing accommodation, even if the markets decline in protest.

The natural byproduct of an extended trade war and rising interest rates is an economic slowdown. If companies see sharp cost increases to their production and supply inputs, it can be difficult to pass those costs on to consumers, and an inability to do so will hurt their bottom lines, pushing earnings lower. Lower corporate earnings lead to worker layoffs and spending cutbacks of all types. Layoffs and cutbacks cause worried consumers to tighten their belts, and reduce their spending, which in turn causes companies to cut back even more. This cycle can reinforce itself in a vicious "loop", where business and consumer confidence are crushed, and recession ensues.

Fear, like greed, moves markets, and occasionally violently so, as we've seen twice this year, first in late January, and again in the past couple of months. Market participants find this volatility particularly challenging, as they longingly look back to 2017, the least volatile stock market on record.(3)

Fear also destroys investor returns. Dalbar, a financial research firm, has shown how the temptation to try to "time" the entry and exit points in any market has actually caused the average investor to dramatically underperform a "buy and hold" approach to both stock and bond markets. In its most recent study, the "average investor" in both the stock and bond markets have lagged their benchmark indices over the past 20 years, and it's not even close.



Graph Source: https://www.americanfunds.com/advisor/pdf/shareholder/ingefl-050_dalbar.pdf

The almost 2% differential between the average stock market investor's returns and the returns of the stock market itself, or the over 4% differential between the returns gleaned by the average bond market investor, and the returns of bond market itself can only be explained by "buying high", and "selling low". As anyone who's been in my profession as long as I have will confirm, the temptation to jump into a market that has taken off is strong, but the desire to jump out of a market that is in decline is even stronger. This leads to selling in fear, watching the markets fully recover and advance above the point at which the investor has sold, and buying higher.

The reason it is hard to "beat" the markets is that we are human, and subject to both fear and greed in our decision making. In order to "beat" the markets, investors must be "right" *two* times. First, they must be "right" about the timing of their exit from the market, and later, they must be right about the timing of their re-entry into the market. And by far, the more difficult decision to be "right" about is the one to re-enter the markets, because the optimal time to re-enter the market is obviously at the *bottom* of a bear market, which is naturally when the investor's level of fear may be at its highest. That's why investors need professionals to help them avoid making bad decisions.

Market professionals understand that the less emotion plays in the deployment of capital into and out of the markets, the greater the likelihood of success. Instead of acting on emotion, investment professionals use time-tested disciplines to make these decisions, and the most successful investors are those that stick to their disciplines, even when emotions may be pushing them to do the opposite of what their disciplines would indicate. We employ such managers on behalf of our clients, professionals who employ trend analysis, momentum measures, stop losses, put options, and other methodologies to avoid large losses, and to have "dry powder" to deploy when opportunities present themselves. These managers have proven track records of success that allow me to sleep better at night, knowing they've seen this movie (or ones like it) before, and they know to look beyond "headline risks", and the "talking heads" on financial news networks. They know that they can "win by not losing", and the very best of them see market disfunction as "opportunity" to buy things that have gotten cheaper.

As is always the case, should fear be creeping into your psyche, we'd urge you to call us and talk. We are certainly not fearful, and that's largely because our money managers, which whom we speak virtually daily, have "been there, done that" in the past. They aren't losing any sleep during these turbulent times, and that gives us great comfort.

As always, we welcome your questions and comments. Happy investing!

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(1) https://www.thestreet.com/investing/stocks/faang-stocks-near-bear-market-as-rates-demand-us-china-trade-hammers-tech-14787058
(2) https://www.census.gov/foreign-trade/balance/c5700.html
(3) https://finance.yahoo.com/news/p-500-volatility-2017-lowest-113321953.html