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Perspectives

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Synchronicity

It happens. It doesn't happen often, but it does happen.

Thirty years after the 1987 Stock Market Crash, and with the current bull market setting new highs almost daily, there is much discussion about the potential for another crash – or even for a plain vanilla market correction. On the latter score, it has been a remarkably long 16 months since the market has declined by even 5%. This is the fourth longest streak without such a correction in history. Understandably, this has led many to ask, "when will it end?"

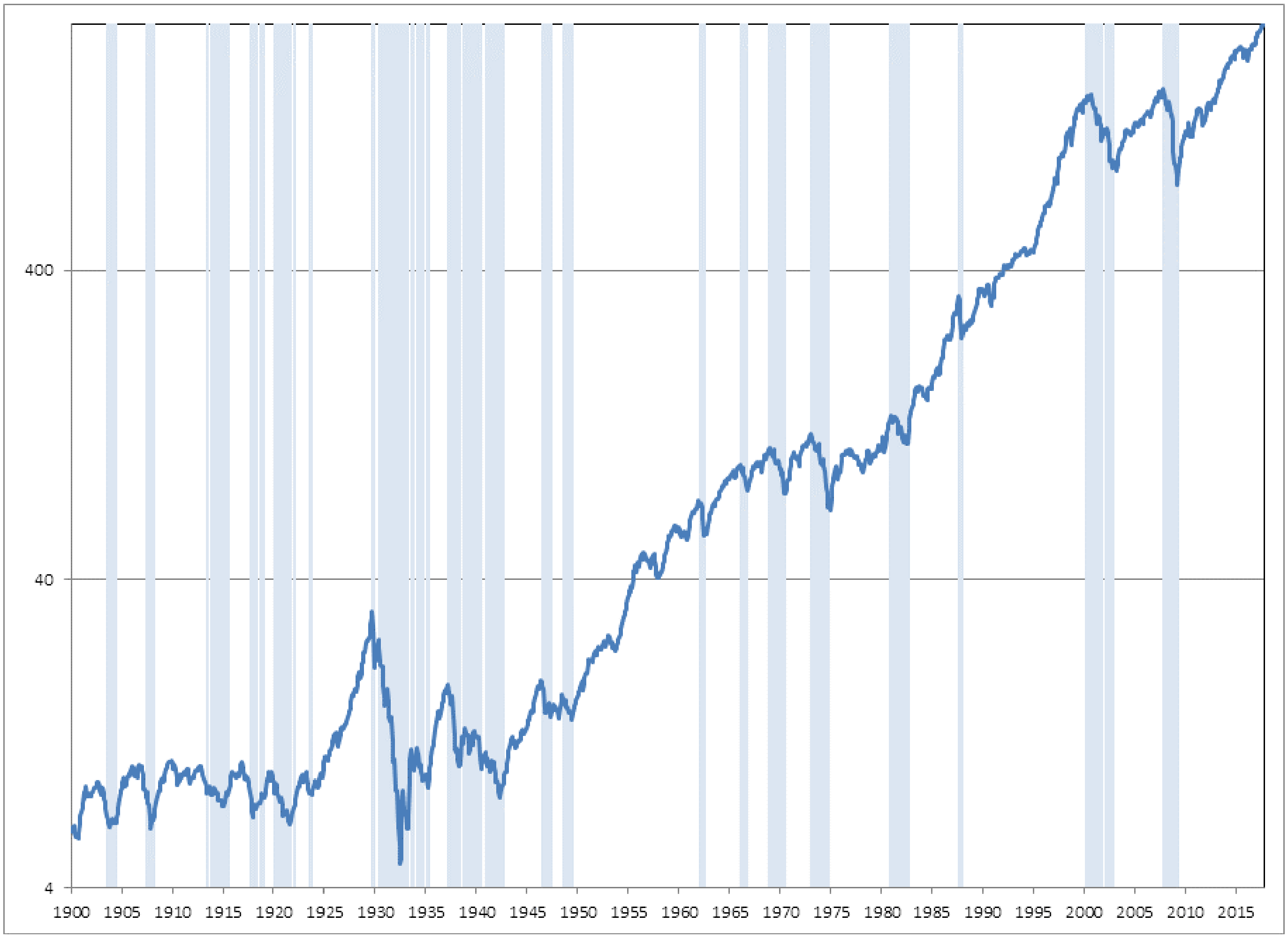
By way of perspective, on this 30-year anniversary, the events of October 1987 were a rarity. Not only did they constitute a "bear market", which is commonly described as a decline of over 20%, but they also occurred while the US economy was growing. Oh yes, and the big drop took place on a single day. More on that later.

Bear markets, especially in the post-WWII era, almost always coincide with a recession. Stocks and the economy tend to be directionally "synchronized", albeit with a slight lag. Almost always, the stock market – as a leading indicator, able forecaster, and occasionally as proximate cause – moves first. As a discounting mechanism, the stock market has proven itself a highly accurate predictor of the economy. Credit highly attentive investors, focused on the fortune of their investments. But in 1987, the market got it wrong. There was no recession.

Being highly attentive ourselves, both as avid students of the market but especially out of fidelity to our clients' fortunes, we have examined the history of bear markets and recessions in some depth. In preview, and in answer to our opening line above: yes – a 20% or more drop in the market *outside* of a recession can happen. But it certainly doesn't happen very often (exactly once in the working lives of the two authors of this newsletter!).

The graph at the top of the next page shows that over the past 118 years, US stocks have seen more than a few bear markets. And, flipping further ahead to the graph at the top of page three, you will see the bear market exceptions – which we have labeled "rogue bear markets". These are the remainder after we take away all the bear markets that are coincident with recessions. These exceptions – which represent bear markets when there was not a recession – have for the most part happened in or around the two World Wars, in the midst of the Great Depression, and during several particularly painful corrections in the 1920s, in the 1960s, and, of course, in 1987.

Singin' the blues or blue skies?: A history of bear markets in the US stock market 1900-2017, S&P 500 data from 1954, DJIA prior



Blue bands bracket corrections of 20% or more in the broad US stock market indices

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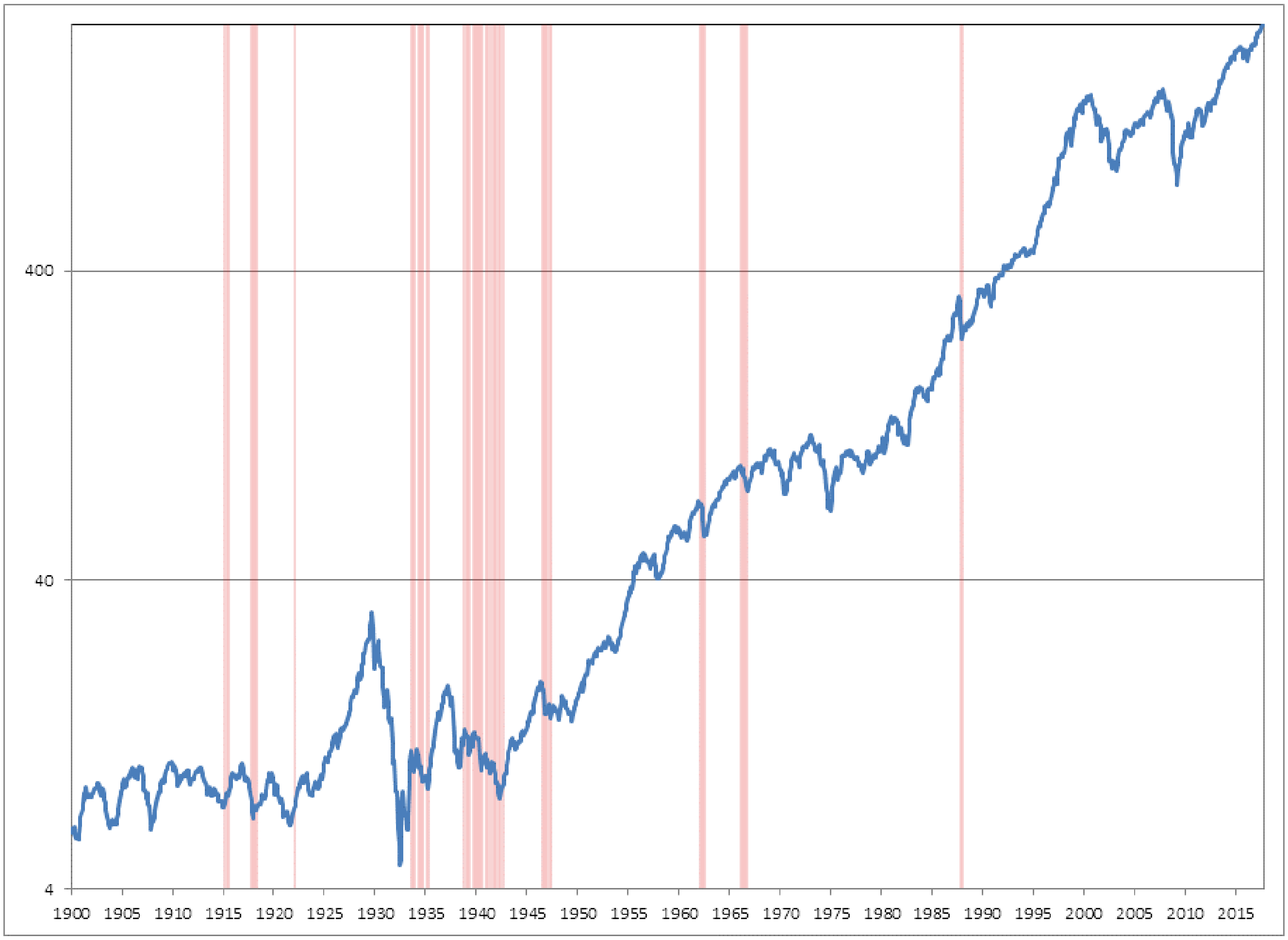
Setting aside war and depression, the remaining rogue bear markets have much in common. The 1920s were a period of significant economic change, bracketed by a severe recession at the beginning of the decade and market euphoria at the end. The 1960s were similarly marked by market enthusiasm – the 'nifty fifty' stocks were emblematic of the era – and by an economy grappling with technological change, social strife and government fiscal challenges. The 1987 crash was presaged by a very strong bull market and rampant market optimism. Portfolio insurance and program trading were also a factor

"Rogue" bear markets are a rarity in the Post-WWII era
Instances of a 20% or greater drop in the broad market averages **not** coincident with recession

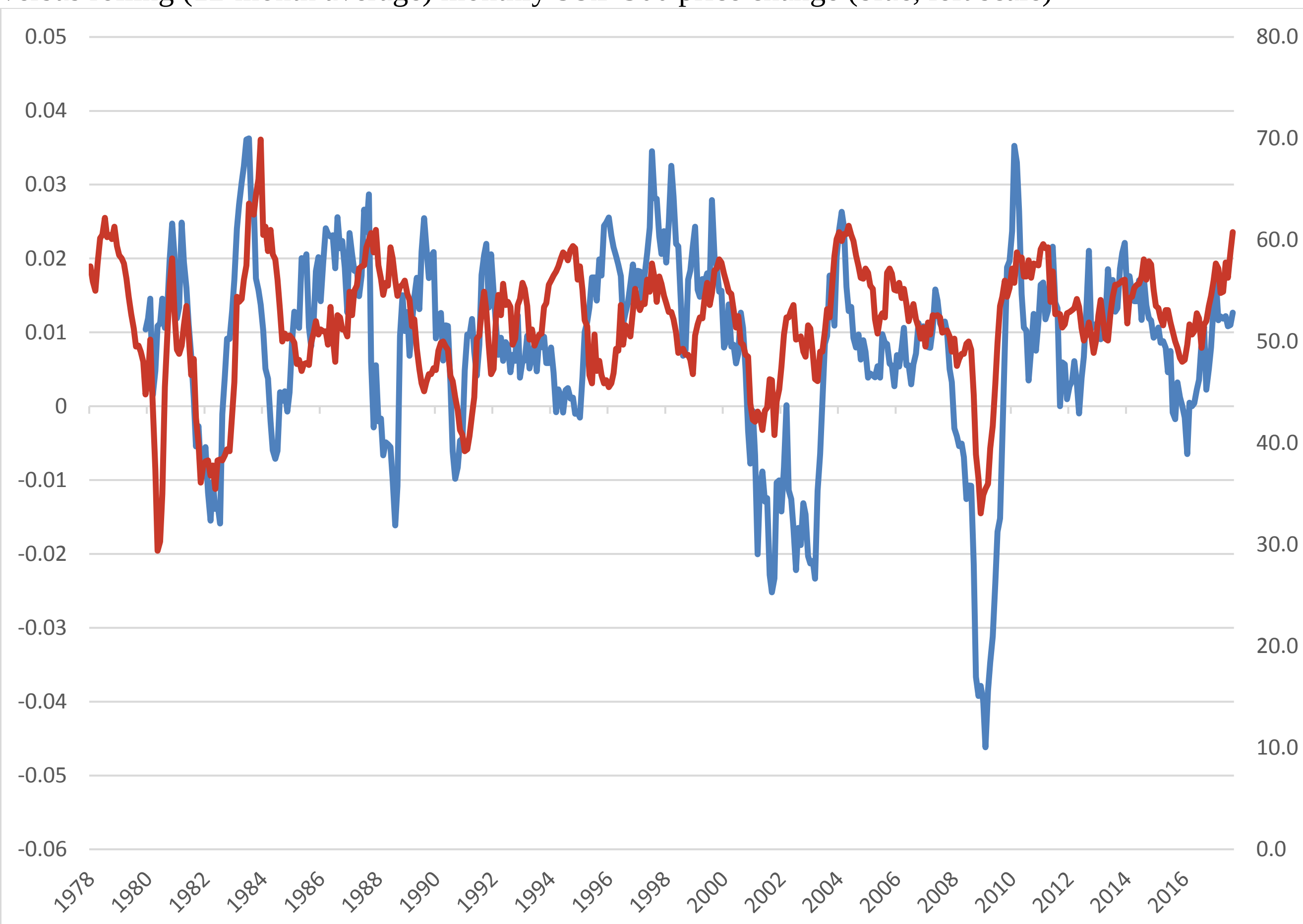


source (both charts): FactSet, ATIA

in that correction, and largely explain the very steep and unchecked drop of 22% in one day. That constituted the worst single day on record for the US stock market.

Are we set up for another rogue bear market? Could we see another 1987? We'll never say never, but let's consider the evidence. Certainly, valuations are stretched, as they were in the 1920s, 1960s and late 1980s. But relative to interest rates, stocks are still fairly – if richly – valued. Were interest rates to rise, and quickly, that could trigger a sharp selloff. But monetary authorities are keenly aware of this dynamic, and seem to be working in concert to lessen the risk. Ironically, the success of fiscal policies such as tax cuts and infrastructure spending could afford the Federal Reserve the opportunity

Synchronicity II: It's all about…the economy!
US Purchasing Manager's Index (red, right scale),
versus rolling (12-month average) monthly S&P 500 price change (blue, left scale)



source: FactSet, ATIA

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to unwind its stimulative policies. But we see that as more of a lid on the market than a catalyst for a drop. Still, this likely represents the biggest risk. Related risks include the potentially inflationary pressures of trade policies and an overheating economy. The geopolitical scene represents another set of risks, but barring war, is likely less relevant.

Many have asked: Why is the market so high, given all the noise out of Washington? The surprising answer, after a near record economic expansion: It's the economy! After years of dogged, lackluster growth, it is finally revving up. The chart above shows the Purchasing Manager's Index – a widely used measure of economic activity – hitting near record levels. Note the close correlation with stocks.

The simple implicit (and not surprising) message: As goes the economy, so go corporate profits, and so too, go stocks. What is surprising is the extent of the soaring Purchasing Manager's Index. While political and even geopolitical uncertainty is high, business confidence is also very high. Somewhat unusually, too, the current economic expansion is global – with virtually all the major economies around the world participating.

Given its evident strength, we expect the US economy to continue growing for the next few years. As we have pointed out previously, it took 68 months to fall into, and then get out of, the 2008 recessionary hole…far longer than any other experience in our lifetimes. The current period of forging ahead, at 48 months, is still well short of the 65-month average. If history is any guide, our economy should keep growing through mid-2019. And of course, absent a recession, chances of a bear market are slim (but not non-existent).

There are aspects of the current bull market we distrust, including the huge groundswell of funds moving into passive investing (no thinking required!). Further, with higher interest rates a possibility in the US, the calculus for discounting future growth will likely change, with particular risk for the high-flyers. We believe that our growth-at-a-reasonable-price (or "GARP") orientation and individual stock selection, emphasizing high quality franchises built on solid balance sheets, should serve us well on a relative basis should valuations come under pressure.

We continue to have confidence in the durability of US economic growth, but in recent months have taken action to lessen portfolio risk through: 1) halving some technology sector positions with large gains and reinvesting in similar end market exposure but at better perceived valuations; 2) taking advantage of what we believe is unjustified pessimism in some quality company stocks; 3) buying less expensive overseas shares; and 4) selectively buying shares in gold mining companies. We intend to continue these techniques in the coming months as we strive to balance long-term opportunity with prudent risk management.

We look forward to speaking with you soon to discuss our recent actions and outlook.

Paul Collins　　　　　　Carey Callaghan

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