Investment Insights

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What Is Going on with the Stock Market?

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The last few days have seen the largest decline for US stocks since late 2016. The sell-off ended the S&P 500's longest ever period without a 3% decline. The primary catalyst for the decline was a strong labor report on February 2nd which included higher than expected wage growth numbers.

This caused investors to fear both higher inflationary pressures along with the possibility of more rate hikes than expected by the Federal Reserve. Based on stronger than expected wage growth, the US 10-Year Treasury yield continued to move higher, rising to 2.85% before declining. Over the past three trading sessions, volatility increased from the extremely low levels seen for the past two years. The volatility index (VIX) – also known as the "fear index" - jumped from about 12 to approximately 50 in only three trading days before receding. While the numbers do not mean much to most investors, we note the level had not exceeded 15 in more than a year. In fact, the last time the VIX index was at 50 was during the 2008 recession. When the VIX index gets to these extreme levels, fundamentals get tossed in favor of pure emotion which further distorts financial markets. In just over a week, investors shifted from concern they were missing out on a strong equity rally to fears of a bear market. Both emotions were overdone in our opinion.

As investment managers, we step back from the noise and look at the current environment. After years of concern that wages were not rising and the Fed could not push inflation toward its 2% goal, investors now are fearful that both of those issues are now changing. Wage growth - along with inflation - is moving higher. This "good news" is taken as a negative by investors who have spent the past decade conditioned that interest rates will remain at multi-decade lows forever. In fact, aside from fears of higher inflation and interest rates, we do not see any other economic news to concern us. A combination of steadily rising markets over the past several years, along with extremely low volatility in the equity markets set the stage for the rapid decline over the past few days. Economic fundamentals have not changed in the last week. Only investor emotions have changed.

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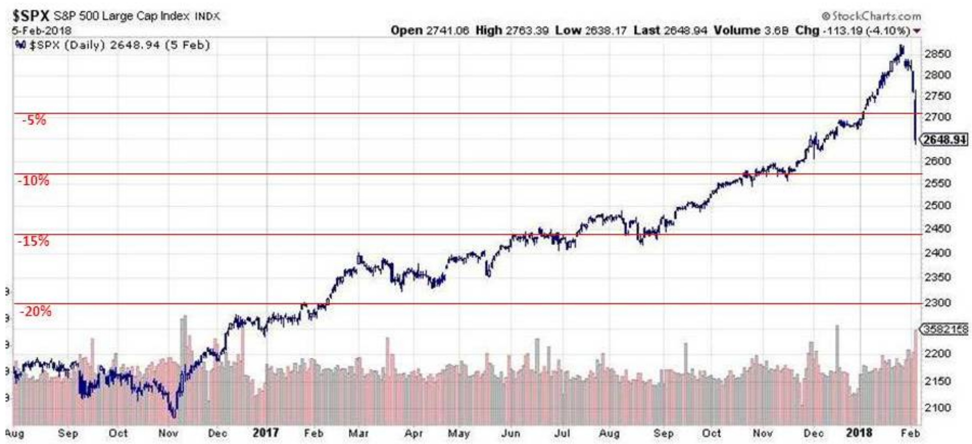
The adjacent chart shows the S&P 500 over the past 18 months. As you can see, we are back to the levels in mid-December 2017. We have marked various levels of decline from the all-time peak (5%, 10%, etc). The chart shows that a 10% decline – which would be the offcial measure of a correction – would bring the S&P back to where it was as recently as mid-November 2017. A full-blown 20% bear market decline would take the S&P down to its level from a year ago. Equity markets have been so strong that a correction means giving up a few months (not years) of gains. The reason there is so much concern is the extreme rapidness of the decline. A slow drift lower would have the same effect on portfolios, but when declines are gradual, people tend to be less concerned. Nobody likes to lose money, but when put in this context, we believe it gives needed perspective.



The issue for investors is what they should do now. In many cases, the proper answer is – nothing. If you have a proper asset allocation that is in line with your individual level of risk tolerance, this decline should not change your thinking on long-term investing. At Tandem, we have always focused on risk management which entails both asset allocation along with portfolio rebalancing when market moves cause client portfolios to stray from their desired asset allocation. We do not rebalance according to the calendar, but rather whenever warranted. This has had us reducing overweight equity positions in client portfolios regularly for most of the past year, using proceeds to add to fixed income which had dramatically lagged equities. This rebalancing maintains proper asset allocation and allows client portfolios to better withstand short-term market declines.

Warren Buffett, famously said, "You can get fearful in five minutes, but you don't get confident for some time." This is why many investors that sell stocks into downturns usually miss the bulk of the upturn before getting back in.

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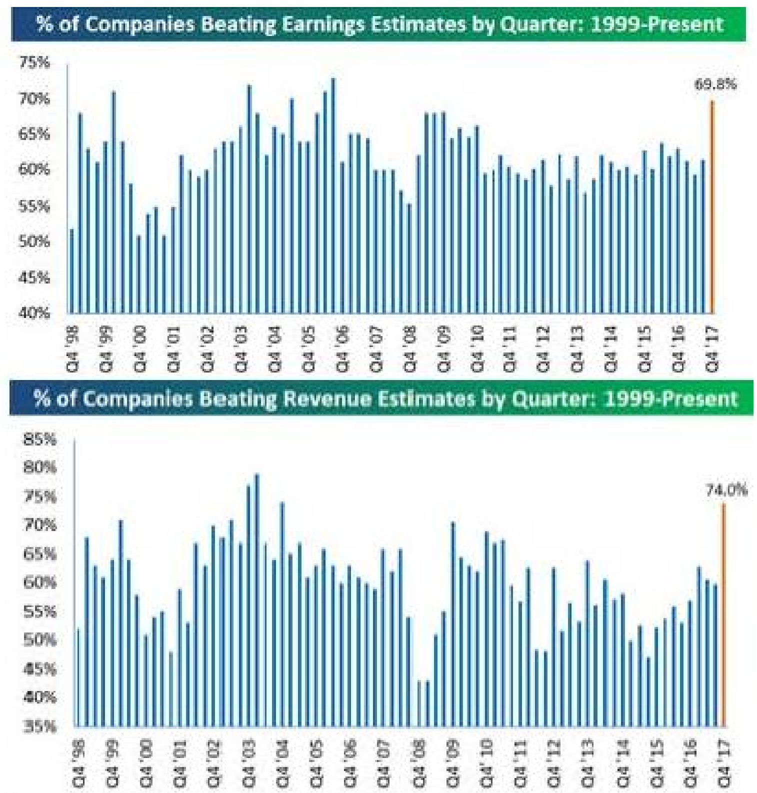
We have continuously reminded clients that in the long run, earnings are what ultimately drive stock prices. Previously we had written that in late 2016, the bull market transitioned from one driven by lower interest rates to one driven by rising corporate earnings. Looking at earnings and revenues, companies are doing phenomenally well. We have seen about half the companies in the S&P 500 report results for the fourth quarter of 2017 thus far. Earnings are up almost 15% from the same quarter a year ago, according to Thomson Reuters. If this is maintained for the remainder of the company reports, it would be the fastest earnings growth since the third quarter of 2011. Additionally more companies are beating estimates than in the average quarter. Lest people believe financial engineering is behind the earnings growth, we note that revenue growth has averaged 8% among companies that have reported, which is also the fastest growth rate since the third quarter of 2011. This information can be seen in the nearby charts.



Source: Bespoke Investment Group

In summary, the market decline was long expected, and in many ways welcome. Seeing the market decline sharply in a short period is disconcerting and tugs on investors' emotions, pushing fundamentals from the discussion. Pullbacks allow the markets to digest rapid rises, flush out weak and speculative investors, and - combined with the rapid increase in earnings - reduced or eliminated any over-valuation in equities that built up over the past several months.

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