—New Albany—
Investment Management

December 16, 2018

Market Insight: It's Nasty Out There
Is This a Bear Market?

Year-end commentaries are supposed to be filled with reflection, thankfulness, and inspiration for the New Year. In the grand scheme of things, yes indeed, we all have much to be thankful for, and it is most important to remember that, especially when we hit a rough patch. We have a great country, freedom to pursue dreams, and opportunity to thrive. So I am indeed thankful!

That said, as far as the markets are concerned, unless you have been 100% in cash, there has been little to cheer about in the financial market. World stocks have taken the biggest beating since 2011 and yet the economy is far stronger on all fronts. Even gold, US Treasuries and Corporate bonds are down. There simply has been no place to hide. Yet there are no asset bubbles, inflation is well under control and growth is still decent. All of this good news helped propel the US market to all-time highs in the 3rd quarter, but since then, it has been in a brutal downward spiral throughout much of the 4th quarter. Many are asking: How long will this nose dive last? Are we in a Bear Market? The short answer is, no one knows, but I can offer some perspective.

Sometimes being right is not a good thing. If you recall in the previous *Market Insight* I wrote the following:

> "*Selling begets selling and the price action turns into a nasty downward spiral*. ***Price action is chaotic, volatility is wicked***. This is where we are now. Some may call this a Bear market, others may call it a severe correction. I call it no fun! *So until the fears are alleviated (sentiment turns), the market will continue to experience fierce downdrafts.* It is unlikely the bottom has been found. How long will this continue? No one knows, **but it would not be unusual for the markets to be unsettled for many months if not through most of 2019. It will take time to discover and get comfortable with slower growth in a higher interest rate environment- something we have not experience in over 10years!"**

The above comments were and remain spot on. Price action is likely to continue to be chaotic and volatility high. But why?

Western Standoff: What we are experiencing could be described as a Western standoff. This is when there are '*three or more parties in which no strategy exists that allows any party to achieve victory. As a result, all participants need to maintain the strategic tension, which remains unresolved until some outside event makes it possible to resolve it.*' (Wikipedia) In this case the three parties are the **Fed, the Markets and President Trump, each of which has views and/or policies that are at extreme odds with regards to future economic growth. This tension is unnerving investor confidence and causing a mass exodus of stocks around the globe.** The markets are screaming a recession is quite near; the Fed just reiterated the economy is quite solid and raised rates; and President Trump has launched a massive change in world trade policies. Never in my thirty eight years of the markets have I witness such an extreme divergence in expectations about the economy and Fed policy, and never have we seen the market fall over 13% in between Fed rate hikes! Only time will tell how this all plays out, but in the meantime, the markets are in retreat.

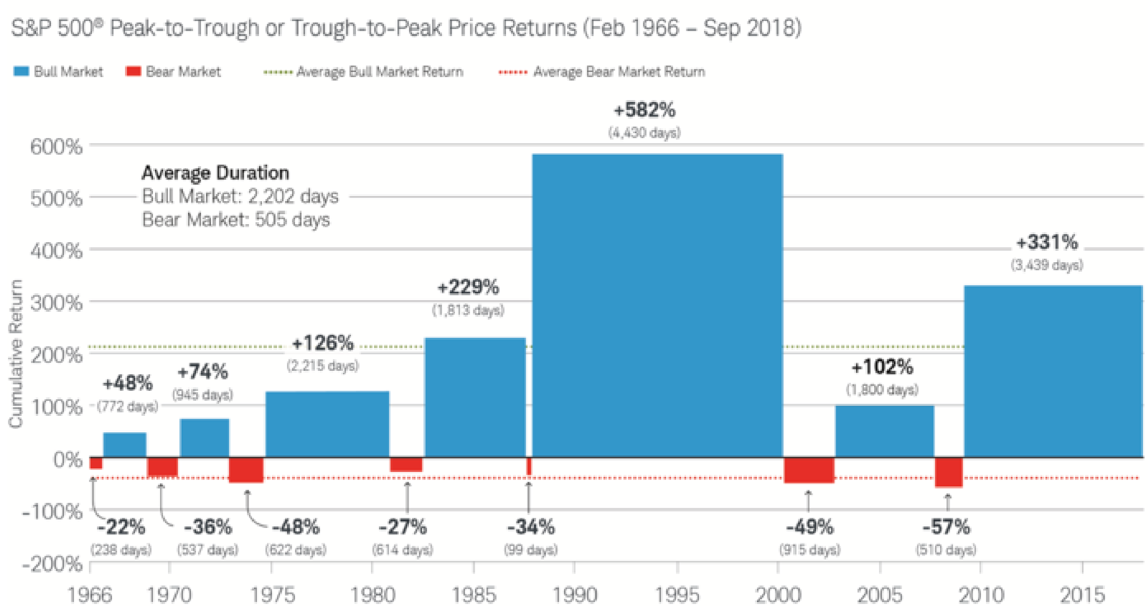
So is this a 'Correction' or 'Bear' market? Does it really matter? Well yes and no. Corrections typically are much shorter and have a price decline from top to bottom of -10% to -20%. Currently every stock market sector is well into 'correction' territory and many have already fallen into 'Bear' territory (over -20% decline) from their recent peak in September. This December is on track to have the worst monthly performance in 16 years. (So much for the typical Santa rally.)

Speaking of history, here are a few stats: There have been 22 market corrections since 1974, with only 4 of those becoming Bear markets (1980, 1987, 2000, 2007). Living through all of these, (I have quite a few battle scare!) I can attest that each Bear market had a unique catalyst, character, and varied greatly in duration and magnitude of decline. So it is important not to 'suppose' a certain path, because each Bear market cuts its own path, the price action is always extremely difficult to predict, and the steep declines have ended just as abruptly they begin. Trying to call a bottom is difficult.

As painful as this current downdraft has been, when compared to other periods, it actually has not been so bad…so far. As of this writing, the current decline began only 85 days ago, and the S&P (peak to trough) has ONLY declined -13.7%. If this is a correction, the decline should be about done, but if this is a Bear market, we may still have a ways to go.

Below is a chart that shows the bull (blue) and bear (red) markets since 1966, and the length and magnitude of change. Bear markets have had a duration of 99-915 days, and a decline of -22% to -57%.

Past bear markets have tended to be shorter than bull markets

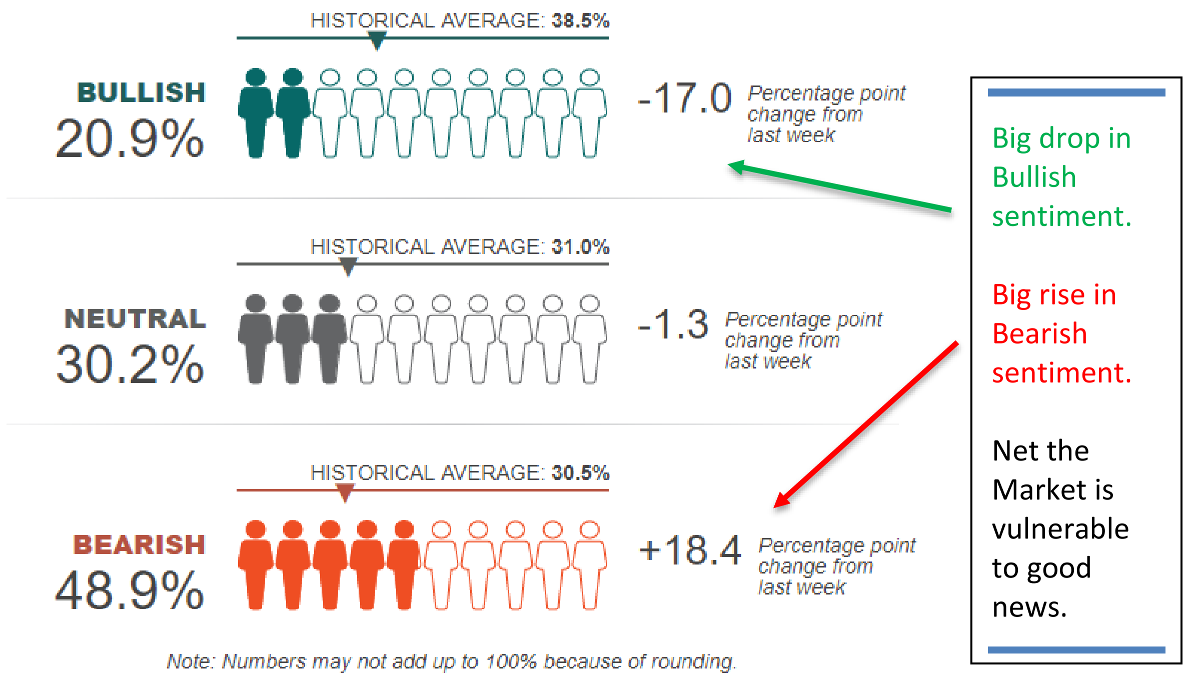


Source: Schwab Center for Financial Research with data provided by Bloomberg. A bear market is usually defined as a decline of 20% or greater. Duration is measured as the number of days from the previous peak close to the lowest close reached after it has fallen at least 20%, and uses a 30/360 date conversion (30 days a month/360 days a year). The market is represented by the S&P 500 index. **Past performance is no guarantee of future results.**

History says it is possible the current difficult environment could easily last for several more months, if not all of 2019, and the decline could be much further. However, <u>I must caution again, that each market season is unique and it is foolish to assume this market is like the others, because it simply is not.</u> So a defensive and patient strategy is key.

There is some good news: No doubt about it, every news story is quite bearish, and most investors are worried. Market sentiment is extremely negative. So why is this good news? It is exactly these conditions that make the market very vulnerable to good news. A good measure of investor sentiment and a contrarian indicator is American Association of Individual Investors (AAII) sentiment index which is a measure of how positive or negative investors feel about the stock market over the next six months. When it is very positive (meaning investors feel confident) the market has often reached a top; likewise, when it is very negative, the market may be nearing a bottom.

The chart below is the most recent survey for the week ending 12/12/2018. Notice the huge decline in bullish sentiment, dropping 17pts and declining well below the average. Likewise, the bearish reading increased by 18pts, and now above its average. The net take away is that a lot of bad news has already been priced into the market.



Source: AAII

So What to Expect for 2019? Here are the main themes:

- U.S. economic growth will likely slow from current 3.1% to 2.2% in 2019, with the risk of a recession rising.
- Trade friction, which remains an uncertainty heading into 2019, could be an important indicator of the timing of the next recession.
- Market volatility is expected to continue and perhaps rise further next year as the economy adjusts to less liquidity and no outside stimulus.
- Even without raising rates any further, the Fed and other Central banks will continue to move toward tighter monetary policy with the unwinding of quantitative easing accelerating. This will put more bonds into the market and could potentially push longer rates higher.
- Earnings growth will decelerate sharply in 2019, as year-over-year comparisons become more challenging in light of the tax-cut-related boost to earnings in 2018.
- Continued U.S. dollar strength could be an additional headwind for earnings, even though stock valuations have become more reasonable.

We will not know for sure whether this current market decline is a correction or the beginning of a Bear market until we are past it. Bull markets cannot run forever so eventually there is a pause, a correction, perhaps a recession, and sometimes a bear market. The market is pricing in a recession, and **historically stocks put in their weakness performance during the six months leading up to a recession**. **So we may well be in the middle of this 'anticipation' period.** But once there is more clarity on the strength or weakness in the economy, the market will find a bottom and begin anticipating better times ahead. It is all a big cycle. Until then, I will reiterate again: … **it would not be unusual for the markets to be unsettled for many months if not through most of 2019. It will take time to discover and get comfortable with slower growth in a higher interest rate environment.**

So what's an investor to do? No mincing words, it has been a brutal quarter. **The market is adjusting to a 'normalized' investment environment, which means credit is no longer cheap, and there is less liquidity and leverage. As this transition completes, the market will find its footing and it will be organic growth that will lead the markets higher**. As abruptly as this market mood has soured, it can quickly reverse back positive again. That's why long-term investors are usually better off staying the course and not pulling money entirely out of the market. Patience is key. That being said, it is essential to always have a plan and reevaluate your risk tolerance. If you are feeling very uncomfortable then it may be a sign your risk is too high. It is always important to match your risk tolerance with your investment goals. Please contact me if you would like guidance.

Investment Strategy: Stock exposure was reduced mid quarter with a more defensive investment strategy and will remain that way until there is more clarity and stability. Specifically, risk was reduced by both lowering total exposure to stocks and shifting risk to low volatility, defensive sectors. Also, with large intraday moves expected to continue, most stock mutual funds have been swapped with exchange traded funds (ETF's) to give further flexibility to make intraday changes if need be. Bond Exposure was increased and duration exposure remains short term to benefit from a continued rise in short term rates.

In Sum, having lived through many rough patches in the market, I know how unsettling it can feel. But take comfort, the market will move through this period and march upward again.

Life is good. I am grateful to have the opportunity to serve each of you and I pray you will experience all the blessing of life and love in the New Year to come!

Best Regards!

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