—New Albany—
Investment Management

February 9, 2018

Market Insight: Is Good News now Bad News?

Technicals Swamp Fundamentals

The decline in the market has been steep and vicious, setting the worst two week performance since 2015. The last two *Market Insights* warned of an increase in market volatility, but I must admit, the veracity and magnitude of this move was not expected! Looking back at other periods of rapid market declines, the cause or trigger was always the fear of a slowing economy; but now the situation is just the opposite. There is fear of too much growth, inflation, and rising bond rates. Up until a month ago, both the market and the Fed welcomed higher growth, inflation and even a small rise in rates. But now this good news is suddenly viewed as bad news. Last week the market began its rapid decent on the news of another strong employment report and rising rates. How can good news suddenly be the catalyst for the market to turn south?

Technicals overshadow the fundamentals: Charles Schwab states: "Market pullbacks always have a catalyst—but they typically aren't the only reason stocks fall, just the straw that broke the market's back. In this case, the recent rise in optimism among business leaders and investors along with 15 straight months without a stock market decline... had left the global stock market vulnerable to a pullback." Though the trigger this time was perhaps the sharp rise in global interest rates, it was the extended technical condition of the market that caused the violent reaction.

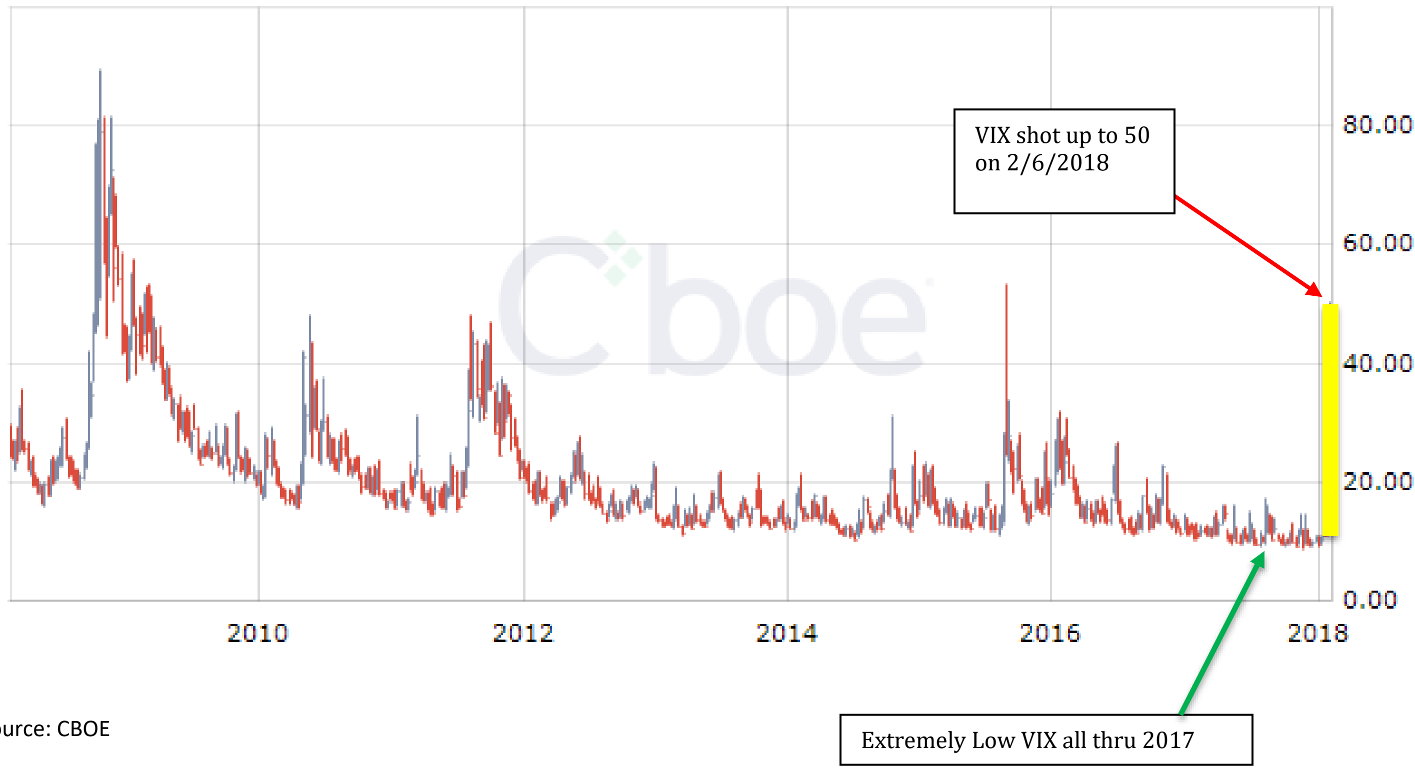
Technicals driving Volatility Overshoot: The term 'Technicals' refer to many different measurements that analyze the supply/demand condition of the market. Measurements can include specific price support and resistance levels, trends, momentum, and investor sentiment. When the Technicals become out of balance, (too many people doing the same thing) the market becomes more vulnerable to any slight change, and a large reaction ensues. Presently, the market is working off an imbalance in the "VIX", a trade that bets on the direction of volatility.

The "VIX", measures the stock market's expectation of implied volatility of the S&P 500 index options, and is one of the most popular instruments used to short volatility. It also known as the 'fear' index because the price rises when traders are uncertain about future volatility, and falls when traders are confident. 2017 saw the lowest market volatility or draw down since 1995, with the maximum decline in the S&P of only 3%, the second lowest in history. Traders were very complacent or sanguine about the future and hence the price of the VIX dropped to an extremely low level of 8. (See chart on next page)

Over the past year, many speculators took huge positions betting volatility would continue to stay low. But the surprise of rates rising faster than anticipated (due to strong growth) upset the apple cart. Uncertainty about the future began to rise, and so did the price of the VIX. Suddenly, all the shorts scrambled to cover, which pushed stock prices lower. And the more stock prices fell, the higher the VIX, forcing more short positions to cover. Thus it turned into a nasty continuous spiral of rising volatility and falling stock prices.

Elephant squeezing through a key hole: The chart below shows the VIX over the last 10yrs, with average price range of 18-20. But in 2017, the VIX fell to a low of 8 and stayed quite low until last week when it punched through 18. Once through the 18, the fuse was lit, and on Tuesday, February 6th, the VIX catapulted to a price of 50, a level reached only two other times in 10yrs. This was a gigantic move! Being an old trader from Wall Street, we used to call this situation the "elephant squeezing through a key hole". As of this writing, the VIX is currently at 35.

10 year chart of the VIX

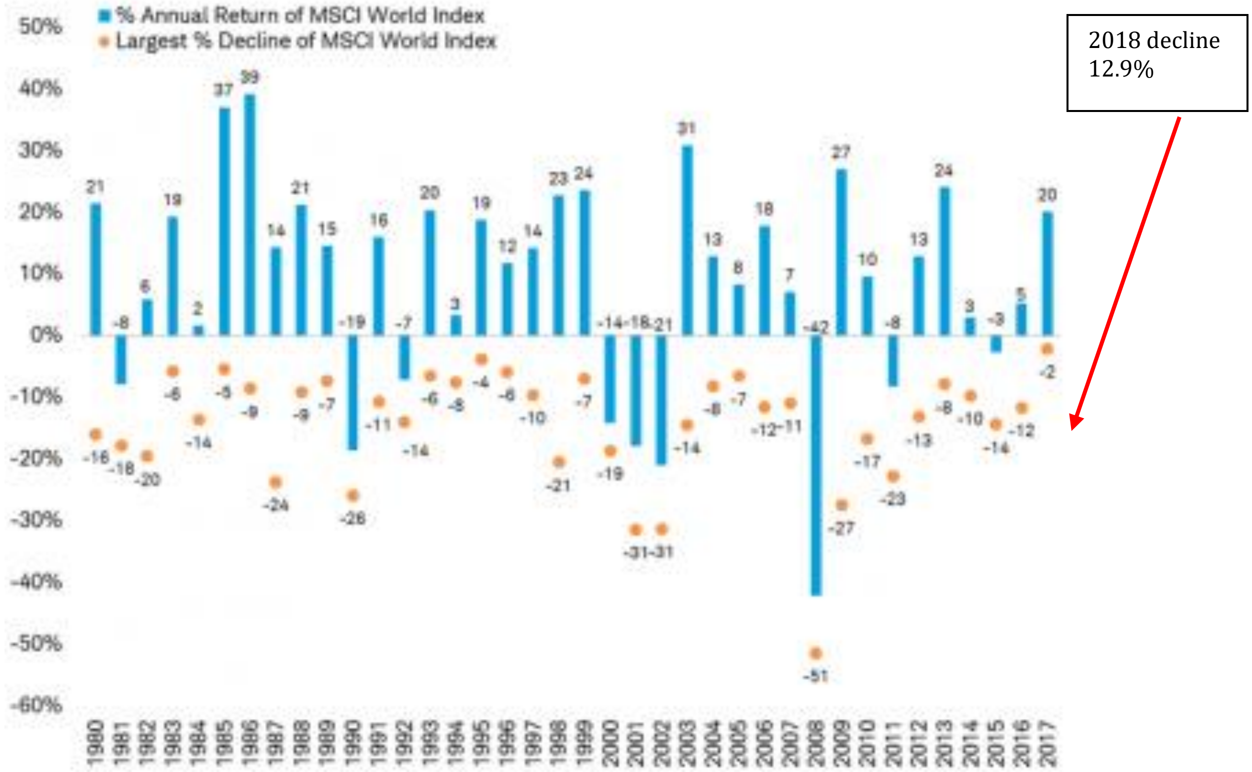


Source: CBOE

History has shown, in years where there has been minimal drawdowns, (like 2017) it is followed by several years of spikes of volatility and larger drawdowns. In addition, <u>when there are 'blow up's of this magnitude, it takes anywhere from six to eight weeks before volatility subsides and the markets regain their footing</u>. The lows may not be in, so keep your seatbelt fastened!

Downdrafts are not unusual: It is not unusual to see pullbacks, including the one we are experiencing now. In fact, **global stocks have fallen from peak-to-trough by more than 10% in over sixty percent of the years since 1979, yet most of those times they have still posted a gain for the year.** As of this writing the market has declined 12.9% from its peak on January 26, 2018. See chart on the next page.

The chart below show the annual return of the World Index (blue) and the magnitude of annual intra year decline (yellow dot)



Source FactSet

What to do? Panic is not an investment strategy. Selling during these periods never works out. At the same time, until the VIX falls back down into the low 20's, it is probably not time to buy. So for the moment, the best course is to sit tight.

The Bull Market is not Dead: A Bear market starts when the market gets a whiff that a recession is coming soon. Today, there is not one economic indicator showing any signs of a recession, in fact, growth is accelerating. In addition, earnings growth has been very strong and companies are adjusting their growth estimates upwards at a pace not seen since the 2009 rebound. It is not just the US tax cut driving upward adjustments, but strong global growth. While corrections are very unpleasant to live through, it is a normal part of a market cycle to wring out excess speculation. We are in the advanced stages of the business cycle which means volatility is expected, but so are more gains in the market. The race is far from finished. Stay diligent, and stay the course!

These are my own thoughts. Please contact me with any questions or concerns.

Remember the many blessings of this day!

Kind Regards,

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