StraightTalk

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The Bull, and The Correction

As I have mentioned to those that I have spoken with so far this year - I have not been this excited about the opportunities in the economy and the markets in a long time. At the same time, I have rarely been as certain that a stock market correction looms.

The reason for this seemingly bipolar outlook is rooted, as always, in the facts. Looking at the facts swirling about in our economy presently, and layering them over historical data gives me great comfort in both outlooks. It is undeniable that a tone of optimism has surfaced across the markets. Attributing all of this optimism to the current President would be as wrong as claiming that this environment was a late blooming creation of the previous President. Rather than spending any ink on who gets the credit, I will just reel off a few of the newsworthy points that have turned the participants in our economy collectively more positive in the last year.

We are set to have three straight quarters of 3+% economic growth, which has not happened since 2004. Unemployment is hovering at 4.1%, the lowest in seventeen years. Corporate earnings (as measured by the S&P 500) are growing at an eye popping 20%, and now 242 companies in this country have announced bonuses and compensation increases to employees. An environment of lower taxes and regulation has certainly contributed to some of these strong data points.

However, the rest of the world is also improving. Japan has finally broken out of economic stagnation, and their economy is growing once again. China, having seen its GDP growth rate slow in recent years (to a rate that was still three times our rate of growth) has halted that slide, and their GDP just ticked up last quarter. And, according to research by The Capital Group, 31 out of 32 European countries are now in expansion. In other words, for the first time in this century, all of the major economic basins of the world are growing simultaneously. This synchronized global growth is certainly feeding investor's sense of optimism, with global markets reflecting that optimism.

"But shouldn't we be worried about......" remains a constant refrain. This fear of another 2008 continues to linger, fueled no doubt, in part by "experts" saying the end is near. One wonders why anyone listens to these people anymore, when they have been so consistently and publicly wrong. Nouriel Roubini, Bill Gross, and Mohamed El-Erian each came on the television for years starting in 2009, and said that we were in a slow-growth era of low returns, and that this was "a new normal." The S&P 500 has since returned 15+% per year for the last five years. *It is hard to be more wrong than that*, yet these people continue to be booked by Fox Business, CNBC, and Bloomberg for their expert advice!

Here again, the facts are what matters, not opinion or emotion. The facts around an investor's chance of loss just do not support the emotional notion that just because markets go up for a few years, they must then go down. Using the S&P 500 as our investment set, and going back to 1926 – your chance of having a 10% loss in any one year is just 13.2%. You have a 6.1% chance of a loss of 20%, while the likelihood of a 30% loss is half of that, at just 3.1%. The chance of having a 40% loss or greater in any one year is around one percent. Seven out of ten years in the stock market are up, and yet everyone acts as if at any minute, everything could head south and stay that way.

With those facts as background, it is incumbent upon me to point out that there have been no market declines from which there has not been full recovery. None. Zero. It has never happened. My legal team will appreciate me pointing out that the past is not a guarantee of future success, all investing carries a risk of loss, and that I am not guaranteeing a recovery from the next decline, whenever it comes.

However, the facts are the facts. Google a chart of the Dow Jones Industrial Average going back to its start in 1896 and look for yourself.

Knowing those facts and that history did not make 2008 feel any less scary, nor did it make 2002, 2001, 2000, 1996, 1990, etc., any more tolerable from an emotional standpoint. Market declines are never fun, but the temporary loss in values is the price one pays for the return from equities - you can't have one without the other. The fear of that temporary price decline should not shake us from why we invest in the great companies here and around the world, which is the chance for a growing future stream of profits and dividends. Sometimes that fear is small and in the background, while at other times, it can become overwhelming and cause irrational decisions from even the most seasoned market participant.

The horrific opportunity cost that many investors have paid by hiding out in bond funds and cash since 2009 is undeniable. The fear of "another 2008" has kept far too many people from being invested as they should have been. The stock market's complete recovery and subsequent advance has left them on the sidelines, and presumably, has left their financial plan in dire straits. Smaller, but no less impressive, is the lost opportunity many investors similarly paid by cashing out of their portfolio the morning after the 2016 election. The Nobel Prize winning economic writer, Paul Krugman, predicted one day after the election that the stock market would never recover from President Trump. Heeding that baseless advice has cost those that listened dearly. More rational people realized that the economy and the companies that make up that economy are always stronger than any one President, and they participated nicely in last year's market gains.

The fear of the next big decline is actually healthy for markets – it keeps them from reaching a speculative fervor, which we last saw in the dot.com 1990s. The historic facts also suggest that we will have that level of optimism again, as it typically occurs in the last stages of a bull market. At present, we are nowhere near the kind of greed readings that typically signal that it is time to become cautious.

So why then, am I expecting a stock market pullback soon? The answer is that we are past due for a *price correction*, which is vastly different than a selloff caused by any economic decline. In other words, there are routine and normal "10% off sales" that happen about once every eighteen months. These corrections are healthy for the market, keep excessive speculation from growing, and allow for investment dollars to rotate out of companies and sectors that have gotten expensive into others that are less so. In fact, the average intra-year decline since 1980 is about 14%, so we should expect a decline of some size during most years.

However, the only double digit price correction in the last thirty months was the first six weeks of 2016. That may be in everyone's rear view mirror now, but the 11% drop in just 28 days was all the breathless media could discuss at the time. The headline, "The Worst Start to a Year Ever" was picked up by virtually every news outlet on earth. The fact that the year went on to finish up 11% was much less newsworthy, except for those of us who ignored the early year correction in favor of counting our gains at year end.

The narrative that the January 2016 selloff was triggered by oil price declines and European banking concerns may be true, or it could have been caused by something else – no one truly knows. The facts are that the economy was healthy, we needed a price correction, so we got one. *And it was short lived.* A double-digit gain less than ten months later was your reward for sitting through the price dip. This is typical of price corrections when the fundamentals are strong, as they are today. Falling prices in economic slowdowns (or recessions) are a little bit different, but will be a future year's newsletter topic at some point.

The moral of this story is that a correction should be waiting in the wings soon, and in an environment where there has been almost no stock market volatility, but a lot of Washington, D.C. volatility, the price drop will get disproportionate media coverage. I'm thinking headlines somewhere between *"This Year's Flu Crisis is the Worst Ever!"* and *"A Meteor Just Hit Earth!"* But we will all know the truth, because we are armed with the facts…..

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