StraightTalk

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A Market Pullback on the Horizon?

It seems that almost all areas of life really do slow down in August (with the one exception being parents getting recent graduates ready to head off to college.) There is a listlessness to the markets in the summer, and the average investor's bandwidth for portfolio discussions and reviews is likewise greatly reduced. August tends to be about beach or mountain vacations, lazy days by swimming pools, slow days at work, and not much worth watching on TV. In this relaxed environment, the network and cable news outlets have to really ratchet up the "wow" factor to get our collective attention.

So, it will come as no surprise that you will likely see numerous headlines about an imminent stock market decline, but this time - in my opinion - those headlines will be correct. The size and duration of any media predicted decline will vary, depending on how badly each news source needs your attention, but there are some facts that lead me to believe we will get a pullback shortly. There are also numerous economic realities that make the case that not only will the pullback be a short lived one, but that our stock market will move meaningfully higher afterwards, perhaps even by year end.

First, though, we must discuss some recent disingenuous story lines and the underlying reality to those stories. I won't get into how incredibly and utterly wrong Mohammad El-Arian, Bill Gross, Paul Krugman and Larry Summers have been about our economy and markets. Suffice it to say that the "new normal" and "the government should have applied more stimulus" crowd that predicted an economy that can't ever grow faster than 2% have been effectively put out to pasture. Hopefully forever.

How about all the breathless reporting on "Brexit" over the last two years? Does anyone remember the dire predictions of how Brexit was going to lead to an implosion for London's investment and banking community and crush the U.K. economy? Perhaps you may recall that in the week after the 2016 "leave" vote, markets dropped about 6% on fears this would dismember the European Union. Fast forward to last month, when an article in the Wall Street Journal discussed in detail the nonevent that Brexit has turned out to be for the London banking community. The article states "the amount of international lending channeled through U.K based banks *increased* between the June 2016 Brexit vote and the end of 2017." Whoops, the doomsday crowd got that one wrong! The article goes on to state that the number of banking jobs leaving London has been "negligible" and have been mostly attributable to normal operational moves. So, again, the actual economic facts have turned out to be far different from the negative predictions of them in the news.

And sometimes, it's the news that you don't hear or see that is even more important to your portfolio. We have all heard plenty about the White House's ill-advised stance on tariffs, and what that could mean for an economic slowdown in our country. While not defending our current President, I have said frequently that I think this is a negotiating tactic to end up in a lower tariff world in the future. Whether this lowering of trade barriers around the world occurs remains to be seen, but the actual impact of tariffs has not been accurately reported by most news outlets. I have lost count of the number of stories I have read about the negative impact that tariffs *could* bring to investment portfolios. A recent article in USA Today, titled, "Trade War Could Hit Shoppers, Your

401(k)" wins the prize for negatively tethering tariffs to both consumer shopping and your retirement plan balances. However, research on the *actual* effect of tariffs (should they be implemented in full) shows a different economic reality. According to the research firm, Strategas, the currently announced tariffs would have a negative impact of between $90-120 billion on our economy, while the positive impact of the recent fiscal policy (tax cuts and repatriation of foreign profits) will be roughly $800 billion. I think we can all do that math, and see that the currently proposed tariffs, even if they come to pass, can be easily absorbed by our growing economy.

But what if all of our trading partners ramp up their tariffs in retaliation? Again, I think the odds of a real trade war are extremely low, but a full blown trade war would definitely be a negative for our economy. However, the positive effects of deregulation across wide swaths of our economy are estimated to be three times as large as the impact of the tax cuts, and are longer lasting. So, it is unlikely that a trade war stops this bull market.

Which brings me to what could make this bull market pause over the next few months. At a recent conference, I heard a statistic that tells anyone who is listening that the stock market leadership has become more and more narrow over the recent months, a condition that often leads to a short term cooling-off period. The investment team that spoke indicated that over the last twelve months, roughly 50% of the S&P 500 return has come from just five stocks. This is great for S&P index funds, and makes it harder for diversified investments to keep up. At the same time, should money rotate out of those five stocks (as recently occurred from Mr. Zuckerberg's company) this would push that index lower in a hurry, while diversified investments would likely weather the dip better. Rotating market leadership is a healthy aspect of any bull market, but when that leadership is very concentrated like today, it often leads to pullbacks before resuming the upward trend.

Two other historic facts are pointing towards increasing odds of a broad market pullback. According to a study by Federated Investors, every newly appointed Federal Reserve Chairman dating back to 1930 has seen the stock market be down during the first six months of their tenure. Jay Powell began his term in February, so if the pattern holds, we could see some market weakness in August.

A more meaningful set of facts (simply because there are more of them in the data set) has to do with Presidential terms, and mid-term elections. Remember the famous quote by Benjamin Graham, "in the short run, the market is a voting machine, but in the long run, it is a weighing machine." This speaks to emotion moving markets short term, and there is usually no shortage of emotion approaching mid-term elections. This year appears no different in that regard, and the facts around this period of time are clear. Federated's research shows that for every President since WWII, the second and third quarters of their second year have been down, but have averaged double digit market recoveries afterward. In other words, the summer and fall heading into mid-term Congressional elections are bad for the markets, and as the election approaches, the market historically begins to rally. These are averages over many decades, and the past pattern does not guarantee the outcome this year, however the old adage about history "not repeating, but rhyming" does spring to mind. We have a highly controversial President, a hotly contested battle for control of the House of Representatives, with a newly appointed Fed Chairman, and really narrow stock market leadership. To me, this looks like an opportunity for a normal 5-10% pullback in our markets.

What we know, however, is that the news media will make it seem like a 45-50% scary bear market, rather than a routine pullback. What we also need to remember are all of the strong underlying economic trends that this bull market is reflecting. More on that in the next newsletter!

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