Pyrotechnics in the Market

Pine Haven Investment Counsel, Inc. – Commentary –4th Quarter 2018

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The roller coaster ride of the past quarter was unsettling and brought back unpleasant flashbacks of the great recession period of 2007-2009. However, as uncomfortable as it was, our economy is in much better shape now than 10 years ago.

One of the starkest contrasts is the unemployment rate which peaked at 10.1% in October 2009. Currently, unemployment is a low 3.9%. Since the early 1970’s our gross domestic product (GDP – a measurement of our economic health) has grown an average of 2.7% and, of course, during the recession it was negative. The last reading, as of September 2018, showed year over year growth of 3% and quarter growth of 3.4%. Additionally, household debt has shrunk to a several decades low while personal net worth has risen.

The most recent fireworks burst in October with a confluence of concerns. Some issues were new and others had already been simmering: trade tariffs and wars, a government shutdown, slowing global growth, interest rate increases and slowing corporate earnings. This year in February we also had some market fireworks. These market gyrations (or volatility) were slightly greater than this past quarter. The difference: in February, the US stock markets were up and in the fourth quarter they were down.

Highlighted in the table here are differences in market behavior between 2017 and 2018:

	2017	**2018**
Number of Days with 1% more change in S & P 500 Index	10	110
Decline (top to bottom)	-2.8%	-20%
Number of Down Months	0	4
S&P 500 Total Return	21.7%	-4.4%
New 52 Week Highs	62	18

From the highs of early October, the market had dipped around 20%: into bear market territory by the end of the year. The chart below is included to further illustrate the changing landscape from 2017, 2018 and against the 15 year averages. Cash was the only asset class that was positive for 2018. Compare this to 2017 where every asset class was positive.

Asset Class Performance Returns		
2017	**2018**	**15 Years (2004-18)**
Emerging Mrkts Equity 37.8%	Cash 1.8%	Real Estate (REITs) 8.5%
Int'l Developed Mrkts Equity 25.6%	Fixed Income 0.0%	Emerging Mrkts Equity 8.3%
Large Cap US Equity 21.8%	Real Estate (REITs) -4.0%	Large Cap US Equity 7.8%
Small Cap US Equity 14.6%	High Yield Bonds -4.1%	Small Cap US Equity 7.5%
Asset Allocation 14.6%	Large Cap US Equity -4.4%	High Yield Bonds 7.3%
High Yield Bonds 10.4%	Asset Allocation -5.8%	Asset Allocation 6.2%
Real Estate (REITs) 8.7%	Small Cap US Equity -11%	Int'l Developed Mrkts Equity 5.2%
Fixed Income 3.5%	Commodity -11.2%	Fixed Income 3.9%
Commodity 1.7%	Int'l Developed Mrkts Equity -13.4%	Cash 1.3%
Cash 0.8%	Emerging Mrkts Equity -14.2%	Commodity -2.5%

The Asset Allocation Category on the chart represents a diversified portfolio of approximately 60% stocks (equities) and 40% fixed income (bonds and cash). This helps show the benefits of diversification - the value of not having all of your eggs in one basket.

Of course investing or participating in the markets can be emotional. We can cite data forever, but in the short-term, the markets will swing with sentiment, while in the long-term, they will reflect fundamentals. There are recent structural changes in the financial marketplace which will influence and possibly exacerbate the swings.

1. As a response to the fear in the stock markets during the recession, the US Federal Reserve started buying bonds. This was done to help drive bond prices upward – which helped drive interest rates lower. Additionally, it was a tool to encourage stock market investors back into investing in equities. This action created market conditions which were more placid than the fireworks we experienced this past quarter. The Federal Reserve ended their bond buying program early this past quarter.
2. The advent of algorithmic trading has also influenced market gyrations. Some of these computer models kick in trading to follow momentum of either buying or selling stocks or markets.

3. Finally, there has been a greater interest in passive investing (Exchange Traded Funds – ETF's). This type of investing focuses on a particular index or basket of holdings regardless of the underlying fundamentals and prices of the holdings. Active investors, like Pine Haven, prefer to buy on dips – or buy low – when prices seem to be good values. As more money has flowed into passive investing, we are seeing that active investor purchasing takes longer to help the markets find its footing.

While our world is ever evolving, we appreciate that human nature remains fairly constant. Most of us, including business and policy leaders want to improve our condition and want to have ourselves and our loved ones safe. The markets continue to reflect these sentiments and taking the long view, we're rewarded.

"To leave the world a bit better, whether by a healthy child, a garden patch, or a redeemed social condition; to know that even one life has breathed easier because you have lived - that is to have succeeded"

-Ralph Waldo Emerson