TOWNELEY Capital Management Inc

Current Market Fluctuations – February 7, 2018

The market had seen little volatility in recent months, but Monday made headlines as stocks declined. Stock markets can move quickly. Here are our insights about the last few days:

1. It is helpful to think in percentages, not points.
2. Previous market gains earned in January offset most of the decline.
3. Diversification in your Towneley portfolio softened the blow, as gold and fixed income holdings rose on Monday while equities fell.
4. Economic fundamentals remain strong, a good sign.
5. We have seen similar corrections that did not end in recession.
6. Computerized trading may play a role.
7. The market was overdue for this correction.
8. Worry over increasing inflation helped to spook the market.
9. We anticipate more volatility as the year goes on.

Read on for details.

1. A decline in points and a decline in percent are two different things. As widely publicized, February fifth was the largest point decline on record for the Dow Jones, as it dropped over 1,100 points, a decline of -4.6%. It was not the largest percentage decline. This week's drop of 1,100 points is smaller than a 500 point drop 30 years ago because the index value is much larger today. The worst day for the Dow Jones Industrial Average was in 1987 when it was down 508 points or a -22.6% decline. The decline on Monday was the largest point decline but only the 99th largest percentage decline in history.

2. The Standard & Poor's 500 gained 7.6% for the year-to-date period ending January 26. Between January 29 and February 5, though, the market turned negative, down -7.8%, and the positive returns for the year were erased. The market was down slightly today but rebounded yesterday and the index is back into positive territory for the year. Meanwhile, interest rates have increased slightly as well. The 10-year US Treasury yield declined on the fifth but has been increasing lately and is at 2.8% after starting the year at 2.5%. Gold gained 2.3% during January.

3. This market correction illustrates the critical role of diversification. The equities in client portfolios were negative on Monday, but gold and fixed income both notched positive returns. A 30% equity portfolio lost -1% for the day and a 70% equity portfolio was down -2.7%. Diversification helped to decrease the total portfolio negative return resulting from the market decline.

4. Economic fundamentals look strong worldwide, a good indicator that a recession is not a foregone conclusion. Here in the US, conditions include low unemployment, strong consumer and business confidence, and record profits. Other countries also look stronger, thanks to a synchronized global recovery. Nothing has changed in the economy to suggest a recession is on the horizon. Companies are plowing their record profits into employees and business investment, so stronger growth in the near term is possible. Stronger growth is good for the stock market as long as inflation does not get out of control and the odds of runaway inflation are still low.

5. Historically, we have seen market corrections without recessions. In 1987, the market corrected, but the economy remained good, no recession developed, and the market ended the year with a positive return. That correction occurred in an environment of overvalued equities and extremely positive market sentiment. Time will tell if the market will mimic 1987 this year.

6. In Monday's market decline, computerized trading may have played a role as market participants placed market orders to sell instead of limit orders. Sell orders can collapse prices with large gaps between trades as the price searches for a buyer. In 1987, we had market makers called "specialists" on the floor of the NYSE who had an affirmative obligation to make orderly markets; they bought the declines and sold the rallies. In today's world, computers make markets. It remains to be seen how well they work in a crisis where historical norms are broken. Computer algorithms are only as good as their programmers.

7. It had been 80 weeks since the S&P 500 last saw a correction of more than 5%. The average period between 5% corrections is ten weeks, so we had gone an abnormally long time since a decline in the stock market. Volatility had reached one of the lowest points we had seen in over 50 years. We were due for a correction, which can serve to remind investors that equities are risk investments and will not climb forever. A correction is very healthy for the market but difficult emotionally.

8. So what happened? The stock market started the year off with a bang because of the synchronized global recovery, low inflation and interest rates, and the prospects of higher profits due to the recently passed tax act. Many companies reported revenue in the latest quarter that exceeded forecasts, so momentum in the economy and stock market looked strong. As the market went higher, the Cyclically-Adjusted Price to Earnings (CAPE) ratio became more expensive, hitting 33, a level reached only once in the last 90 years (the technology boom of the late 90s). Last week, a strong jobs report came out, but wages increased more than expected as well, stoking the fears that inflation is starting to creep into the economy.

   Increasing wages are normal at this point of the economic cycle: Unemployment is very low, and workers become scarcer. When the labor pool shrinks, companies must offer higher wages to entice and retain workers. Inflation also brings about higher interest rates, which can dampen economic growth. The Fed is expected to increase the Fed Funds rate two or three more times this year. However, if inflation increases faster than expected, the Fed will need to increase the rate more to make sure the economy does not overheat. The increase in inflation expectations and the possibility of faster rate hikes by the Fed spooked the market this week, and the market reacted negatively.

9. Last year, market volatility was quite low, but 2018 could be a much more volatile year. The S&P 500 was down -4.1% on February 5, but was up big yesterday, gaining 1.8%. The market was very volatile today and ended up slightly negative. Monday, the market was spooked, but momentum seems to have swung the other way. These wide swings demonstrate that in an overvalued market, it does not take much for the market to overreact. If the market were cheap, it would not have too much farther to fall, but when it is expensive, it can drop fast.