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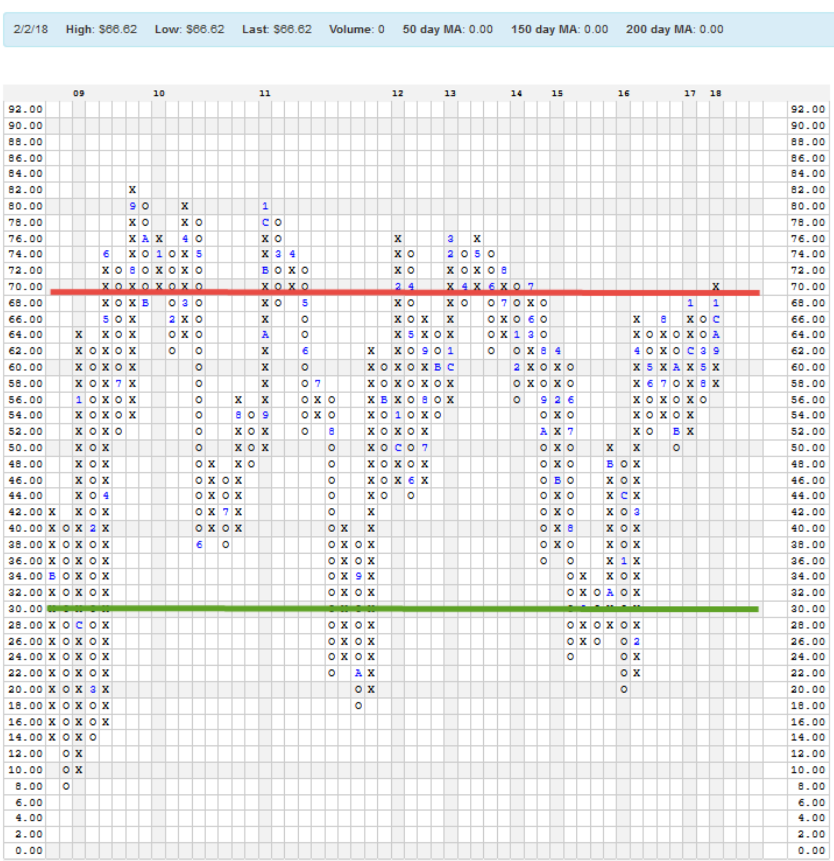
IT'S NOT EVEN A CORRECTION - YET

February 5, 2018

It's probable that today's market action will be the headline on this evening's news, so I thought it wouldn't hurt if I sent a short message to put it all into context. First, don't panic. If you are a regular reader of my commentary the market activity of the past week should come as no surprise. That said, after a long period of market gains (what some have been calling a "market melt-up"), large price drops can be a little unsettling.

Let's start with a little context. With the exception of five months during 2017, the market has been in an over-bought condition for over a year. And, by most measures, it has also been over-valued. And while valuations have begun to ease, the over-bought condition persists, and both have a long way to go.

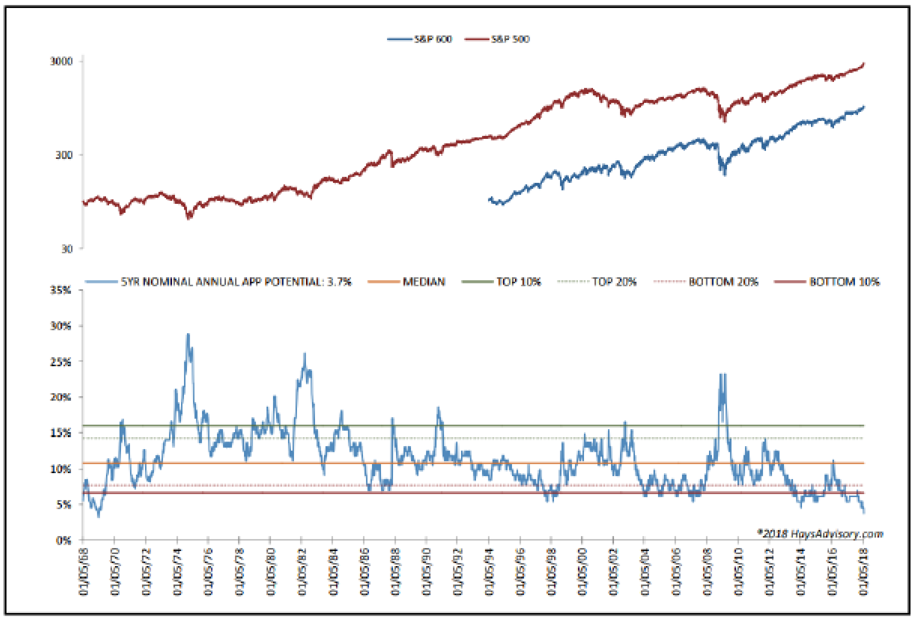


The reason that there has been no “reversal” in the over-bought condition is that this chart measures the percentage of stocks that are in up-trends versus those in down-trends. And most stocks are so far above their trend lines they will have to fall pretty far to reverse into a down-trend.

This is one of the main reasons that we have been holding what, for many of you, seemed to be large amounts of cash in your portfolios. It’s not just that markets have been over-valued, but how **much** they have been over-valued. One commonly used valuation method is the Valueline Median Appreciation Potential.

Chart – Valueline Median Appreciation Potential

Five Year Annualize Return Expectations for the median stock in Valueline’s 1700 stock universe



Source: Hays Advisory, Valueline

Last Wednesday found this metric within a couple of percentage points from being the worst reading on record. Valueline calculates a forward looking expected 3 to 5 year total return for each stock in its 1700 stock universe, taking into account likely earnings growth and end of period valuations. Every week, they publish the median appreciation potential figure for all stocks in their universe. It serves as a good measure of broad market valuation and risk/reward for the typical stock in the market, ignoring the effects that market capitalization might have on the valuation of broad indices.

It is interesting to note that over time, Valueline’s analysts have been overly optimistic. Another method, one that has historically had a better fit with actual returns, is a regression-based return forecast using the Valueline data. It was projecting a NEGATIVE 2.5% annualized total return expectation over the next five years.

So why are the markets falling now, instead of six months or a year ago? The best place we to look is probably interest rates. When I refer to interest rates, I’m referring to the rate at which people and companies borrow money. This is the cost of capital and keeps our economy moving.

The simplest explanation of why interest rates move up or down has to do with inflation. And for the past 10 years, there has been little to none. Gradually, over the past decade, the economy has grown stronger. And now we are beginning to see a normalization in the economy that, if the economy remains healthy, will result in "normal" inflation. And, because nothing is free, the capital markets will generally set the "cost of money" somewhere above inflation for shorter term loans, and more for longer term loans.

But today's selloff was pretty severe. Part of this is due to the fact that a very large amount of market activity is now driven by algorithms. These algorithms are used by the so-called "high-frequency traders". At one point today over 1 billion shares changed hands within a matter of minutes. No human can enter orders that quickly. It had to be computer-driven. Another part has to do with the possibility that we may see above normal rate increases. These are NOT inflation driven.

You see, another component in interest rates is demand for credit, or borrowing. Normally, that demand comes from businesses and individuals. The recently passed tax cut legislation is projected to result in an additional $1 trillion of **government** borrowing over the next 10 years. I would suggest that an EXTRA $1 trillion is quite a lot of demand. Couple that with the return to near-normal inflation, and you might make the case for interest rates substantially **above** normal for an extended period of time.

This could affect stock prices in two ways. One, if the cost of capital increases, you can expect lower profit margins, thus lower stock prices. Two, if an investor can achieve a low-risk rate of return equal to or higher than that of a riskier rate of return, they're going to choose the lower risk option. This will take capital from the equities (stock) markets and shift it to the debt (bond) markets.

Hmmm… I think I said something about a short message in my opening paragraph. Let me wrap this up. The title of this piece "It's Not Even a Correction - Yet" is based on the fact that a stock market correction is one of 10% or more. We are not there yet. You might, and probably will, see buyers come into the market tomorrow. But in my opinion, there is still more risk to the downside, so I am in no hurry to rush into the market with the cash we have set aside. That's not to say we might not nibble a little here and a little there, but before I commit the bulk of this cash, I want to see a market that is at least fairly valued, and I would prefer one that is oversold.

We will just have to wait and see what happens in the days and weeks ahead. If you have any questions or comments please do not hesitate to contact me. And, as always, feel free to share this with anyone you think might enjoy or benefit from it.

Have a great week!

Joel

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