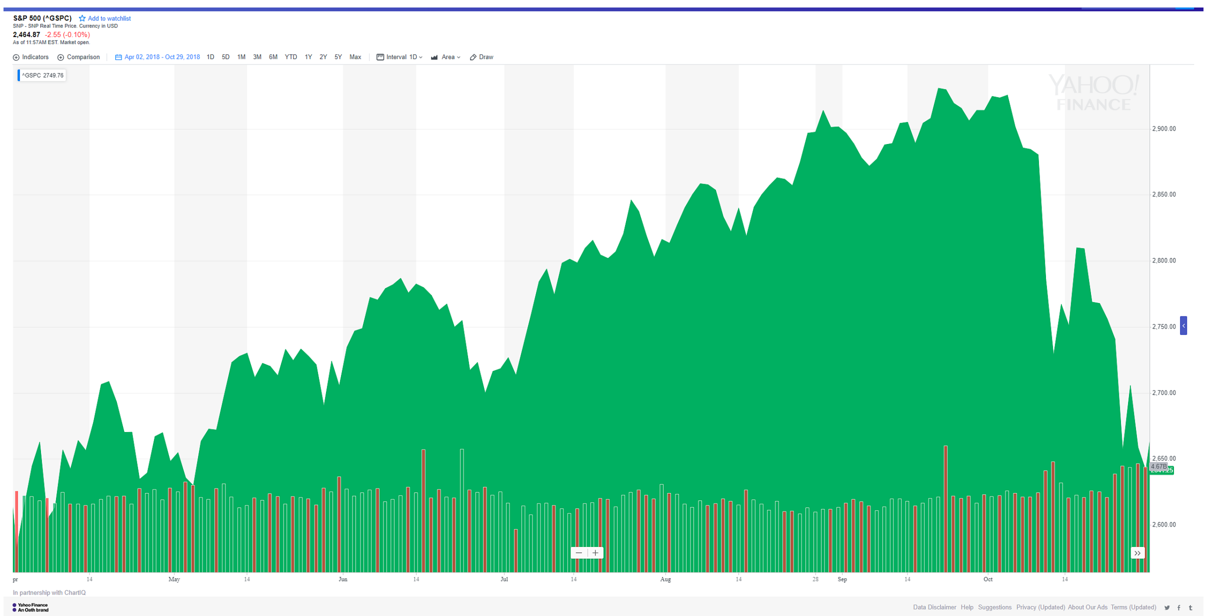
Up the Escalator, Down the Elevator

Thoughts on the 4th Quarter Market Selloff

Do you ever get the sense the stock market goes up on an escalator (slow and steady) but down on an elevator (rapid decline)? Unfortunately, the chart below displays this reality of the S&P 500 index as shown by *Yahoo Finance* from April 2, 2018 through October 29, 2018. More than six months of grinding higher in the S&P 500 was wiped-out in only about 29 days of decline in October 2018.



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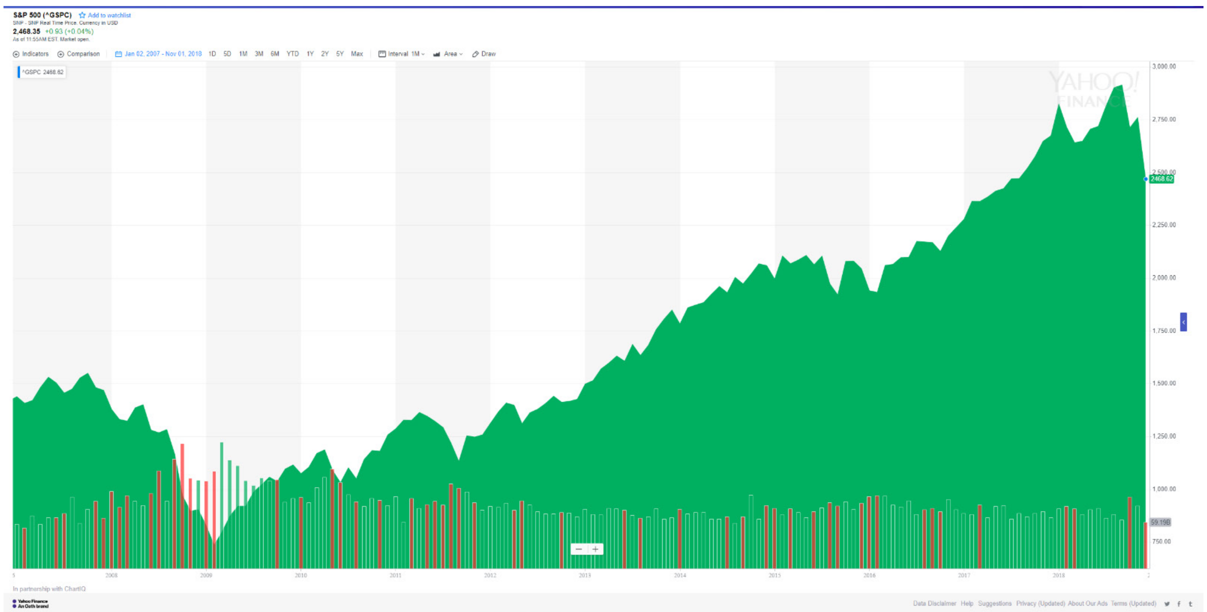
Quarterly Market Commentary continued …

However, while this frustrating reality can dissuade some from investing in the stock market at all, the picture really comes into focus the more time you give the market to mature. The chart below shows the S&P 500 performance from January 2, 2007 (before the great recession in 2008) through December 20, 2018.



Even after considering the 2nd worst decline in the history of the stock market (2008) the chart above still clearly displays why many long-term investors pick stocks as the “engine” of their portfolios.

Nevertheless, to really evaluate the severity of this 4th quarter 2018 market decline we should first define a few terms.

Correction

A “correction” typically refers to a fall in the overall stock market an index or specific security of at least 10%. **Corrections are common and happen approximately once per year in the stock market.** Corrections are usually short-term in nature and commonly last less than 2 months. Corrections are normally associated with an overbought or overpriced security or index whereby that security or index must “correct” itself back to an appropriate valuation.

Bear Market

A "bear market" typically refers to a decline in the overall stock market or index of last least 20% over at least 2 months or more. Bear markets tend to last longer than a common correction and can be marked by a more wide-spread panic where investors begin to sell securities for fear of further losses. **Bear markets are also common and happen approximately once every 3.5 years.**

Recession

A "recession" is an economic term that relates to the general slowdown of economic activity that is marked by 2 consecutive quarters of negative GDP growth. While negative GDP growth is typically accompanied by negative stock market performance there is not necessarily a direct correlation between the two and the term itself is not meant to indicate a specific stock market performance outcome. **Since 1900 there have been approximately 22 recessions which equates to a recession every 5.36 years.**

Stock Market Crash

A "stock market crash" typically refers to the sudden drop of the overall stock market prices or prices within a specific sector of the stock market. Stock market crashes are typically associated with declines in the S&P 500 or Dow Jones Industrial Average of at least 50% or more (but not to exceed an 80% decline… otherwise it could be considered a depression). **Since 1950 there has been only one stock market crash, and that happened during the financial crisis of 2007-2008** *(also known as the Great Recession)*.

Depression

A "depression" is an extended recession that is defined by 6 consecutive quarters of negative GDP growth and can lasts multiple years. **While there have been approximately 22 recessions since 1900 there has only been one depression in the last 118 years (The Great Depression of 1929).** The Great Depression lasted approximately 9-10 years and was marked by a 25% unemployment rate, a 50% decline in US economic output, a 42% decline in wages and over an 80% decline in the stock market.

It's important to note that Correction, Bear Market and Stock Market Crash are all defined by what happens in the stock market. A Recession and Depression are defined by the health of the economy. While the economy and stock market have impacts on each other, it is important to remember that they can have individual reactions to events.

Quarterly Market Commentary continued …

Now that we have identified our terms and the severity of each items as it relates to stock market performance or economic output, let's evaluate what is currently happening.

The Stock Market

- As of 12/20/2018 each of the 3 major indexes (S&P 500, Dow Jones Industrial Average and NASDAQ) were down more than 10% from their peak but less than 20%. **This means that we can currently define this market volatility as a "correction" which happens on average once every single year.**
- In the past 90 years of S&P 500 performance the index has been positive on a year over year basis approximately 68% of the time. In the past 50 years of S&P 500 performance the index has been positive on a year over year basis approximately 74% of the time. Finally, in the past 90 years of S&P 500 performance the index has averaged approximately 10% per year in average annual performance.
- The market has not posted a negative return in the 12 months following a mid-term election since 1946 and we are currently only about 6 weeks removed from this year's mid-term election.

The Economy

- The unemployment rate has stayed low at 3.7% during the 4th quarter of 2018. The last time the unemployment rate was this low was in 1969.
- Gross Domestic Product has remained strong in the 3rd quarter at 3.4%, even though it was slightly below the estimates of 3.5% growth.
- The Conference Board's Leading Economic Indicator Index is up 5.2% year over year as of November 2018.

Economic Indicators

There are economic indicators that help to predict a recession. One common indicator is the yield curve, which measures the yields of US Treasuries. The 2-year US Treasury bill has slightly inverted with the 5-year US Treasury note on the yield curve for the first time on December 3rd. As of December 19, 2018, the yield for the 2-year US Treasury bill was 2.63% while the 5-year US Treasury note was 2.62%. However, the economic indicator to help predict a recession is based on the comparison of the 2-year US Treasury bill against the 10-year US Treasury note. These have not yet inverted on the yield curve. Typically, once the 2-year and 10-year US Treasuries invert, a recession typically follows but still can take a few years to begin. There are many indicators that can help to predict a recession aside from just the yield curve. The health of the economy and other indicators show that a recession could still be as far away as 2-4 years from now.

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Quarterly Market Commentary continued …

What are the drivers behind the selloff?

The volatility in the market largely has to do with uncertainty around trade tensions, rising interest rates and slowing global growth.

There are other common items that can intensify the reaction in the market. Algorithmic trading can cause more volatility in the market as these trading strategies can differ greatly from general consumers. Investors may also be selling to harvest losses to offset gains as we are nearing the end of the year.

In summary, while our team is concerned with the trend of the markets and our clients' performance within their portfolios. We are also mindful of history and the lessons we have learned. Market selloffs are a normal part of investing and can happen several times a year, even when an economy is strong and showing signs of continued growth. There are undoubtedly some trends we find alarming in the stock market and economy that we will be monitoring closely in the days and weeks ahead. Nevertheless, we encourage you all to stay the course within your diversified portfolios and certainly reach out to us if you have any questions or concerns you would like to discuss.

Finally, we hope you know how much we appreciate the trust and confidence you have placed in our organization to help you both plan and invest for retirement.

Have a Merry Christmas and a happy New Year!

Sincerely,

Your Klaas Financial Team