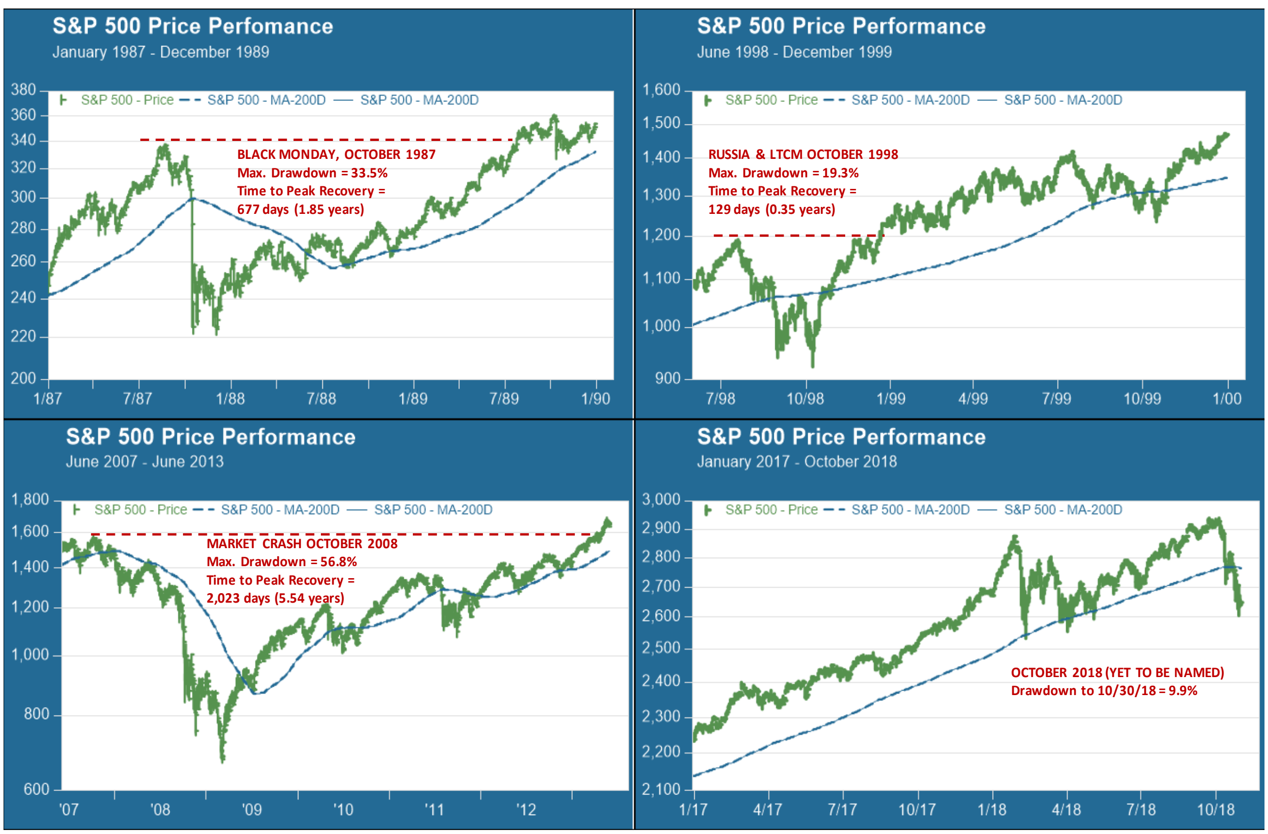
Weekly Market Flash

Four Octobers

November 2, 2018

So October just happened. With a couple relatively calmer days seeing out the year's tenth month and seeing in the eleventh, it is a good time to take stock of what has, and what has not, happened in the story thus far. What hasn't happened, as of today, is a technical correction in the broader market. The S&P 500 closed 9.9 percent below its 9/20 high this past Monday, just shy of a correction (recall that we have written in the past about the technical factors leading to these occasions when the market plays footsie with a correction or a bear market without actually going all-in).

The full story on this pullback has yet to be written. But we have lived through various flavors of October fright nights over the course of our careers in this industry. Each has its own story to tell – and from these stories we may gain some insight into how to think about the current version. History does not repeat, but it does rhyme from time to time. Here, then, are three Octobers of yore plus the one just passed. They are: Black Monday 1987, the Russian debt default and LTCM meltdown of 1998, and the Crash of 2008.



Source: MVF Research, FactSet

1987: Bang Goes the Market

On October 19 1987, Wall Street woke up to a market in full-scale panic mode. Prices had fallen throughout the previous week after an earlier rally fell short of reclaiming the record high set back in August. But the carnage on Black Monday was like nothing traders had seen before – and nobody had a convincing answer for why it was happening. By the end of the day the S&P 500 had fallen more than 21 percent, the largest percentage drop in its history (which thankfully remains unbroken today). Modest correction one day, full-on bear market the next. Not driven by any major piece of economic news, nor a major corporate bankruptcy, nor a catastrophic act of nature. What, then?

Black Monday happened largely due to a very new, very little understood investment strategy called portfolio insurance. The basic idea behind portfolio insurance was to protect downside by selling out of long stock positions when market conditions turn down. Selling begets more selling. On October 19 everyone wanted to sell, nobody wanted to buy, liquidity dried up and the market crashed. But the damage was over almost as soon as it began. Investors figured out in relatively short order that, indeed, the global economy wasn't all that different from what it had been a month earlier. It took a bit less than two years to get back to the previous high of August 1987, but without much drama along the way.

1998: Russia Meddles In Our Tech Bubble

Everything was going along just fine – the economy was on fire, the Internet was well into stage one in its takeover of the human brain – but while America was rocking out to "…Baby One More Time" our erstwhile Cold War foe Russia was defaulting on its government debt. Which would have largely passed by unnoticed were it not for the massive exposure to Russian sovereign bonds among many of the world's most sophisticated investment funds, including a super-smart group of pros called Long Term Capital Management. What we all learned from LTCM was that the interconnected global market has a dark side: a failure in one place can wreak havoc in a whole bunch of other, seemingly unconnected places (a lesson to come in handy a decade later). The S&P 500 flirted with a bear market though (stop us if you've heard this one before!) halting just at the cusp with a 19.3 percent peak to trough decline.

Again, though, the absence of any real, fundamental change in our economic circumstances, coupled with a quick and relatively efficient bail-out to contain the toxins released by LTCM, made this a relatively short-term event. By the end of the year the market had reclaimed its earlier record peak and was set to power its way through that giddy *annus mirabilis* of 1999.

2008: The Almost Depression

1987 and 1998 were instances where a major market pullback didn't lead to worse outcomes – in both cases recessions were more than a couple years away (and neither the 1990 nor the 2001 recessions were particularly deep or durable). 2008 was a different category, of course. The entire financial system came close to shutting down, millions of Americans lost their jobs and – perhaps even more consequential for the long term – a deep sense of distrust in experts and institutions took root and strengthened. 2008 was not a "pullback" – it was a long, wrenching bear market.

Though it could have been worse. It took five and a half years for the S&P 500 to get back to the prior record high set in October 2007. By contrast, investors who saw the stock market crash in October 1929 (the mother of all scary Octobers) would not see their portfolios return to September 1929 levels until the mid-1950s.

There's more to the 2008 story, though, than the spectacular failure of investment bank Lehman Brothers and the cataclysm that followed that fall. More than a year before the events of autumn 2008, there was already plenty of hard evidence that things were not well in the economy. Home foreclosures had started to trend upwards as far back as 2006. Monthly payroll gains stated to trend down in the middle of 2007, with particular weakness in areas like homebuilding and financial services. A sudden loss of liquidity in certain risk asset markets got investors' attention in August 2007 – a small taste of the carnage to come.

MV CAPITAL MANAGEMENT

When to Hold 'Em, When to Fold 'Em

So while the story of October 2018 continues to be written, what lessons can we apply from the lived experience of previous downturns? One approach we believe will serve investors well would be a healthy skepticism of the relationship between cause and effect. Any pullback of a meaningful enough size is likely to generate an army of Monday morning quarterbacks, fatuously explaining "why" it was so obvious that Event X would cause the market to reverse on Day Y (thanks for waiting until after Day Y to tell us!). Even highly sophisticated quantitative analyses, while arguably preferable to insufferable blow-dried touts spinning tales on CNBC, fail to deliver on the crystal ball front with their deep dives into correlation patterns. Those algorithms can tell you the likelihood of something happening based on tens of thousands of random hypothetical simulations. But they fall victim to the law of small numbers when applied to the sample size of one – one actual event on one actual day.

Because pullbacks and technical corrections happen much more often than actual bear markets, a good starting point is to make "not bear market" the default hypothesis, and then set up tests to see how easily the default hypothesis can be disproven. Understanding the macroeconomic environment, corporate earnings trends, sentiment among businesses and consumers and the like is important. So is a sense of history. For example, a currently popular thesis among some market pros is that a 3.7 percent yield for the 10-year Treasury will be a trigger point for rotating out of equities into fixed income. Why? A cursory look at past growth cycles seems to offer up little evidence that equities will encounter impassable headwinds once yields pass that threshold. And yet, we can't dismiss the 3.7 percent crowd out of hand, because if there are enough of them, perception can become reality whether that reality makes logical sense or not.

The best way to survive market corrections is to always stay diversified, to resist the behavioral urge to sell after the worst has passed, to be alert to red flags but careful about acting on them. Unfortunately there is no failsafe formula for deciding when a correction looks set to metastasize into something much worse. Often, though, there will be enough data to build a case against the "not bear market" hypothesis, affording a window to build some protection before the worst happens (with no certainty, of course, that the worst will ever happen). It can be a frustrating exercise in practice – but it is also what makes markets so eternally fascinating.

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