MV CAPITAL MANAGEMENT

Weekly Market Flash

People Are Calendar-centric; Markets Are Not

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So, it's that time of year again. Those endless "year in review" digests, the "10 best songs/books/episodes/tweets of 2017" listicles, the prognostications about what 2018 has in store. As if anyone actually knows. Yet, despite the fatuousness of the Old Year / New Year content factory, we absorb it all nonetheless, because we align the pace of our lives to the metronome of the calendar. The 365 days bookended by January 1 and December 31 are inherently no different than any other random sequential span of days. Yet we endow them with special meaning. How many investors know how their portfolios performed from, say, May 7 2015 to May 6, 2016? Some particularly assiduous types, perhaps, but not many! But how that mix of assets performed over the 12 months ended 31 December – well, to that particular performance metric attention must be paid.

683 Days and Who Cares

There's nothing wrong, of course, with ordering our lives around the calendar. After all, that annual portfolio performance number does factor into something very real, namely the taxes on interest, dividends and capital gains to be paid by April 15. The problem with our calendar-centricness comes when we overplay the importance of these arbitrary dates in the context of asset market trends. 2017 was a good year for US equities. So was 2016 and for that matter so were 2013 and 2014 (2015 was so-so). There is a tendency to think, as one year ends and another begins, that some new dynamic must be at hand: some confluence of factors that will lend their distinct imprimatur to 2018. Nowhere do we see this tendency more pronounced – particularly this long into a bull run – than in people's expectations about the arrival of the next reversal.

On February 11, 2016, the S&P 500 had retreated 14.2 percent from its previous all-time high reached on May 21, 2015 -- an elapsed time of 266 days. In between that high and low point, the blue chip index experienced another correction, falling by 12.4 percent from that May 21 high to October 25 (the market recovered again before falling in that subsequent Q1 2016 pullback). By popular convention, a "correction" represents a pullback of 10 percent or more from a previous high.

Here at MVF, we have our own metric of defining a meaningful pullback / recovery event: a retreat of more than 5 percent from a previous high, followed by a recovery of at least 5 percent from the low. We make note of this because it has been 683 days since the last 5 percent-plus pullback (corresponding to that 2/11/16 event). Now, 683 days is a long time. A very long time. Longer, in fact, than any other elapsed number of calendar days between two pullbacks of 5 percent or more in the S&P 500 since the end of the Second World War (the previous record being 593 days between December 18, 1957 and August 3, 1959). We came close – the S&P 500 fell about 4.8 percent from its previous high just before last year's election. But close doesn't count; the record stands. If we wake up on the morning of February 11, 2018 having not experienced a pullback of 5 percent or more from 2690 (the last high point on 12/18/17) then a full two years will have elapsed without a meaningful reversal in the market's fortunes.

Pullbacks Don't Need Reasons…

The question is, should anyone care that the current stretch of calm waters is the longest in postwar history? The answer is no, but the answer requires establishing the difference between a pullback (which can happen any time and often for no apparent reason at all) and a bear market (which tends to happen for specific reasons, is structural in nature and is also very infrequent). Perhaps the best illustration of this is the extremely brief, but nonetheless "meaningful," pullback the market experienced in October 2014. The S&P 500 fell about 7.4 percent over a period of just less than a month from late September to early October (in reality, most of the carnage happened in a very brief few days leading up to the October 15 floor). And then it was over, and nobody quite knew what had happened. There was a brief "flash crash" in Treasury yields, there were some disconcerting headlines about the Ebola disease, and there was a freak-out of very short duration. And then it was over and back to business as usual.

…Bear Markets Do Need Reasons

That 2014 freak-out was largely due to chance – a random confluence of events that just happened, on that particular calendar week, to engender a brief market squall. It is also largely a matter of chance that the market didn't pull back by more than 5 percent in late October 2016 (before the election), and it is largely a matter of chance that none of the various X-factors that bubbled up over the course of 2017 managed to form a vortex of disruption strong enough to pull down asset prices. In other words, that 683 day record from the last meaningful pullback event is due more to chance than to some unique set of circumstances. Another squall similar to the Ebola frenzy could also break out at any time, also largely due to chance.

Bear markets are different. The difference between the market crash of 2008 and that Ebola pullback wasn't just a difference in magnitude, but in character. The 2008 event came along with an economic recession, which for its part came about on account of a systemic financial crisis that threatened to disrupt everything from bond markets to corporate payroll direct deposits. The textbook bear market, which ran from 1968 to 1982, came alongside the US economy's running out of gas after its breakneck pace in the 1950s and 1960s. The high inflation, high interest rates and lackluster growth throughout much of the 1970s supplied plenty of reason for investors to avoid or dramatically reduce exposure to common stocks and bonds, in favor of real assets like precious metals and fossil fuels.

As this calendar year turns, we see very few signs of the kind of economic or financial unrest that could metastasize into a full-fledged bear market. That's not to say that everything is rosy, and you can count on us to cast a cold eye over the particulars of the global landscape in our Annual Outlook next month. But the key features of that landscape – low inflation, moderate growth in output and stable labor markets – do not appear positioned for any kind of major sea change. Corporate earnings look set to continue to grow in the high single or low double digits, on average. We suggest keeping this in mind if you wake up one day and find your favorite stock market index pulling back by a few percent. Remember the Ebola freak-out. Remember that these things happen largely by chance. And remember that markets don't march to the beat of the calendar.

Happy New Year to you and yours.

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