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ON OUR MINDS

Every Picture Tells a Story

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The stock market's sudden gyrations this week have jolted many investors, reminding us of past market crashes and triggering fears of another bear market. To put the week's trading in context, a quick review of the economy and a graphical look at the stock market can be quite helpful. In both cases, what we find is encouraging.

Outlook

First, a look at the economy. As we discussed in our 2018 outlook,[1] we think the U.S. and global outlooks remain upbeat. We expect robust economic growth and strong corporate profits. GDP growth is likely to remain above 2.5%, spurred by strong consumer demand and rising business investment. Inflation is likely to be a bit higher this year, spurred by higher labor costs[2] and housing prices, but we don't think that we're anywhere close to an inflationary spiral. The Federal Reserve is unlikely to accelerate its gradual pace of interest rate hikes.

Recessions don't just arrive out of the blue; they are preceded by many warning signals. These signals are almost entirely absent today:

- The yield curve typically inverts (long-term bond yields falling below short-term interest rates) several months before a recession begins. We were seriously concerned about this prospect last December, but the curve has steepened since then; even if the Fed raises rates three times this year, it is unlikely that long-term bond yields would drop below short-term interest rates. This indicator is still green.

- Inflation often skyrockets or plunges into deflation before recessions; neither scenario is remotely evident today. Inflation remains in a muted 2% to 2.5% range, and even a modest rise above this band would not be worrisome. This indicator is still green.

- The labor market shows signs of strain, as job growth exceeds the supply of workers and unemployment rates drop below the so-called "full employment" level. That's essentially true today, although there is still a large number of low-skill workers who are clamoring to get back into the work force. It's also true today that vast numbers of high-skill workers from abroad are eager to work here, should immigration policy allow them. This indicator is flashing yellow.

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[1] "Turn the Page," *On Our Minds* commentary published January 18, 2018.

[2] It was the Labor Department's report of an uptick in hourly wage growth that triggered the market's plunge in the past week, as investors feared that higher inflation would lead to higher interest rates that might quash the economy's expansion.

- Credit metrics typically weaken before a recession, as banks reduce their underwriting standards and as borrowers incur obligations they can't meet. Credit quality today is outstanding, and there are no signs anywhere that borrowers are in trouble. Rising student loan debt is a potential hazard, but it's not likely to cause a recession any time soon. This indicator is still green.

- The housing market often fades before a recession, as builders' speculative construction leads to excess inventory that drives prices down. Today, we have the opposite problem: New construction is seriously lagging demand for new homes, driving prices higher. Housing is critically important to economic growth because its effects ripple through the economy in many diverse ways. This indicator is still bright green.

Fundamentally, then, there is no reason to foresee a recession around the corner. Stock markets are forward-looking, and their collective wisdom often anticipates any fundamental changes in the data. So it is prudent to look at what the market's recent activity is telling us. One way of looking at market behavior is shown in the chart at the top of page 3. This three-year weekly chart of the S&P 500 index is simply a graphical representation of the human emotions that drive stock prices; since human nature is eternal, we can glean some meaning from this chart.

This chart shows weekly prices and other indicators for the large-cap stock index, going back three years. The center panel shows the index price; each vertical bar shows one week's range from high to low, with the opening and closing prices indicated by slight dashes left and right. What's immediately obvious is that the advance from the market bottom two years ago has been remarkably stable and consistent – no major spikes upward or downward.

Short-Term Volatility Indicators

The two green lines surrounding the price line are important indicators. They represent the boundaries of where prices could be expected to fall 95% of the time, given recent trading history. Compare this trading band's shape in 2017 vs. 2016: Two years ago, the band was fairly wide, as investors were concerned about whether the crash in oil prices and the strength in the U.S. dollar would short-circuit the ongoing economic expansion; last year, by contrast, the upper and lower boundaries of this band were quite close together, indicating that trading behavior has had very little volatility; investors were confident and the economic data was tracking according to expectations.

Last year, not 2016, was the anomaly. Note also that beginning late last year – about the time that tax reform became a real possibility – the bands started widening again, albeit almost entirely because the upper boundary rose faster while the lower boundary stayed on track. *The upshot: Investors were getting euphoric about tax reform, and forgetting about risk.*

Trading bands have an interesting property: Whenever stock prices pierce above or below these boundaries, they almost always reverse direction and head back toward the center of the band. You can see that phenomenon clearly at the bottom of the early 2016 downturns, and you can see it in reverse in the past week. (A daily chart shows that Monday's trading pierced the *lower* boundary of daily trading bands, suggesting that the market's fall was perhaps excessive.)

Source: www.stockcharts.com

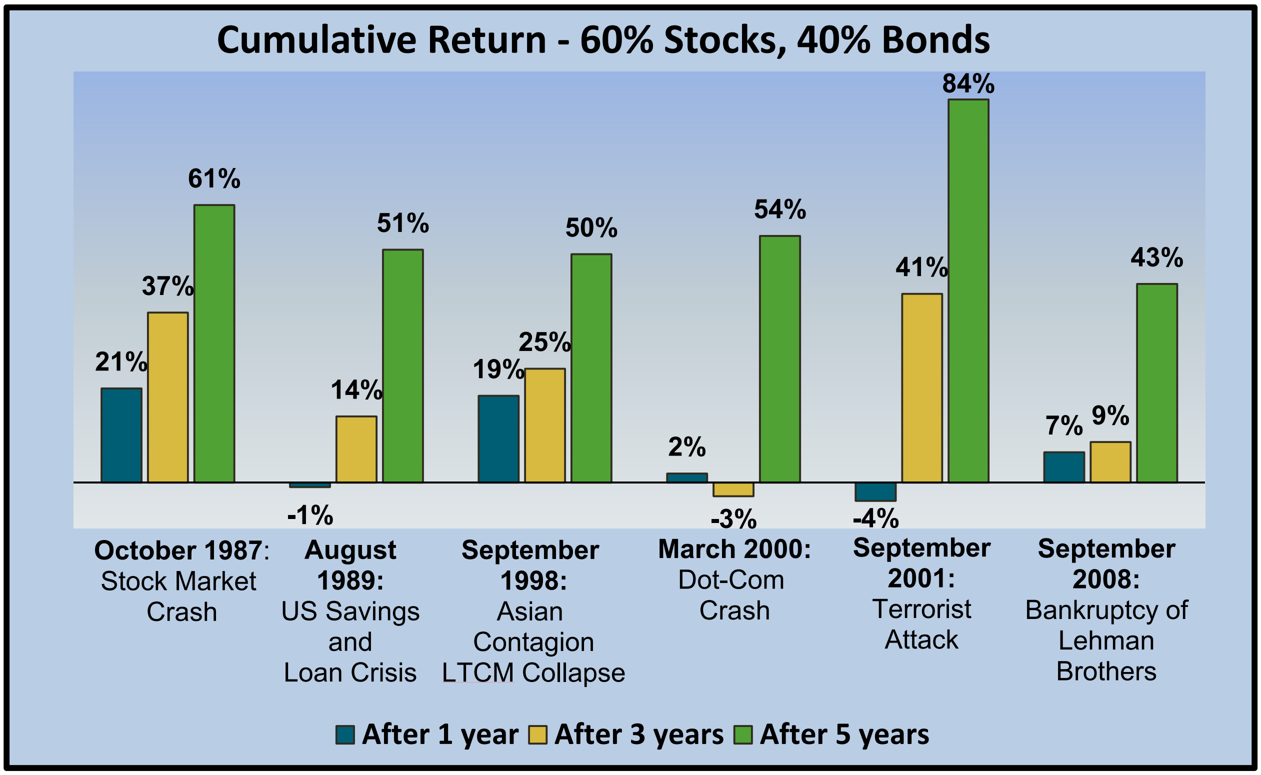
Now let's look at some short-term indicators. The top panel is a "relative strength indicator" (labeled RSI); when the market is behaving normally, this indicator typically hovers between 30 and 70 on a 0-to-100 scale. When investors are bidding up prices too aggressively, the market is "overbought" and this indicator pops above 70; likewise, when investors are fleeing for the exits, the indicator drops below 30 and the market can be described as "oversold." At the far right of this panel, you can see that the market was highly overbought, with an RSI reading of nearly 90 in mid-January. That clearly wasn't sustainable, making a downturn almost inevitable.

The same is true of the bottom panel, showing "moving average convergence / divergence" or MACD. This chart shows how the short-term and long-term moving averages are behaving relative to each other; the blue bars are positive when the short-term moving average is rising faster than the long-term, i,e., the market is accelerating. When you see the averages as elevated as they are today, it's a short-term indication that a pullback is due: This oscillator also suggests that January's acceleration couldn't be sustained.

In sum, what this one picture of the stock market tells us is that investors were getting too euphoric in January (mostly about tax reform and its impact on corporate profits), and that a near-term dip was almost certain to follow. Now that prices have "corrected" these short-term excesses, the market is positioned for further healthy advances for as long as the economy continues to cooperate.

Long-Term Implications

Finally, here's one more picture, a look at what happened to a hypothetical investment portfolio (60% stocks, 40% bonds, rebalanced regularly) through each of the last six major bear markets:



Source: Dimensional Fund Advisors

The chart above shows that a thoughtfully constructed and rebalanced portfolio has rewarded investors quite well in the years encompassing and following each of the last six major bear markets. So even if the current stock market takes an unexpected turn south, the wise investor will stay the course. (It helps, of course, that we did rebalance our client portfolios in January, pulling some money out of stocks at the time.)

A client asked me yesterday how I think the next few weeks and months will play out. Markets are like the humans who comprise them: They can do some really weird things in the short term, but human nature is eternal and they are fairly predictable in the long term. So I responded to this client by saying that I have no idea where markets *will* be over the next three to five weeks, or even the next three-to-five months; but I have absolute confidence that investors will be well rewarded for their patience and fortitude over the next three-to-five years.

Conclusion

After a year of exceptionally low volatility, the stock market is beginning once again to behave as it normally does. We typically see several individual days every year with market moves of more than 2% in either direction, but that didn't happen at all in 2017. We also typically see cumulative market dips of more than 5% every year – in fact, several times a year in many instances – but we hadn't seen even one in more than two years. In short, we had grown accustomed to a historical anomaly; we had collectively forgotten that volatility is the norm, not the exception.[3] And while a bear market is undoubtedly in our future at some point, that point has not yet arrived; we think the bulls still have the upper hand.

The economy is clearly in good shape. Corporate earnings are doing well; in fact, the just-completed fourth-quarter earnings reports show S&P 500 EPS growth of over 12% last year. We think another double-digit year is in front of us, partly spurred by tax cuts and partly by strong underlying demand. Meanwhile, the stock charts tell us that the market remains healthy; this week's sharp price swings are a nothing more than corrective to an overly euphoric January, putting us back into a steadier groove.

As the esteemed British market watcher and football fan Rod Stewart observed 40 years ago, *Every picture tells a story, don't it?*

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[3] The rise of passive index funds and of quantitative "factor-based" trading schemes probably exacerbates market movements and volatility. When investors got happy in January, these funds were forced to buy more shares to keep up, thereby adding fuel to the fire. Likewise, when some investors took some profits in light of the jobs report last Friday, the machine-driven traders kicked into overdrive and drove the market lower.