Stocks sold off sharply on Wednesday, with the S&P 500 down about 3.5% for the day. Any number of reasons have been cited for the sudden rush to the exits, among them:

- **Anxiety about the upcoming earnings reports.** We frequently see market jitters in early October because that’s when the bad news comes out: companies like PPG Industries and Fastenal issue profit warnings, and with so little time left in the year they can’t make up a third-quarter shortfall with a strong fourth quarter.¹ Earnings expectations are quite high, so these isolated shortfalls jar investors’ confidence. As the month rolls along and other publicly traded companies report earnings, the overall picture is likely to brighten.

- **China trade tension.** Treasury Secretary Steve Mnuchin warned China not to devalue its currency further; the yuan is already down about 10% this year. A lower yuan would offset the effects of new tariffs, leaving China no worse off from American attempts to force new trade terms. Mr. Mnuchin’s warning indicates that China may see the tariffs more as wet noodles more than as sharp sticks, while American consumers still get stung.

- **Higher interest rates.** Federal Reserve Chair Jerome Powell has made it increasingly clear that the central bank will continue raising short-term interest rates well into next year; the markets are increasingly worried that he will go too far (as the Fed typically has done in the past), tipping the U.S. into recession sometime late next year or in 2020. For the first time in the current rate cycle, long-term rates are also rising, which has stoked fears of a bear market for stocks. (That’s one important reason that tech and other high P/E stocks were hit hardest yesterday.) Higher long-term rates would also drive mortgage rates over 5%, which is seen by some as an important psychological threshold.

- **Inflation.** Investors are worried that higher prices are evident in many areas, including housing, health care, energy, labor, materials (due to tariffs), and some intermediate goods (passing the tariffs up the supply chain). These fears were partly allayed by today’s Consumer Price Index report showing only a 2.2% “core” (excluding food and energy) inflation rate in September. Still, a core CPI over 3% isn’t implausible in the next year.

The litany evokes Fleetwood Mac’s admonishment: *If you wake up and don’t want to smile / It just takes a little while / Open your eyes and look at the day / You’ll see things in a different way. Yesterday’s gone, and today a fresh look can bring encouraging insights.*

¹ Similar weakness is often evident in early April and July, as the bad-news companies pre-announce weak results, but in those quarters the companies can plausibly say they aren’t changing their year-end targets because they have much more time to catch up; the stock market effects are therefore less extreme in the earlier calendar quarters.
For starters, it’s important to acknowledge that these fears are all essentially valid – but today’s “different way” to see them is to recognize also that none of them are new. The investment community has been grappling with these issues for months already, and nothing has happened in the past week to change expectations meaningfully. So why did stocks collapse yesterday? And where are they headed?

The downdraft could have happened at any time in the past month; if not yesterday, it could have come anytime in the next month, too, and for any reason; sometimes the herd mentality just grips Wall Street’s traders (and computer algorithms) and won’t let go. Although the cable TV pundits will have plenty to say about the selloff, it was just a mild reversion within normal trading parameters. (Please see the appendix for a technical review of the market’s behavior.)

Stocks are still up about 4% year-to-date, and clients with properly allocated portfolios haven’t felt much pain this year or even this week. Yet uncertainties abound, and they are important: Will the Fed go too far? Will the yield curve invert? Will “temporary” tariffs become permanent? Will inflation spiral upward? We think about these questions all the time as we manage our clients’ portfolios, but it’s a rare day that we feel compelled to act just because the rest of the investment community is going off the rails.

For now, at least, we remain favorably disposed to U.S. stocks. Further, our bond portfolios tend to be shorter in duration than market indexes, in large part because we don’t want to take too much interest rate risk – a positioning that has helped our fixed income performance lately. In short, we don’t see today’s action as a meaningful change in the market’s direction.

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Appendix: A Technical View of the Stock Market

The chart below can still shed some insight into what the market’s behavior can tell us about what lies ahead. This is a weekly chart of the S&P 500 over the past three years.²

² Explanatory note about the lines and squiggles:
   • Top panel: “Relative Strength Index” shows how the index is doing compared to its constituent elements; a reading between 30 and 70 is indicative of normal trading patterns. Higher numbers indicate excessive bullishness, while lower numbers suggest excessive bearishness.
   • Middle panel:
     o Each vertical line represents one week’s trading, with Monday’s opening price and Friday’s closing price indicated by short horizontal dashes.
     o The two green lines indicate two standard deviations of volatility; in other words, about 95% of the time the stock price will be between these two lines.
     o The blue line is a short-term (50-week) moving average and the red line is a long-term (200-week) moving average.
   • Bottom panel: The vertical bars indicate volume of shares traded; higher volume suggests a change in investor sentiment, while lower volume is considered more stable.
The last two weeks (blue oval) look very similar to two recent periods highlighted in the chart, August-October 2016 (purple oval) and January 2018 (yellow oval).

- In both prior instances, the selloff bottomed almost exactly on top of the market’s 50-week moving average price (blue line). If that were to happen this time, the S&P index would still have another 1.5% downside risk.

- In each of these instances, the market registered a “negative outside week reversal” immediately following an all-time high.\(^3\) This sort of reversal is an excellent short-term indicator that a trend has reversed, but it doesn’t say much about the longer term.

It’s also important to note a couple of differences among the three highlighted instances.

- In January 2018 (yellow oval), the market was clearly overly optimistic: The Relative Strength line (top panel) was significantly above the 30-to-70 “normal” reading, as indicated by the green shading; in contrast, yesterday’s market and the 2016 example are marked by normal Relative Strength readings. While the downdraft this week was more like January in its steepness, the recovery might look more like that of the 2016 instance where excess optimism hadn’t been built into the market’s prices.

- The bottom panel shows that overall trading volumes this week are reasonably close to normal, indicating that investors aren’t panicking. That’s similar to the experience of late 2016, when stocks took a tumble but revived fairly quickly; it’s notably different from the January 2018 experience when volume spiked upward.

There’s only so much that the past can tell us about the future: History doesn’t repeat itself, as Mark Twain famously said, but it rhymes. The recent history of the stock market suggests that today’s action is not likely to spur a sudden bear market but will instead simply provide a better foundation for the market as investors begin thinking about prospects for the next couple of years. *Don’t stop thinking about tomorrow, / It’ll soon be here.*

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\(^3\) An “outside week” is one in which the week’s high is above the previous week’s high and the low is below the previous week’s low. The “negative reversal” indicates that the week ended below where it began, following an uptick the prior week.