Investment Perspective

KANAWHA
CAPITAL MANAGEMENT

7201 Glen Forest Drive, Suite 200 / P.O. Box 18490 / Richmond, Virginia 23226 / (804) 359-3900

CORRECT LESSONS

January, 2019

"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves." — Peter Lynch

If 2017 marked a year in which everything seemed to work, 2018 ended up a dud; a period when few investments panned out. Indeed, almost every major asset class outside of cash dropped in value over the course of the year, many significantly. For the first time in ten years, cash outperformed virtually all else.

Financial markets seemed to reach a tipping point this past fall and swooned in December. The S&P 500 Index and Dow Jones Industrial Average both incurred their largest monthly drops in a decade. Buyers fled to perceived safe havens such as U.S. Treasury bonds and gold. For the calendar year, stocks had their worst performance — and first annual decline — since 2008, when the *Great Financial Crisis* gripped the nation.

But one could argue that 2017 represented the more anomalous time period. The S&P 500 achieved positive total returns every month, an unprecedented feat. The same proved true for stocks globally, as represented by the MSCI All-Country World Index (ACWI). And volatility remained suppressed: The U.S. stock market closed up or down by 1% (or more) on only eight days. The largest drawdown during the year turned out to be a mere 3%.

Corrections happen

With the subtlety of a bucket of ice water to the face, last year's experience reintroduced several important lessons. First, while often disconcerting at the time, corrections are **common** and a normal part of the investing process. And they will occur even in the midst of bull markets. Sometimes, these sell-offs merely reflect a temporary jolt of fear or manic behavior. At other times, corrections serve the necessary role of releasing some steam from an overheated market.

On average, the U.S. stock market records drops of 5% or more approximately three times a year. A shallow correction of 10% or more tends to occur about once a year. Bear market corrections, commonly defined as sell-offs of 20% or more, crop up every 3-1/2 years.

And since 1980, the S&P 500 has had an average *intra-year* decline of 14%. Three-quarters of the time, annual returns still ended up being positive. During the current bull market, dating from 2009, the S&P 500 has had seven drawdowns of 10% or more.

Can't time them

Second, despite being inevitable, corrections are **unpredictable** and cannot be avoided with any consistency. They represent the cost of owning stocks and creating wealth. Studies show that market timing is a losing proposition. To succeed, one must obviously exit the market at the right time; but perhaps more importantly, also move back in at the outset of the rally. Stock market returns tend to be very concentrated. For instance, just missing a cycle's best ten days can dramatically inhibit performance.

Yet the capriciousness of corrections has not prevented a cottage industry of analysts, pundits, and media types from constantly trying to call the market. How can folks expect to predict the future when they can't even agree on the present?

Entering 2018, who anticipated that almost every major asset class would be down, some by bear market proportions, in the face of healthy 3% GDP growth? Certainly not Wall Street strategists who collectively forecast a high single-digit gain by the S&P 500. In fact, *none* of the strategists tracked by Bloomberg correctly predicted the direction of the U.S. stock market last year, much less the magnitude. The experts' track record has been pretty abysmal.

Herd on steroids

Third, **sharp, short-term swings are endemic** to the market. Investors often move in herds with stocks vulnerable to the mood of the day. Sentiment can quickly lurch between fear and greed, fueling **volatility**. Last year, the market closed up or down by 1% (or more) on *one in four* trading days. This price action was actually close to the annual average of the past ten years.

After a tranquil 2017, the return of some turbulence should not have come as a surprise. The current economic expansion has persisted for ten years. With the Federal Reserve tamping on the brakes, some investors worry that monetary policy is becoming too restrictive. The day's news can move the market in such an uncertain environment.

Short-term volatility has also been accentuated by a structural shift in trading volumes. The *Wall Street Journal* reported recently that around 85% of all stock trading is now dictated by "machines, models, or passive investing formulas." In particular, quantitative hedge funds account for nearly 30%

of volumes, twice their share of five years ago. These traders utilize algorithms that automatically buy or sell based on pre-set inputs. Many models use *momentum* as a prominent factor. Therefore, when a particular stock, sector, or market turns south, sell orders flood the exchanges, amplifying the initial declines.

Bar has been reset

The tumult of the prior three months stemmed from a repricing of stocks in line with a more sober outlook. In 2018, the economy grew above trend, propelled by the large fiscal stimulus. Concurrently, corporate profits surged more than 20%, aided by substantial tax relief. However, as investors looked ahead and inferred a period of slowing growth, stock multiples contracted.

But in recent months, many commentators have gone farther, raising the possibility of an impending recession. This concern seems to have seeped into our general consciousness. *Google Trends* indicates that internet searches relating to the "R" word spiked after late November. The prospect of the business cycle turning soon — whatever the odds — has added to the selling pressure.

Mixed messaging from the Federal Reserve has only contributed to the debate. In October, Chairman Powell suggested that short-term rates would be heading significantly higher because they were "a long way from neutral". The latest bout of market turmoil coincided with this comment as the specter of higher rates fueled recession fears. Later, at a mid-December press conference, Powell characterized the Fed's wind down of its massive bond portfolio as being on "autopilot". That statement also set stocks off. He subsequently backtracked, stressing — appropriately — that future monetary policy would be adjusted for prevailing financial conditions.

Growth redux

The sharp sell-off in the fourth quarter really denoted a recession of *confidence* rather than a looming economic recession. Growth will certainly downshift to a lower gear but key signals are not yet flashing red. Of particular note, the yield curve has flattened but not inverted as it typically does ahead of a contraction. Accommodative fiscal policy, credit growth, and wage growth should continue to provide support in 2019. Workers are now scarcer than jobs. And with mortgage rates rolling back down, the housing sector should not act as a drag like it has over that last twelve months.

Analysts have reduced corporate earnings estimates for 2019 and further revisions may be in the offing. However, if the economy continues to expand, profits should also rise, although at a much less robust rate than in 2018.

Of course, a slowing China remains a wild card for both global growth and investor psychology. Policymakers recently lowered bank reserve requirements but have so far restrained from another aggressive stimulus program. High levels of debt that spurred excessive capital investment argue for a different policy path; perhaps one that targets domestic consumption. Ongoing trade tensions and the potential for Smoot-Hawley 2.0 also threaten a benign economic outlook.

Hold fast

As a result of December's global sell-off, stocks entered 2019 with less demanding valuations and risks better reflected in prices. By mid-January, the S&P 500 had rallied 10% from the lows over the Holidays. The experience last year is a stark reminder that sentiment is fickle and can quickly shift. Stock prices react accordingly.

Over time, stocks generally reward patient investors with rising dividends and prices. The compounding of returns can lead to significant wealth creation that exceeds the rate of inflation. But nothing that yields real value comes without a cost. Temporary losses represent the price investors must pay for potential capital growth. Since one cannot avoid short-term losses if one owns stocks, investors would be well-served to maintain sufficient resources in reserve to address near-term needs. This tactic has the benefit of giving capital devoted to stocks time to work out. For history indicates that stock holdings will indeed work out, if well-diversified.

Much about investing is cyclical: prices, valuations, enthusiasm. Euphoria and fear can both grip the markets and cripple reason. Investors must be disciplined or risk falling victim to the market's sharp moves. Often, the greatest challenge is to maintain a consistent approach that grounds decision making and supports one's long-term objectives. Hold fast.

— Christopher J. Singleton, CFA, Managing Director

January 16, 2019

This newsletter represents the views of Kanawha Capital Management, LLC and is for informational purposes only.
It is not intended as a basis for the implementation of any particular investment strategy or any decision to purchase or sell.

*Kanawha Capital Management, LLC manages investment portfolios for individuals, retirement plans and endowment funds.
Kindly contact Kevin Seay for additional information: seay@kancap.com or 804-359-3900.*