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WE HAVE MET THE ENEMY AND HE IS US

April, 2019

As equities stormed back this year following December's market swoon, investors who managed to stay the course in the face of turmoil have been rewarded. Major indices such as the S&P 500, Dow, and NASDAQ currently stand within striking distance of all-time highs.

For some, such resiliency did not come easily. Confronted by plunging stock prices, many investors become gripped by fear and flee. This is a normal reaction. After all, as evolutionary psychologists contend, humans are hardwired for survival. It is perhaps our most innate trait, dating from the emergence of early hunter-gatherers over 200,000 years ago. You can take the person out the Stone Age but not the Stone Age out of the person.

Investing can be likened to a series of intermittent skirmishes and battles. Threats are assumed to be external and at times seem obvious. However, emotions and biases and their impact on decision-making often represent the greater enemy.

Speaking of battles

Throughout history, for a group of foot soldiers to have any hope of successfully withstanding a heavy cavalry charge, they had to remain disciplined and stay in formation. Such constancy must have proven exceedingly difficult, even counter to a soldier's intuition. Yet a lapse in discipline and breaking of the ranks only invited slaughter.

Similarly, the experience of the last few months underscores the importance of maintaining a disciplined investment approach. Being *disciplined* connotes having a plan or at a minimum, a basic strategy — and sticking to it.

A well-known military adage posits that "no plan survives contact with the enemy." Although investing can be a battle at times, unlike a military strategist, an investor should not be quick to discard his plan. A good one will not only survive initial contact with the enemy, it will help protect the investor from the real enemy, emotions. Market action cannot be allowed to trigger a short-term response that jeopardizes one's long-term investment goals.

Don't fear the bear

Evolution aside, as frequently as markets twist and turn, you might expect that everyone would be used to the occasional plunge by now. For instance, on average, stocks tend to drop by 10% (or more) every twelve months and by 20% (or more) every five years. And since 1980, the market has fallen by an average of 14% within the course of any given calendar year.

The deep market sell-off associated with the *Great Financial Crisis,* although ten years past, still haunts investor consciousness. Many also recall the rather unpleasant experience of the *dot.com* implosion in the early 2000's. So it was natural for some to have extrapolated the recent 20% drop into something more sinister.

Some bear markets have been short and sharp, others deeper and longer lasting. The worst ones see stock prices more than cut in half. Nevertheless, U.S. equity markets have always recovered from a bear. After the next one arrives, there's every reason to expect history to hold. The key is to have enough funds in reserve to ride out a downturn, allowing stocks time to rebound. Said another way, any funds devoted to equities need to have the luxury of a multi-year holding period.

Play the odds

Investors need to get the odds on their side. Over one-year periods, stocks achieve positive total returns approximately three-fourths of the time. However, the dispersion of returns has been quite wide, ranging from -39% to +47% over the 1950-2018 period.

As the holding period is extended, potential downside risk diminishes. For instance, over rolling five-year periods, stocks manage positive returns about seven-eighths of the time. The lowest annualized return over a five-year period has been -3%.

Ten-year holding periods look better still. Historically, over such a timeframe, stocks manage positive returns 95% of the time. Going back to 1950, the weakest 10-year annualized return proved to be -1%. That occurred in 2009 and essentially amounted to a lost decade; so while very painful, it was not necessarily catastrophic.

Yielding clues

Much of the market turmoil late last year emanated from fears of a global growth contraction. Then as stocks drifted lower, investor fear and trading algorithms both kicked in, amplifying the initial sell-off.

Market pundits and media types have been tripping over themselves to call the next recession. Bear markets almost always overlap with an economic downturn so this issue is far from academic. The buzz reached a crescendo in late March after the 10-year U.S. Treasury bond yield dipped below that of the 3-month T-bill. Stocks sold off sharply that day on news that the yield curve had "inverted".

An inverted yield curve is a typical occurrence during the later stage of an economic cycle as bond investors anticipate a weak economy and subdued inflation. Historically, this signal has proven a reliable precursor of recessions. And it now seems to have entered the common lexicon — even the shoeshine boys are talking about the yield curve.

Signal noise

But as a true signal, the action tells us little about the *timing* of a potential contraction. There tends to be a long and highly variable lag between an inversion and a recession's onset. Moreover, as BCA Research likes to point out, stocks generally "sprint to the finish line" with outsized gains during the late stages of a bull market. Those who raise cash too early risk forgoing meaningful returns.

Additionally, it is not yet clear that the yield curve has actually inverted in a sustained way. In fact, by mid-April, the 10-year / 3-month spread had turned positive again. So current pessimism prompted by the yield curve movement may well be misplaced — for now.

Fed pivot

An inverted yield curve also implies that the Federal Reserve has been in tightening mode too long. But since its December rate hike, the Fed has pivoted to a more dovish position. The board subsequently lowered its assessment of the U.S. economy, shifting gears from forestalling inflation pressures to supporting inflation and extending the expansion. A majority of FOMC members now do not anticipate any rate hikes in 2019.

The Fed has apparently concluded that persistently low inflation remains a problem as the expansion heads into its tenth year. Chairman Powell recently described low inflation as a "major challenge of our time". The Fed no longer thinks that containing inflation requires restrictive policy. In practical terms, this new stance suggests that the Fed will need to see an actual inflation spike before hiking rates again. Such a mindset has opened the door for a future rate *cut.*

The grenades lobbed at the Fed by the Trump Administration have been a distraction and could challenge its independence. The recent threat to begin stacking the board with overtly political governors (Stephen Moore and Herman Cain) should not alter current policy. Even if confirmed by the Senate, they would only be two of twelve voting members. But once the norms are shattered, what would stop the next president from packing the Fed with partisans? A trend to politicize the Federal Reserve would not benefit the U.S. economy nor stock and bond markets.

Green shoots

Expansions tend to end after monetary policy becomes too restrictive. A more dovish central bank supports the view that this expansion still has legs. Indeed, some earlier headwinds to growth seem to be fading. For example, the sharp slowdown in Chinese economic activity may be ending. The Peoples Bank of China has reduced bank reserve requirements by 35% over the past year while interbank lending rates have dropped. Chinese policymakers continue to push through more stimulus measures including tax cuts for both consumers and businesses to boost activity. Recent data hint at a pickup in the domestic economy.

The Trump administration appears to be heading toward an agreement with China that will ease trade tensions. Such an accord will no doubt fall short of desired structural reforms. China may agree to purchase more U.S. goods and take steps to "open" markets. However, substantive progress to stem the theft of intellectual property and end discriminatory regulatory practices represents wishful thinking.

Trade detente would obviously help China jumpstart its economy. It would also bode well for the country's supply chain — largely other developing countries — as well as for the Eurozone which relies on China as a key export market. The dissipation of tensions would also buoy investor confidence.

How does it play out?

There are few signs of economic imbalances in the United States, in part due to the slow, grudging recovery from the last recession. Absent some external shock, the current economic expansion will be largely dictated by Federal Reserve policy. At the moment, inflation is both low and contained so Fed policy remains friendly. However, if history is any guide, inflation will eventually accelerate, forcing the central bank to respond aggressively by raising rates.

Easy monetary policy benefits equity and bond markets. But as we have all seen, stocks can still undergo meaningful corrections in the midst of an economic expansion. So have a plan that will weather the next pullback and be prepared to stick with it.

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April 17, 2019