

THE ORANGE SWAN?

FALL 2017

David Stockman, the Director of the Office of Management and Budget during the Reagan administration, recently appeared on CNBC and reiterated his warning of a dangerously overheated market. This was not startling news, even though he called for a correction of 40-70%, as he has been quite pessimistic throughout much of the advance in the market over the past few years. What caught our attention was both the magnitude of the predicted decline and the possible trigger for any dramatic reversal.

As for the magnitude of the decline, thankfully there have not been many annual 40% declines from a market high to low during a calendar year. Declines of over 40% from annual high to low occurred in 1929, 1930, 1931, 1932 and 1937 and not again until 2008. These eras are known as the Depression and the Great Recession.

Stockman believes there is a bubble in stocks and bonds created by the easy money policies of the Federal Reserve and that as the Fed continues to gradually pull money out of the system, bond yields will rise and the premium valuations afforded to stocks will collapse. When questioned about why these very well communicated and accepted Fed policies should shock the market into a meaningful retreat Stockman said it might take some unanticipated and yet unknown "Black Swan" event to instigate the downturn. He stated that "...you got a black swan in the old days and maybe you just get an orange swan now." The brightly hued swan in Stockman's view is President Trump.

Stockman believes that the Trump tax reform plan will either fail or be amended to the point of losing any effectiveness. He also believes the President's irrational behavior will further contribute to a loss of confidence in the economy and markets. He believes a meaningful correction is long overdue and that the underpinnings of the market will be eroded as the Fed tightens and Trump's policies fail.

The point in reviewing Stockman's comments is not to disrespect his views as we accept that a meaningful correction is long overdue. We don't share the opinion that we are on the verge of a decline such as those experienced in the 1930's or even 2007-2009. For all the drama in Washington, the economy seems to be in reasonably good shape. A recession is inevitable in the next few years but we don't expect it will be as severe as 2007-2009.

It is important to remember that even during the 2007-2009 Great Recession that many top-quality companies continued to pay, and many even increased, their dividends even as stock prices swooned. Many investors who held firm were able to recoup the losses of 2007-2009 and by the end of 2012 had more than regained any lost ground as measured by the S&P 500.

It took a lot longer for the hapless theoretical investor in 1928 to regain what was lost during the Depression but by the end of 1936 the investor was ahead once again. A subsequent slide in the late 1930's and early 1940's brought more angst but by the end of 1944 all was well again. The point of this history lesson is not to minimize what can be very disconcerting multi year declines in stocks but to recognize the long-term resiliency of stocks and the economy.

We share one concern troubling Mr. Stockman and many market observers that the stock market has been unusually stable despite national and international turmoil. In a study of market volatility since 1928, Pension Partners looked at the maximum intra-year drawdowns (declines from intra-year highs to lows). As of the July 17, 2017 report, Pension Partners said the maximum drawdown from high to low in 2017 had been a meager 2.8%. This is the smallest drawdown since a decline of 2.5% in 1995. This has been one of the longest periods in the study without a drawdown of at least 5%.

By way of comparison, in 2016 and 2015 there were drawdowns of 10.5% and 12.4% respectively. Both of these years produced overall positive returns for the S&P 500. There have been drawdowns of over 10% in many years where the index still posts an annual gain. In 2011 for example, the maximum drawdown was 19.4% but the S&P 500 finished that year up 2.1%. Those of us who have been around a while remember vividly the one day "drawdown" of over 25% in October of 1987. Instead of ushering in the new Depression as many feared, the market actually finished the year on a positive note.

The point of all this is that no one really knows what will happen to the market over the short term. There are very intelligent and experienced investors and advisors who are concerned about the level of the market and expect a meaningful decline. A decline of some magnitude will almost certainly occur within the not-too-distant future but just as certainly the market will eventually recover from that decline. It is important for investors to bear this in mind and persevere through the inevitable difficult times.

As always, we believe long term investors should hold cash and short-term bonds to meet their expected next few years of cash flow requirements and to reflect their investment time horizon and risk tolerance. For the remainder of the investment portfolio, buying and holding the stocks of good companies trading at reasonable valuations and paying solid and growing dividends has provided reasonable returns over the long haul. We hope with sound planning and experienced guidance to be able to help our clients through any downturns brought on by black swans - or orange ones.

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