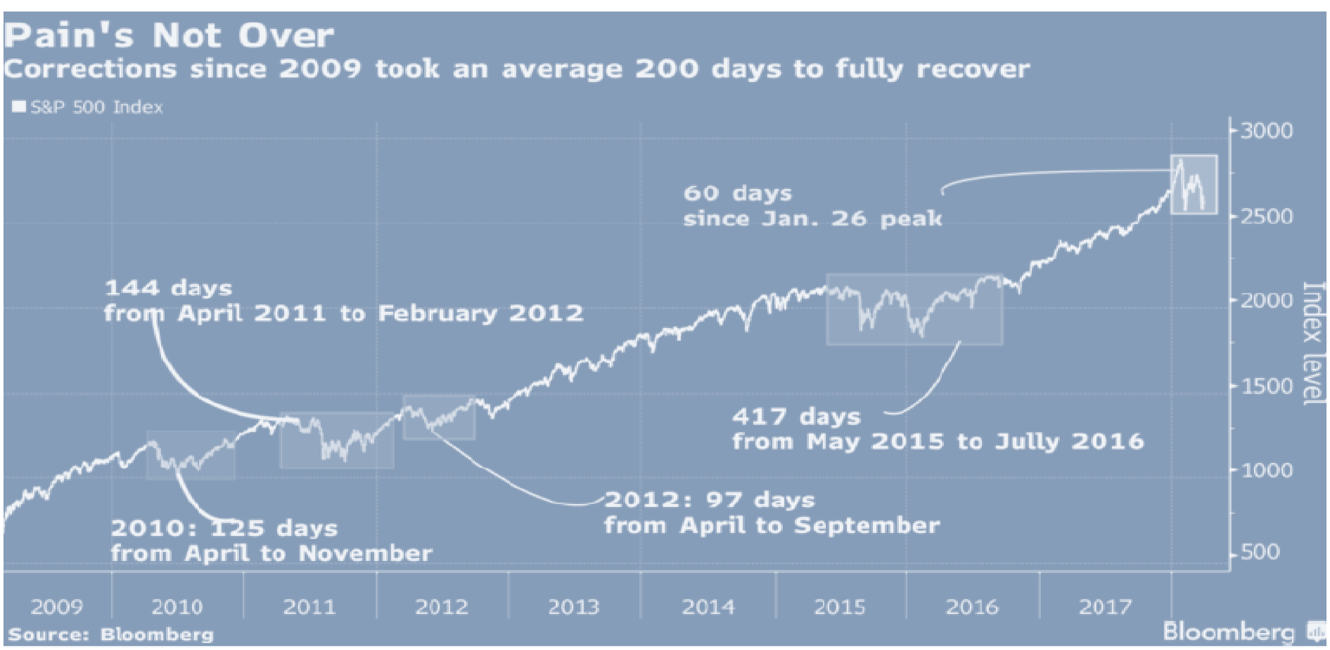
# NO PAIN NO GAIN

"Many an optimist has become rich simply by buying out a pessimist."
~ Laurence J Peter, educator, author

Well we knew the calmness of 2017 wouldn't last forever. As so often happens with markets, when volatility returns it comes back with a vengeance. After a historically strong start to the year, the stock market gave it all back and then some in the early part of February and it's been bouncing around ever since. With the economy on solid footing and earnings growth continuing to be quite strong, in my opinion the reason for the market decline was not related to the fundamentals of the market.

I believe, the decline was sparked by a pickup in volatility which led to the blowup of a volatility ETF that a large amount of hedge funds and institutions owned. I won't bore you with the minutiae, but suffice to say they owned a product that would go up in value so long as volatility remained low. It worked beautifully until it didn't, and now it has no value at all. Sort of like picking up pennies before a freight train. With no ability to sell the underlying asset and margin calls coming due, they sold what was liquid and that was equities.

Since that time, there have been a whole host of reasons for continued market volatility, tariffs being just the most recent. However, regardless of the news of the day, once the stock market goes into one of these waterfall type declines, it takes time to come out of it. As you can see from the chart below, previous declines that were similar in nature lasted anywhere from 97 days to 417 days. With the underlying fundamentals still quite positive, I think this will prove to be a shorter term correction, meaning there is likely another month or two to go before the market makes new highs. This is why I think it's important to use this decline to add some high quality companies that have been unfairly punished by the market.



**"The genius of investing is recognizing the direction of a trend, not catching highs and lows."**
**~John Bogle, investor**

# Pullbacks are normal

While the recent market instability has been stomach churning at times, it's important to remember this is normal market behavior. Looking at the chart below, most years have seen significant market declines, and yet just as often finish the year with positive returns. Stocks can sell-off for all sorts of reasons, some real and some imagined. I have seen nothing so far that would lead me to believe that this is anything more than your run of the mill market correction.

I think a large part of the fear in the market is due to these large point swings. However, much like a nickel, a 1,000 point move in the Dow Jones Industrial Average (DJIA) isn't what it used to be. As the stock market has risen in value over time, the amount each point means on a percentage basis has declined. In early February when the DJIA dropped by 1,000 points twice in the same week, it was touted as "unprecedented" by the news media. While technically that's true, on a percentage basis though, it was hardly historic, constituting the 26th and 33rd worst days since 1985. I was surprised to learn that most other countries use percentages rather than points when discussing the daily moves of their respective stock markets. I can only wish that we would do the same as it would likely reduce a lot of needless worry and apprehension. Probably wouldn't sell as many newspapers though.


Source: Russell Investments

**"The most important lesson in investing is humility."**
**~ Sir John Templeton, investor**


# Tariffs

One concern I do have, that could morph this typical correction into something worse, would be a trade war. Although the President has since backed down from the recent steel and aluminum tariffs by granting exclusion to practically every country not named China, he hasn't backed down from his stance on using tariffs in order to garner more favorable trade terms. This might be his most politically consistent issue as he's been in favor of tariffs for years. While the realistic hope remains that this is merely bluster and posturing, there remains the real possibility of this turning into something far worse, if cooler heads don't ultimately prevail.

The Smoot-Hawley Tariff act of 1930 was a significant, if not leading factor, as to why an ordinary recession turned into the Great Depression. Few realize that the DJIA which had famously crashed during the fall of 1929, was only down 5% year over year by April 1930. The worst was yet to come however as the Tariff Act enacted in June of that year, started a trade war that dropped world trade by 65% over the next few years! As you can see in the chart below, the great crash really got going after the Tariff Act, as the DJIA fell 86% from the April 1930 high to the bottom in 1932. As the well-known saying goes, "those who cannot learn from history are doomed to repeat it".


Note: T = Smoot-Hawley Tariff enacted June 17, 1930. B = Emergency Banking Act passed March 9, 1933. M = Mark-to-market suspended June 1938.
P = Pearl Harbor attacked December 7, 1941.
Source: Haver Analytics.

# The MY Ratio

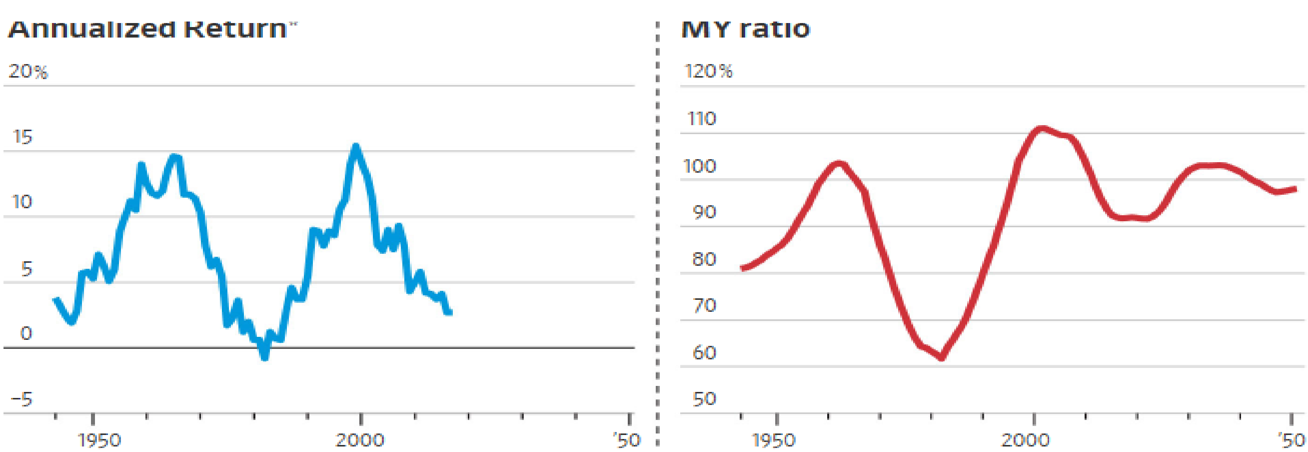
**"The years teach us what the days never know."**
**Ralph Waldo Emerson, poet**


It's been well documented that demographic trends play a large role in the performance of our economy and consequently the stock market. When relatively large groups of people such as the baby boomers, move through their life, various parts of the economy will do better or worse depending on where they are in their life cycle. People tend to buy their first car at a certain age or their first house at a comparable time in their lives. In the same way people tend to reduce their exposure to stocks as they enter or near retirement in favor of fixed income. This has been a consistent trend since the financial crisis as large swaths of baby boomers have retired and have subsequently reduced equity exposure.

These demographic trends were captured in a ratio developed by a number of highly renowned economics professors which they called the MY ratio. The MY ratio is essentially the number of Middle-aged people (ages 35-49) in relation to the number of Young people (ages 20-34). As you can see from the chart below, it has been a fairly accurate predictor of the long-term returns of the S&P 500. When this ratio was initially developed back in 2002, it was predicted by these professors that the stock market would struggle until the ratio turned back up in 2016, which I think it's fair to say that it did. Now that the ratio has turned back up, it is expected to rise until 2035, which would fit in nicely with my belief that we are still in the early innings of a long term secular bull market, with years yet to go. *Cont. on pg. 5*

**Remarkable Long-Term Model**

The S&P 500's inflation-adjusted, dividend-adjusted annualized return over trailing 16.25 years, versus ratio of middle-aged population to the young (the MY ratio))




* Over trailing 16.25 years

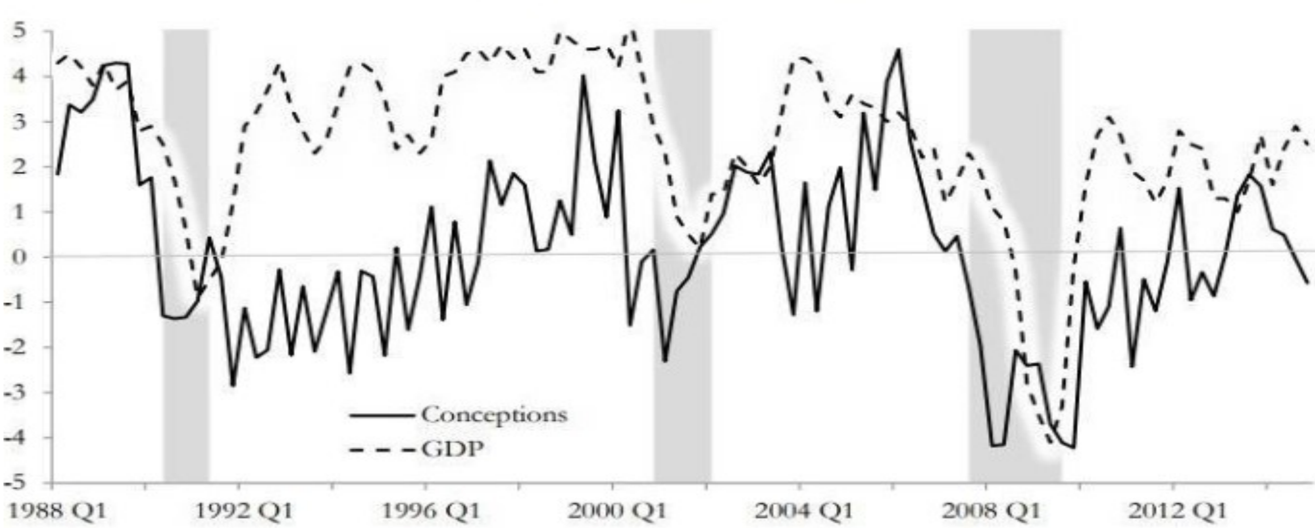
Sources: Ned Davis Research, Morningstar

**"I have noticed even people who claim everything is predestined, and that we can do nothing to change it, look before they cross the road."**
**~ Stephen Hawking, physicist**

Speaking of demographics, there was a recent study put forth by the National Bureau of Economic Research (NBER) which shows that falling conception rates in the US, consistently preceded each and every economic downturn of the past three decades. This means that you could use fertility rates as an economic indicator. In fact, the bureau's report stated that fertility rates can predict recessions just as well, if not earlier and better than, conventional market indicators such as equity prices and consumer confidence levels. Basically, they're saying that economic contractions can be predicted by a falling number of an entirely different type of contraction.

I still believe that the stock market will be making new highs before the year is up and likely far sooner. While volatility has returned to the stock market, in many ways it's a return to normal as most years see similar types of corrections. With no recession on my horizon, I think you invest accordingly. Namely, use this market correction to add high quality companies that are now trading at more attractive prices. High equity valuations had been one area of concern for many investors. However, with the drop in prices and the continued earnings growth, that seems to no longer be the case. According to S&P Global, the S&P 500 is now trading at about 16.8 times forward earnings, which is just slightly above the 16.4 average since 2000. With S&P 500 earnings expected to grow 18% this year and continued growth next year, seems to me the market has given us a good opportunity to buy some stock at undervalued prices.

**Figure 1: Conception and GDP Growth Rates**




Notes: The figure shows the growth rate of conceptions and GDP over the preceding year, reported quarterly. The shaded areas indicate NBER dated recessions. Sources: Natality Detail Files and the BEA

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- COMPLEX AND UNIQUE PASSWORDS. These contain a combination of upper and lowercase letters, numbers and special characters. Do not share your passwords.
- ALERT TO RISKS ONLINE. Never open attachments or click on links in suspicious emails or from senders you don't recognize, and limit the personal information you share on social media websites.
- PRACTICE SENSIBLE DATA MANAGEMENT. Shred sensitive documents when disposing of them.
- USE MULTI-FACTOR AUTHENTICATION WHEN POSSIBLE. Choose security questions wisely and enable

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# Year-to Date Index Performance

| INDEXES | 12/31/2017 | 3/29/2018 | % CHANGE |
|---|---|---|---|
| **Dow Jones** | 24,719.22 | 24103.11 | -2.49 |
| **S&P 500** | 2673.61 | 2640.87 | -1.22 |
| **Nasdaq** | 6903.39 | 7063.44 | 2.32 |
| **Wilshire 5000** | 27794.17 | 27410.72 | 1.38 |
| **Russell 2000** | 1535.51 | 1529.43 | -0.40 |
| **MSCI EAFE (Intl)** | 2050.85 | 2005.67 | -2.20 |



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