21st Century
Equity Advisors Corporation

Year-end Commentary – 2018
From: John Hegler
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Dear Clients and Friends,

During the week ending Friday, December 21st, the stock market was in virtual free-fall as major market averages fell in the neighborhood of 7%. A lousy neighborhood if you ask me! The S&P 500 fell 20% from its all-time peak reached on September 20th through Christmas Eve, before recovering somewhat in the last 4 trading days of 2018. For the fourth quarter 2018, the S&P 500 fell by 14% and the Dow Jones Industrial Average fell by 11.8%. For the year 2018, the S&P 500 fell 6.2% and the Dow fell 6.1%. For 2018, other major market averages also fell: New York Stock Exchange Index – 11.2%; Russell 2000 Small Cap – 12.2%; Nasdaq Composite – 3.9%. Declines presented exclude the effect of reinvested dividends of approximately 2% per year. For the moment, the news is predominantly bad, including the government shut down, lack of a trade deal with China, and reports of a slowing economy.

Following is my reaction to those events and the stock market going forward.

<u>Stock Market Panics</u>. What happened in the month of December was an old-fashioned stock market panic - indiscriminate selling without regard to value or price. The panic reached its peak on Christmas Eve when the Dow Jones Industrial Average plunged 653 points. Many asset classes are now inefficiently priced during this moment of panic. For instance, high-yield ETFs, which traded at a premium to net-asset-value (NAV) just a few short months ago, were recently trading at substantial discounts to NAV by up to 15% in some cases, a HUGE swing in sentiment. <u>Significant stock market bottoms are born out of panics</u>. I remind readers that the stock market advanced more than <u>58%</u> in the 26 months following the stock market crash of 1987.

<u>The Government Shutdown</u>. Should this event be another reason to sell stocks? History says otherwise. The logic is that everyone knows the shutdown won't last long and all paychecks will be cut. In the 20 shutdowns that occurred from Sept. 30, 1976 through Feb. 9, 2018, average loss of the S&P 500 during the shutdown was .4%. The S&P 500 actually increased during the last 5 shutdowns.

<u>Chaotic Government</u>. As I write this paragraph, Pandora is turned to Country/Western and Patsy Cline's "Crazy" is playing, which inspires me to make a few comments about our government. In spite of the hysteria from both parties, here is the bottom line: The Trump Administration will be unsuccessful in passing any significant legislation during the remaining 22 months of its term – the votes just aren't there. The wall will remain unbuilt. The opposition party will also be unsuccessful in passing any significant legislation during the balance of President Trump's term, because the votes (2/3rds) necessary to override Trump's veto in each chamber are also not there. The tax cuts will not be reversed. So, grid-lock for the foreseeable future is in store, in spite of the drama taking place. I'll take gridlock – do no harm. The positive steps necessary to advance America's competitiveness, tax reform and reducing regulation, have already taken place and will remain in place.

<u>Arguments for a Bear Market</u>. Bear markets are most likely to rise out of periods of recession and/or over-valuation. With regard to the first point, the economy is strong and showing no serious signs of recession. A slowdown in economic activity would be OK since interest rates would remain "in check". I point out that during the 8 years following the 2008 financial crisis, economic growth was generally tepid and the stock market performed well nevertheless. With regard to the second point, valuation,

the trailing price-earnings (PE) ratio of the S&P 500 currently stands at 18.5, just nominally higher than the post World War II average of 17.3, and about 1/3rd lower than the 29 PE ratio in place prior to the onset of 2000-2003 bear market. The two key “bear market arguments” do not stand up at this time.

Investor Sentiment. At recent social gatherings, I’ve talked with some folks who have had a rough time in the stock market lately. To a person, investor sentiment was black – not even one person wondered about opportunities that might be presented in the wake of the carnage. Cheap stocks abound, but no one seems to be interested. This type of black sentiment is often found near stock market bottoms. Other evidence of lopsidedly bearish sentiment can be found in a record bearish CBOE equity put/call ratio and recent investor sentiment polls. Record equity mutual fund/ETF outflows (by a large margin) in the most recent week, were the flip side of record inflows found the week prior to last January’s market top. Finally, the usual suspects preaching doom are getting some publicity lately. Ron Paul’s renewed predictions of a 50% or more stock market decline seem to invariably attract attention near stock market bottoms. I suppose he’ll be right someday, but not today since the market rallied by 1,086 points last Wednesday!

Internal Condition of the Market. The market decline was characterized by a steep angle of descent as the Dow Jones Industrial Average declined by 352 - 653 points in 6 out of 7 trading sessions through Christmas Eve. The market “felt” that it was approaching a panic-induced bottom, although positive technical signs were not yet visible. Finally, relief arrived on Dec. 26th as the market rallied a record 1,086 Dow points. Importantly, “up” volume, as a percent of total volume, was 95%, the highest level of “up” volume since 2016. 95% “up” days could take on different interpretations depending on the timing of its occurrence. For instance, if it occurred at the tail end of a multi-month rally phase, the interpretation could be that the move marked a blowoff (terminal) end to the rally phase. On the other hand, if it occurred following a serious decline, such as what the market experienced in December, a 90%+ up day usually marks a strong upward initiation, representing a “rush” of buying interest in a significant way. It would be ideal to see a cluster of 90%+ up days to solidify the idea that we are in the early stages of a new rally phase. Clusters occurred near the Feb. 2016 market bottom (3 90%+ up days), and close to the kick-off to the bull market that began in March 2009 (8 such days within 2 months of the bottom).

On the other hand, it is noteworthy that bear markets are characterized by many days of large up or down point moves (1% or more), such as what we have experienced in the 4th quarter of 2018. This is because both bullish and bearish emotions start to run quite high during bear cycles, causing a series of sharp declines, followed by sharp rallies in response to extreme oversold conditions. So, I think it would be helpful if the market would calm down. I would note, with the 20% drawdown experienced during the 4th quarter, that if we are, in fact, in a new bear cycle, I could make the case that in terms of price decline (20%), most of the damage has already been done.

My own take is that in the long run, fundamentals (strong profits/economics) eventually win out. Currently, fundamentals are strong, with only minor indications of economic weakness. In the short run technical conditions win out. The market was oversold to an extreme that compared to many stock market bottoms in the past, arguing for a rally in the near future. So far so good, as the market rallied strongly on improving market internals in the last 4 trading days of the year. However, I do not think the market is going to go straight up from the Christmas Eve low, and a testing of the that low is probably in store at some point. So, the green light is not quite flashing just yet.

Happy New Year! John Hegler

614-487-8873
614-487-1173 (fax)

749 Terra Ct
Worthington, OH 43085

3765 Montreux Ln, 1-102
Naples, FL 34114

Investment Advisory Services
Financial Planning