Friday, February 5, 2016

# JANUARIES ARE CURSED

## First, an update to the 2016 Economic Outlook

- The stock market has predicted nine of the last five recessions.
- The stock market has always been and always will be volatile.
- For those sweet on the economy, there is the job market. Last year we saw the creation of 2.7 million US jobs, and 3.1 million the year before that.
- A steep yield curve, a strong jobs market, lower oil prices, and a still improving service sector argue against a recession.
- Stock market corrections during non-recessionary times are less nasty (but, admittedly, still nasty).

Given the drop of the stock market in January, a number of clients called to ask if we are changing our 2016 outlook. We thought this was worth readdressing. None of us here are saying we expected a stock market correction immediately, but what has happened thus far does not really deviate from what we wrote.

> For whatever the reason du jour the media assigns to the event, once every three-and-a-half years the stock market will correct by twenty percent. The last time the stock market corrected that much (actually, it was about 19%) was in 2011, so you could argue **that we're "due" a pretty big drop. And given that the Fed will be raising rates in 2016 and that we will be confronted with a Presidential election, a drop of the twenty percent magnitude really shouldn't be ruled out.**
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> **But, ultimately, who cares? I mean, how many 5-, 10- and 20- percent drops have we all gone through and forgotten?** We get it – stock market corrections are only healthy in theory and in hindsight. As we go through them, they can be absolutely gut wrenching. But they happen fast and just about always set the market up for higher highs.
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> **So, why do we care? Recessions. It's all about recessions. On average every six years the US goes through a recession and the stock market, in sympathy, goes down 25-33%. And it's not quick.** The decline can endure, thus upsetting cash management and withdrawal strategies for those in the distribution phase of their retirement, and shifting asset allocation plans for those in the growth phase of their retirement planning. Those 5-20% non-recessionary drops happen fast enough so that they are quickly forgotten, causing less emotional stress and reducing the threat of having to make changes to your plan at a less than stellar moment. These larger recessionary drops not only crush us emotionally (and let's be honest – we all get emotional about money), but put us in a position where we can't simply wait a month or two to change investment plans, when the timing is more appropriate.

Talks of US recessions usually intensify during stock market corrections. As the quip goes, stock markets are said to have predicted nine of the last five recessions. But more accurately, according to the information in a February 4 CNBC segment with Steve Liesman, http://video.cnbc.com/gallery/?video=3000491598&play=1, bear markets have predicted thirteen of the last nine recessions. And while the odds are about the same as a coin toss (thus not a strong predictor), the odds are higher than we might like them to be. So let's consider what's going on with the US economy.

Depending on whom you talk to, the US economy is either struggling or it is on fire.

For those who are sour on the economy, there is Gross Domestic Product (GDP). Real GDP grew just 2% last year, and ended with a flat quarter.

For those sweet on the economy, there is the job market. Last year we saw the creation of 2.7 million US jobs, and 3.1 million the year before that. This was the best consecutive two-years since 1998-1999, during the technology bubble. There is no bubble today, just good employment growth.

So which is it? Is the economy sweet or sour? Given that much of the recent GDP weakness is related to less inventory accumulation, which is a temporary drag, and given that the economy still has the waiting tailwind of lower energy prices coming, it is our view that at this point in the expansion the best barometer of the economy's health is the jobs market.

It is important to bring this up because, as stated earlier, as has been happening over the last couple months, the talk of a US recession usually intensifies during market corrections. And whether or not a recession is coming is important. With no recession, stock market pullbacks are just like they have been – regular and ordinary.

We find that declining stock prices are not in themselves sufficient to predict a contraction in the economy. While it's a scary indicator, it's not the best. One of the best, which we have been discussing a lot around the office, is the yield curve. The yield curve is the spread between the Federal Reserve's federal funds rate (currently 0.25 – 0.5%) relative to the 10-year Treasury rate (now hovering around 1.9%). Since the mid-1960's, the yield curve has been nearly perfect in predicting a recession. Historically, this spread has inverted (i.e. short-rates higher than long-rates), at least briefly, between two and six quarters (on average about fifteen months) before every recession since 1964. It has only given one false signal, in 1966, when an economic slowdown – but not an official recession – followed an inversion. Combined with a strong labor market and a still improving service sector, this indicator does not argue for a recession.

## Januaries are Cursed

- Six of the last nine Januaries have been negative for the market. Many of those years have been pretty good for stock prices.

The S&P 500 was down over five percent this past January. As goes January, so goes that market for the rest of the year. Right? I mean, that's all we hear nowadays. And the longer term data seems to back that up.

Since 1950, when the S&P 500 has declined in January, the index has averaged only a 0.7% return for the following February-through-December versus a 12.1% return for that period following a positive January. We can all come up with a number of theories as to why this is, but what is more important is that it simply so. 2016 was the third consecutive negative January, something that has only happened twice before (1968 – 1970 and 2008 – 2010).

That means that six of the last nine Januaries have been negative for the market. Only one of the those five previous bearish signals turned out to follow longer term history (2008), although it would be hard to argue that the 2.5% return of the stock market for the last eleven months was a completely false signal. But the point is that for the last decade you could put as much confidence in the "as-January-goes-so-goes-the-market" indicator as the Super Bowl indicator.

Maybe sometime these things make sense. Maybe sometimes we try to make sense of them. And sometimes these things work until they don't work; this doesn't seem to be working anymore.

## A Quick Comment on Oil

- When the stock market rallies out of its correction, it would be a positive to see energy prices rise but not a prerequisite.

You may have noticed a recent daily positive correlation of the prices of oil (and energy stocks) and the price of US stocks. This is unusual, but nonetheless it has been happening. So we decided that we should look into this. We wanted to know, does oil need to rally for the stock market to rally? What we find is that although it is preferred to have the energy sector participate in any stock market recovery as breadth would be an indicator of sustainability, it is not a prerequisite. Oil rallies have not consistently coincided with stock market bottoms. We looked at four instances in which oil declined by at least 40%. The bottoms of those declines have not aligned with stock market bottoms – oil led twice, and stocks led twice. And in only one case, in 2009, were the bottoms even within three months of each other.

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***The Bottom Line***

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This January hurt. We all know that volatility is the price to doing business in the stock market. We all know it's regular and we all know it is ordinary. But it doesn't make it hurt any less while you're going through it. This is temporary. It will end and prices will go higher. And I'd be willing to bet that at some time in the not-too-distant future that we'll all forget about the pain. Until the next time.

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