BERKSHIRE MONEY MANAGEMENT
The Knowledge and Experience to Build Your Wealth

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Resolution on the Horizon

I stumbled up a statistic yesterday that I found interesting, ***over the last 90-years there has been a 3% stock market correction, on average, every 21 days***. Consider ***that prior to the start of this recent correction the stock market went 300 days without a 3% drop.***

As I write, the S&P 500 is off its recent highs by about 5%. ***Although the first thirteen days of the correction were scary (and unfamiliar), it appears as if we're back to something where volatility looks more normal.*** Now we wait to see if the stock market breaks up, or breaks down. There must be a resolution to this four-month trading rage. ***While it is of utmost importance to concentrate on the long term strategy, sometimes it is important to consider what's on the horizon – and if it's time to get defensive, or if it's time to consider some opportunities.***

Humans are subject to what we refer to in behavioral finance as "recency bias". Recency bias tricks us into making decisions we might not otherwise. We humans have it because once upon a time, from an evolutionary standpoint, it served us well. We learned that if people ate a berry and then those people die, maybe we don't eat those berries. We recognized that wooly mammoths will fight back when we try to eat them, so we developed new methods of hunting. We figured out that it got cold at night, so we found shelter.

(Side note: it's amazing how much of our contemporary human behavior can be traced back to basic instincts. We're not as smart as we think we are. There are a couple clever, quick and fun reads on the subject, such as "You Are Not So Smart" and its sequel "You Are Now Less Dumb". Learning about how the human brain works has saved my clients more money than any math class I ever took. Well, except statistics. And maybe some parts of calculus. OK, so math is important. But so is being aware of how our stupid human brain makes decisions that are bad for us.)

So, recency bias. Coming into 2018 investors thought that the market would never correct again. ***Coming into May of 2018, investors seem to think the market will never go up again***. (Well, more precisely, "some" investors seem to think the market will never go up again. The contrarian in me wants to see more doom and gloom in investor behavior.) ***But when you measure and compare the evidence (statistics) and look at the growth rates of, well, growth rates (calculus), it looks as if the optimists are going to be right on this one.***

In our 2018 Outlook article I wrote:

> "Predicting the stock market over a very long time is science (or, maybe, science-like). Predicting the stock market's performance is one part art, one part skill, a dozen parts luck, and one part obligation. And maybe just one part fun. I think the stock market corrects 7% in the first quarter of the year (quickly; so quickly that it is soon forgotten), rallies 20% from the bottom of the correction, then alternates corrections and rallies in the last quarter, ending the year up about 4.7%."

I still think it's folly to try to predict the stock market's return between two arbitrary dates. But let's face it, folly can be fun. So, the correction ended up occurring in the first quarter (yay for me). The correction ended up being 10% instead of 7% (I'm taking that one as a victory). It took 13 calendar days and in the

days after we had clients wiring in money to get invested (I think that supports my "so quickly it is soon forgotten" hypothesis). Three for three thus far.

OK. By now you're recognizing that I think folly can be fun when I'm right. (Another side note: I'm considering the topic of my next book and on the list of ideas are telling the tales of trading mistakes and bogus calls and examples of retroactive prescience - some of which I was guilty of. I'm not saying I'm always right, but I do enjoy playing with a hot hand).

The stock market hasn't veered much from what might have been expected if you followed our 2018 Outlook and our mid-January update. But what next? Well, I did suggest six-months ago that we'd see a 20% rally from the bottom of the correction. But as John Maynard Keynes said, "When the facts change, I change my mind. What do you do, Sir?" I am now thinking that ***the rally from the bottom will be closer to 15.6%***. More on that in a moment. ***What's important to figure out first is from what price level might the stock market rally by 15.6%?*** That sounds pretty good if it rallies from here. But it sounds pretty lousy if that rally starts after the market first gets cut in half.

I didn't write anything "official, but after the early-February swoon I was talking on the local news and radio shows and podcasts and what-not saying that a market bottom had been reached. My only caveat was that the stock market was missing a classic "breadth thrust" where the market bounced off the bottom with great volume and significant price moves, which would have shown strong conviction from buyers. Not that it was a caveat in so much that I was hedging my bet (when speaking in the media, they like absolutes, so I wasn't talking in terms of probabilities, but in terms of positions that should be taken). The caveat was that the recovery wouldn't be comfortable. There would still be consternation as to whether or not it was still safe to be in the stock market.

Interestingly, from a media standpoint, you take a stand. But for managing money in "the real world" you embrace statistics. I love using numbers to measure fear and greed. As a contrarian, that is important to me. One such indicator is called the VIX, commonly referred to as the "Fear Gauge." When the stock market corrected in early February the VIX spiked. In previous instances where the VIX has spiked above 28.5, the median drawdown in stock prices has been 22%, reflecting the tendency for past volatility surges to indicate threatened fundamentals. (The drawdown after the February VIX spike was just 6%.)

It's always dangerous to utter the words, "this time it's different" when it comes to the market or the economy. But, well, this time we thought it was different. After 300 days without a 3% drop, we had noticed fund flows into an inverse-VIX bet. We speculated that much of the spike had to do with an unwinding of that crowded trade. So while we were concerned that history would repeat itself and the market would drop another 22% (survival instinct kicked in like our cavemen brethren before us), we also were aware that we're just not that smart. It's hard to invest based on just one metric (even if that one metric is representative of a larger class). So we had to recognize what our brain was saying (Run! Hide!), but then try to calculate probabilities based on the other evidence. And our calculations said, the next few months aren't going to be nearly as fun as the whole of 2017, but the resolution on the horizon is positive.

One of the reasons ***I continue to increase the probability of expecting a positive reaction is that the stock market has been following a "continuation pattern" of lower highs and higher lows.*** If you were to look at a chart of the market in that continuation pattern, it would depict a triangle with the pointiest

side to the right. At first, the price range is wild. Then it gets tighter and the swings are less volatile, to the upside and the downside. ***The market is, right now, not bullish or bearish, but the resolution to those tightening continuation patterns tend to break to the upside.*** That is by no means assured, but it is supported by other evidence.

No, I didn't get the classic breadth thrust that I'd want to see. And investors have gotten more optimistic than the contrarian in me would like. But ***the weight of the evidence continues to indicate that the global equity correction will give way to the resumption of the bull market.***

But don't get excited just yet. We're in May. And, well, investors like to "sell in May and go away." Typically, I never take that saying too seriously and just roll my eyes at it (there are some statistical outliers that support it enough to be true, "on average." But "on average" a man with his top half in the oven and his bottom half in a block of ice is just fine.) However, this time around, that particular historically weak seasonal tendency coupled with ***US mid-term elections is an additional hurdle to a breakout of the stock market's current trading range. We need to get past the digestions of what is to come politically, expect weakness into July, pain into September, and then enjoy something close to the average six-month rally of 15.6% following the mid-term cycle low.***

My guess is that your first reaction to that might be to position your portfolio to get more defensive. It is true that during the period of May-to-October that defensive sectors like Staples, Utilities, and Telecom tend to outperform the broad index. However, first of all (and I've been saying this for decades) there are no tools to consistently and reliably time the market on those short term moves. It doesn't pay to get too cute and trade that kind of stuff. Besides, consider that ***since 1972 the S&P 500 has had a positive return two-thirds of the time through that seasonally weak May-to-October period. And when that has been the case, the Financial and Technology sectors have outperformed most of the time.*** Not to mention, if the market is weak over that time, in part, because of rising interest rates then the classically defensive sectors with negative interest rate sensitivity will face headwinds.

The next year looks good, but we do have concerns beyond the next year or so. It is good that unemployment is so low. The broadest measure is currently at 3.9% (and other versions of unemployment rates are also very good). Employment has only been this low a handful of times, most of those time the result of a temporarily reduced workforce correlated with wartime (World War 2, the Korean War, and the Vietnam War). Keep in mind that economic growth is function of population growth and productivity growth. After those events, our troops came home and eased pressure on the job market. The increase in workers powered growth. That won't happen this time. Low unemployment is being driven by a combination of things like massive fiscal stimulus and demographic trends.

Local surveys we perform for the Berkshire Business Confidence Index support the national narrative that it's currently very difficult for businesses to fill jobs. More than one-third of small businesses have openings. The only other time that has happened was at the height of the late 1990s technology boom. I can cite a number of other data points, but I think you get it - productivity growth (basically a measure of output divided by input) ain't what it used to be. Productivity increased 1.2% in 2017, the strongest performance since 2015, after dipping 0.1 percent in 2016. It's struggling to hit the 1% mark now. Theoretically, the best workers have already been hired and each new hire now has diminishing returns. It's not a great sign for productivity growth without the use of new technologies.

The good news though is that unemployment will likely drop to the low-threes by the end of the decade (and, no, that's not a projection based on recency bias). And despite the narrative in the media, I'd argue that wage growth has been good. A lot of government data doesn't take into account worker mix. But some data, such as the Bureau of Labor Statistic's Employment Cost Index (or ECI) does account for the change in worker mix. The ECI shows wage growth is heading to 3% year-over-year. Sure, that's less than the 4% growth seen during the boom of the 90s, the last time unemployment was as low as today. But inflation was higher back then, too. (FYI, productivity growth was a whopping 3% back then.)

So, calculus. Things are good. Very good. But the growth rate of the growth rate (the 2nd derivative) of said goodness slowing. ***The economy looks pretty good today and I expect it to remain good for a while.*** In 2018 alone the tax legislation is expected to boost disposable income by $122 billion. But I recognize how my stupid brain works – I've deprogrammed my stupid brain so that I am not (always) comfortable with comfortable data. And right now, there is a lot of comfortable data.

My survival instinct tells me that it's not different this time. ***Eventually we will hit the wall in terms of job gains and productivity will shrink and the Fed will be deep into a tightening cycle. And it'll be around 2020. Then we'll be talking about recession.*** Yeah, I know. Year 2020 sounds like something far in the future, or from a science fiction movie. But it's not that far away. ***We've got a good year or two for the stock market, then it's going to get…uncomfortable.***

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