BERKSHIRE MONEY MANAGEMENT

The Knowledge and Experience to Build Your Wealth

Friday, October 26, 2018

BERKSHIRE MONEY MANAGEMENT

Downside Risk Potential

- There is, historically speaking, a one-in-four chance the market drops another ten(ish) percentage points.
- There is, historically speaking, almost certainty that the market will surge after mid-term elections.
- History aside, we think the most likely scenario is a bit more pain followed by a rally.

At 9:55 am on Wednesday October 24th I replied to an internal e-mail asking me "Can you weigh in on where we go from here?" It reads as follows:

> Per my e-mail earlier this morning, sentiment is getting stretched enough for there to be a rally. But that's just one piece of the puzzle. The 200-day moving average is beginning to slope down. And while I think technical stuff is voodoo, it turns out that a lot of investors practice voodoo. I see two outcomes.
>
> - A 33% probability of the stock market continuing it's correction for a week or two (maybe down 10% ish, putting the S&P 500 down to its May lows), then rallying double digits for the rest of the year.
>
> - A 33% probability of the market rejecting the mid-term elections as good and/or renewed trade war talk, and the market continues its correction longer, through January with a slightly larger drop (a total of 12-13% instead of 10%). In this scenario the rally is more subdued until the conversation shifts away from trade wars to the new tax cut proposal for the middle class
>
> - A 33% probability that the stock market starts improving mildly over the next couple of weeks and renews it's rally in a mild manner (no matter what the rhetoric).
>
> - A 1% probability that the correction gets closer to 20%.
>
> - A 0% chance that a new bear market has started.
>
> In regard to the level of the S&P 500 at the end of the year, I always put in the caveat "give or take a few months. We Americans love our calendar years, but it's stupid to think in such ways. It's arbitrary."

The last word in that internal e-mail was “arbitrary.” And if you consider my evenly split probability assessments, you can get the idea that those were a bit arbitrary. The reality is that there is no real way to properly create accurate probability assessments. But the gist of the internal memo is A) after a month-long spree of pre-midterm election stock selling, we’re probably closer to the bottom than not, and B) this pullback is not associated with the beginning of a new long-term bear market.

But I do want to point to the fourth bullet point, “A 1% probability that the correction gets closer to 20%.” Quite frankly, I think the probability of a 20% pullback is now bigger than one percent. Maybe it’s a four percent chance. Maybe it’s a one-in-four chance. Again, you cannot accurately measure that. (It’s actually an 18% chance if you want to get historical – there have been 22 similar market corrections since 1974 and four of them have developed into 20% drops.) Not all corrections become bear markets. From the start of the current bull market in 2009 through February 2018, there were six corrections that didn’t turn into bear markets.

But, as I mentioned in that internal e-mail, technicals are starting to look ugly. Technical market analysis is kind of a stupid tool. Stupid in so much that it helps tell you what stupid people will do.

We humans are masters at controlling and interpreting content to serve our own narrative. We watch “news” that supports our ideology. Even PhD candidates have been found to weigh less important information that might oppose their dissertation theory. And in the stock market, we look at pictures to help tell us a story because it makes us feel more comfortable to be able to rationalize the unknown. So when stock market sentiment gets bad, we look for reasons to sell. And a downward sloping 200-day moving average on the stock market is often the nudge needed to accelerate selling. In large part, that’s why I think we’ll get a bit more pain.

So, the bad news is that there is a growing chance of the stock market falling 20% peak-to-trough. The good news is that unless economic conditions worsen (and we don’t see that happening meaningfully; i.e. no recession; Q3 GDP just rang in at 3.5% as I am typing this), history suggests that the downside risk is limited to about 20%.

Bear markets during recessions are much different animals than bear markets during periods of economic growth. Going back to 1900, on average, bear markets that have overlapped with US recession have had a median decline of -35.9% and last a median of 17-months. Non-recessionary bears have a median decline of -23.3% over seven months.

Post-Midterm Tendencies

The US stock market is about to enter the most bullish period of the four-year presidential cycle. Of the sixteen quarters of a presidential term, the top three in terms of average S&P 500 gains are Q4 of the mid-term year (now) and Q1 and Q2 of the third presidential year (the first half of 2019). The median gain over those three quarters is 18.4%. Since 1946, the S&P 500 has not declined over that time period.

Of course, this time it may be different. Q3 2018 saw S&P 500 gains in excess of 5%. In the eight other previous instances when that has happened in the Q3 of a midterm year, the index soared 9.8% in Q4. But so far the market is dropping, not soaring.

Even if the market does turn around soon, that doesn't mean that the rest of the three-quarter streak is bullet proof. The median correction over those three quarters has been -6.8%. Four of those declines were double-digit declines. But that's just further evidence that bad things can happen to good markets, and it's temporary.

I could write a lot about policy uncertainty and how it is affecting the stock market. And while that undoubtedly plays a part in the recent decline, it seems like wasted ink since we'll move from speculation to knowledge in a short period of time. Besides, the bigger headwind right now seems to be a combination of tighter monetary policy (which I've talked a lot about, including on the Allen Harris LinkedIn page; as a reminder, the Fed's Quantitative Easing is turning to Quantitative Tightening in November as net central bank purchases turn negative) and tough tariff talk. Those are the reasons, in my estimation, that the market has been struggling.

Bottom Line: I've been very vocal (for about half a decade) about my expectation of a recession sometime between2020-2022. But we're not there yet. And without a recession, we can expect the downside risk to be limited to about 20% (we're halfway through that). There is, historically speaking, a one-in-four chance that we'll get a drop of that magnitude. Which means there is a three-in-four-chance that we've just about hit a bottom, give-or-take a few percentage points.

BERKSHIRE MONEY MANAGEMENT

The Knowledge and Experience to Build Your Wealth

GENERAL DISCLOSURES

Article may include forward-looking statements. All statements other than statements of historical fact are forward-looking statements (including words such as “believe,” “estimate,” “anticipate,” “may,” “will,” “should,” and “expect”). Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct. Various factors could cause actual results or performance to differ materially from those discussed in such forward-looking statements. Historical performance is not indicative of future results. The investment return will fluctuate with market conditions. Performance is not indicative of any specific investment or future results. Views regarding the economy, securities markets or other specialized areas, like all predictors of future events, cannot be guaranteed to be accurate and may result in economic loss to the investor. Investment in securities, including mutual funds, involves the risk of loss. Registration with the SEC should not be construed as an endorsement of Advisor’s investment skill or acumen. Investment process, strategies, philosophies, allocations and other parameters are current as of the date indicated and are subject to change without prior notice. This article is intended to provide general information only and should not be construed as an offer of specifically tailored individualized advice.

STANDARD & POOR'S

The S&P 500 Index (S&P) has been used as a comparative benchmark because the goal of the above account is to provide equity-like returns. The S&P is one of the world’s most recognized indexes by investors and the investment industry for the equity market. The S&P, however, is not a managed portfolio and is not subject to advisory fees or trading costs. Investors cannot invest directly in the S&P 500 Index. The S&P returns also reflect the reinvestment of dividends. Berkshire Money Management is aware of the benchmark comparison guidelines set forward in the SEC Clover No-Action Letter (1986) and compares clients’ performance results to a benchmark or a combination of benchmarks most closely resembling clients’ actual portfolio holdings. However, investors should be aware that the referenced benchmark funds may have a different composition, volatility, risk, investment philosophy, holding times, and/or other investment-related factors that may affect the benchmark funds’ ultimate performance results. Therefore, an investor’s individual results may vary significantly from the benchmark’s performance. The S&P 500 Index (S&P) has been used as a comparative benchmark because the goal of the above account is to provide equity-like returns. The S&P is one of the world’s most recognized indexes by investors and the investment industry for the equity market. The S&P, however, is not a managed portfolio and is not subject to advisory fees or trading costs. Investors cannot invest directly in the S&P 500 Index. The S&P returns also reflect the reinvestment of dividends.

DOW

The Dow Jones Industrial Average (NYSE: DJI, also called the DJIA, Dow 30, INDP, or informally the Dow Jones or The Dow) is one of several stock market indices, created by nineteenth-century Wall Street Journal editor and Dow Jones & Company cofounder Charles Dow. The Dow average is computed from the stock prices of 30 of the largest and most widely held public companies in the United States. Clients of BMM may have portfolios that differ substantially from the composition of the DOW and therefore, their performance may vary significantly from that of the Dow. The Dow is used for illustrative purposes only, as one indicator of the overall US economy, and its past, present, or future performance should not be viewed as an indicator or comparison point for BMM client performance.