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BERKSHIRE MONEY MANAGEMENT

Mid-term Concern is So Yesterday

- The markets are pessimistic enough that contrarians like us expect a solid rally through year end.
- Q4 of a mid-term year (now) and the first half of an election year (first half of 2019) are, on average, the best three quarters for the stock market. However, a flipped House majority softens that historical tailwind.
- The sell-off in October had less to do with perceived election jitters and much more to do with real concerns about tariffs and tightening monetary policy.

Whoever said that the stock market's struggles are due to mid-term election uncertainty is only telling you a small part of the story. While America's attention has recently been focused on election battlegrounds, the real fight for the stock market is the escalating trade war between the U.S. and China. If that isn't figured out, we'll get a recession and, subsequently, a bear market in stocks.

Tariffs and trade wars are bad for business. Locally, I recently visited a Berkshire-based manufacturing firm that ordered a new machine for their manufacturing facility and the price went up $85,000.00 due to the Chinese tariffs. Businesses are feeling pain from the tariffs across the nation. Here are some sample comments:

"…shortages and much longer lead times…" – Computer & Electronic Products
"Tariffs are causing inflation…" – Chemical Products
"…pace has slowed since the first half of the year…backlog is declining…certainly trepidation about the future." – Machinery
"…pricing pressure and longer lead times in most commodities." – Primary Metals
"…supply chains stressed." – Transportation Equipment
"Backlog for Q4 and next year are way down." – Fabricated Metal Products

President Trump tweeted that he had a "very good conversation" with China President Xi Jinping, which made the markets a bit more hopeful about the outcome of their meeting in Buenos Aires this month. We'll be watching this very closely as its much more of a concern than elections. The other great concern for the stock market is monetary policy.

Regarding monetary policy, BMM sent a contingent to Washington D.C. last week for the largest annual professional investor conference, Schwab Impact. Former Federal Reserve Chair of the Board of Governors was one of the keynote speakers. Ms. Yellen shared, “I’m worried we’re headed for an economy that may overheat…At this point, a couple more interest rate increases are necessary to stabilize growth at a sustainable pace and stabilize the labor market so it doesn't overheat"

So you can see the yin and yang between the dangers of an international trade dispute and a US economy so strong the Fed has its sights set to slow it down. Presidential tirades about the Fed moving too fast aside, the Fed is moving at a moderate pace. The Fed is moving at about half the pace it did in 2005, when it raised the federal funds rate 0.25 percentage points at each meeting (which, by the way, was considered a measured and gradual pace at the time).

Rising interest rates and tighter monetary policy in general are major headwinds to the stock market. But the Fed causing a recession is a less immediate concern than the insistence of President Trump to threaten it via tariffs.

On the matter of headwinds, there’s the incredibly tight labor market. There are more job openings than job seekers, much less qualified job seekers. There were 218,000 jobs added per month over the last three months, which is just incredibly strong for a nine year old expansion with the unemployment rate already at a super low 3.7%

I present an incredibly good labor market as a possible headwind (not a definitive one) because we just don’t yet know how low the Fed will let unemployment go before it feels it needs to advance the pace of raising interest rates. Of course, the pace of interest rate hikes doesn’t have to accelerate at all – the Fed can keep the same pace and just decide to keep raising them past neutral and into something more restrictive.

The tight labor market and the competition for qualified workers are pushing up compensation, especially for the better trained and educated employees. Small businesses have not experienced this level of labor market related challenges since the late 1990s when Y2K produced a surge in demand for computer and programming specialists. Current labor shortages though are more broadly distributed across industries. I publish a quasi-quarterly newsletter called the Berkshire Business Confidence Index, and it shows that small businesses are feeling this pain of overheating.

The Fed sees this small business party as a problem. And it's their job to take away the punch bowl right when the party is getting good. The Fed hasn't taken away the punch bowl just yet, but it is thinking we should all be acting a bit more soberly regarding our outlook and confidence levels.

October Surprise

Once the U.S. stock market dips 10%, as it has, there is about a one-in-four chance that the decline continues and reaches 20%. God that scares us.

Once you go past 5%, you typically go further, for an average drop of 12% over 40 trading sessions. The selloff through October saw the market drop 11% over 25 trading sessions. It really seems as if, as scary as it was, this has been pretty textbook in terms of corrections. Of course, that usually means it takes months and months to leave that damage behind us, but it looks as if the majority of the damage is behind us. We could go further. This decade had one correction for 21.6% and another for 15.2%. Either decline would be perfectly reasonable and within the low-point (2,300 on the S&P) and mid-point (2,500 on the S&P), respectively, of the S&P 500's trading channel over the last decade.

Other history is on our side, too. Not that history repeats, but it often rhymes.

According to data compiled by Yardeni Research, the S&P 500 has been up in the 12 months following every midterm election since the middle of the last century, with gains ranging from 1.1% in the post-1986 vote stretch (which included the Oct. 19, 1987, crash) to 33.2% in the year after the 1954 election.

That positive pattern appears to relate more to the four-year presidential cycle than to mid-term elections. The span from the fourth quarter of the second year of an administration through the first and second quarters of year three has been the best nine-month period for the Dow Jones Industrial Average in presidential cycles dating back to 1896.

But don’t get too excited, again going all the way back to 1896, when the House majority flipped from one party to another following mid-terms, the DJIA was up only 1.9% a year after (vs. 16.8% when the majority party retained control). The evidence doesn’t point to better days, just a delay of the next stock market crash.

Nonetheless, a rally of the 5% magnitude wouldn’t be surprising over the next few months (that’s about a year’s worth of returns crammed into a short period of time, so that’s pretty good). At BMM, we’re contrarians. We like to buy when others are selling, and vice versa; we become more bullish when others become more bearish. And right now investors are about as bearish as they were prior to the last election, which was elevated. Looking at what we call put/call ratios, there is a lot of pessimism out there. The put/call ratio mesaures the number of investors making bullish bets (by using puts) versus making bearish bets (by placing calls). When that ratio is high, as it is now, that’s a sign investors are looking to protect themselves. The ratio has gotten to a level where a contarian rally looks likely through year end.

Bottom Line: For a long, long time now I’ve had concerns of a recession sometime around 2020-2022. There really is no sure Midway to predict that. But to invest properly, you need a hypothesis and then you constantly need to adjust to new data to update your hypothesis. But if tariff talk continues to exist at the same time the Fed tries to take away our punch bowl, a recession in that time frame looks more realistic every day. Until then, investors have gotten pessimistic. As contrarians, we think that limits downside and sets us up for a rally over the next few months.

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