Tuesday, December 11, 2018

BERKSHIRE MONEY MANAGEMENT

You Brexit, You Buy It

This column is being written the day after Theresa May delayed the Brexit vote (that was December 10th), the same day the US stock markets experienced a roller-coaster ride where indices plunged to test recent lows of the year only to bounce back up and close in the positive. Given it was a rather crazy day, let's inspect it for clues about what to expect in the months ahead.

British Prime Minister Theresa May, much to the chagrin of her colleagues, delayed a parliamentary vote on her proposal of how Britain should exit the European Union. May was concerned she'd not get the necessary votes, wounding her political party and further knocking back any progress thus made on the divorce between the United Kingdom and the European Union. I won't bore you, or me, with UK politics, but I will remind you that if a plan cannot be approved, then Brexit still happens on March 29, 2019. It will happen with all the expected economic ugliness of doing so without a plan. In response to that concern, British companies have spent millions preparing for disruptions such as supply shortages, new tariffs, and delays at the borders.

Even if things go swimmingly (or as swimmingly as possible at this point), businesses must still contend with new needs, such as obtaining new licenses, changing labels, and spend time shifting from defense to offense. This is not going to go well, and the ripple will affect global economies, including the US firms who are growing more skittish about our own economy.

According to the Institute of Supply Management's semiannual report, over half of US businesses expect 2019 to be worse than2018. That's not a shocking assessment of the year to come. Economically, 2018 was a remarkably positive year, so it's easy to understand that businesses would expect some cooling next year. The concern is the trend, that more and more businesses (both anecdotally as well as via survey) are becoming gloomy about the year ahead. This type of steadily creeping pessimism has a way of gaining momentum then becoming self-fulfilling. That's bad for the economy, and bad for the stock market.

Yesterday, in the wake of a delayed Brexit vote, the S&P 500 index was down 1.9%, at six-month lows, then rallied back to close up 0.18% on the day, holding at important technical support around the 1,625 level. Investors and financial media praised the intraday rally as a sign that the lower level, tested for the third time in less than two months, can't be broken and a longer-term rally is next. The S&P has been trading roughly between 2,625 and 1,800. It's

bound to break one way or another and you don't want to be on the other side of the trade when it does happen. So let's explore what to make of such a huge intraday rally.

Yesterday, (December 10th) was the fourth time in 2018 where the S&P 500 was down at least 1.5% then rallied back to positive by the day's end. Not that three data points are meaningful, but you could argue that those types of reversals have recently occurred closer to short-term lows than the highs. So that is good news for the bulls going into the last few weeks of the year. However, historically, the follow through to these types of days have not been similar to those more recent occurrences.

From the year 2000 until the invasion of Iraq in 2003, there were 13 occurrences of 1.5% drops with intraday rallies to the positive. This happened as the S&P 500 lost about half its value. In the bull market that followed, there weren't many of those types of reversal days. But there were 19 occurrences in 2008 alone. These intraday rallies feel great at the moment. For example, the language and tone of guests on CNBC and Bloomberg literally changed in front of my eyes from gloom to hopeful, even optimistic. But they don't tend to be positive signs beyond the particular day of the reversal.

In the 61 total occurrences since 2000 as well as the 20 occurrences when the positive reversal occurred when the S&P 500 was at its lowest level in at least three months, returns the next day, the next week, the next month, and the next three months were all negative, on average.

S&P 500 After Positive Intraday Reversals: Since 2000

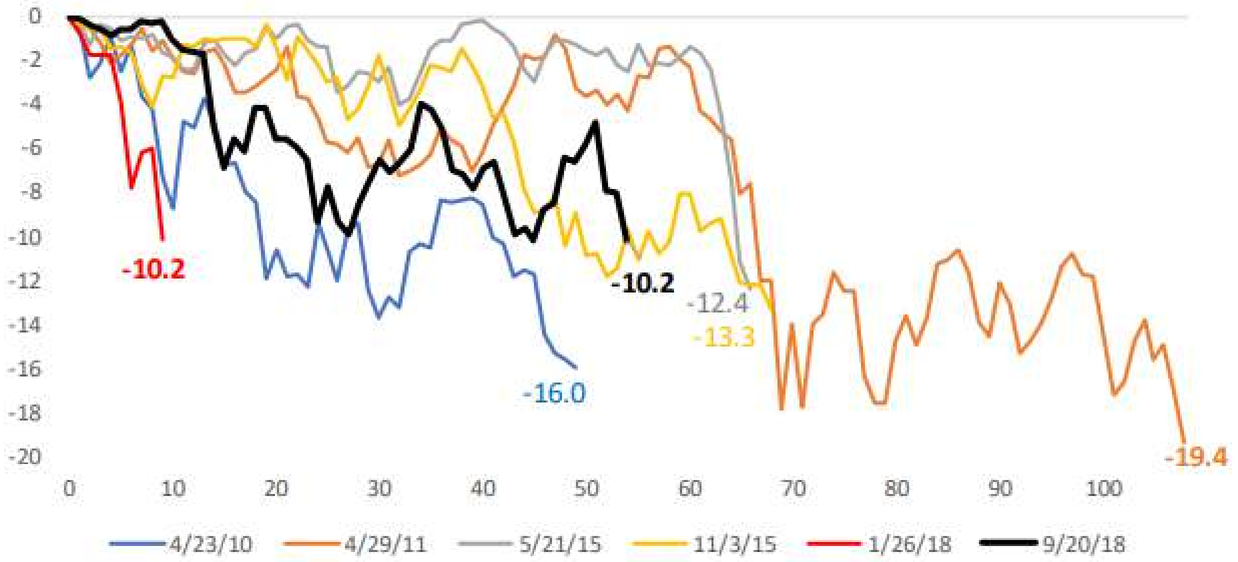
Occurrences: 61

	S&P 500 Performance (%)			
	Next Day	One Week	One Month	Three Months
Average	-0.3	-0.3	-0.8	-1.6
Median	-0.1	-0.3	1.1	0.1
% Positive	47.5	41.0	55.7	52.5

Positive Reversal From a Three Month Low: 20 Occurrences

	S&P 500 Performance (%)			
	Next Day	One Week	One Month	Three Months
Average	-0.5	0.6	-0.1	-1.1
Median	-0.6	0.5	0.4	0.8
% Positive	30	55	55	55

So, of course, the question is, if we are going lower, how much lower are we going? Well, first we need to break the recent lows for confirmation that we'll actually go lower. At the lows on Monday the S&P 500 was down about 12% then closed at -10.2% from its record high on September 20. Below is a graph of how this correction compares to the other five 10% corrections we've had since the end of the financial crisis. The average of the previous five corrections was -14.26%. Following this script would put the end to the correction in the first quarter of 2019, with "only" another 5% drop to go.


S&P Post Financial Crisis Corrections: Percentage Declines
0
-2
-4
-6
-8
-10
-12
-14
-16
-18
-20
-10.2
-10.2
-12.4
-13.3
-16.0
-19.4
0
10
20
30
40
50
60
70
80
90
100
4/23/10
4/29/11
5/21/15
11/3/15
1/26/18
9/20/18

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DOW

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