A Scary October – Should you be worried or not?

In the first quarter of this year, US equity markets experienced a downturn of almost 10% from January 26th through February 8th. The worst of those days was February 5th, where US stocks lost 4.1% in one day. In the midst of that turbulence, we hosted a client call where I stated that “a market selloff absent a fundamental catalyst or set of catalysts causing that selloff is a reason to hold or buy – not a reason to sell.” Our views proved to be correct, and from February 8th through September 20th, US equity markets rebounded +15.3%. Our belief at that time was broadly founded on two views. First, fundamentals, not sentiment and rhetoric, drive intermediate to long-term market returns, and second, history has demonstrated that more often than not, short-term significant market selloffs (i.e. > 3% in a day) within a cyclical bull market have a history of reversing course.

Interesting observation on the chart above – going all the way back to 1950, there have been only 21 days with a daily S&P 500 market decline in excess of 3% (within a cyclical bull market). 3 of those 21 days have occurred already this year – the S&P 500’s close on October 24th of -3.1% added a fourth, tying the most ever since 1950!

Market volatility is yet again rearing its head. Recent investor surveys have indicated that investor sentiment has rather dramatically changed course to one of a more “Bearish” tone. While it may appear on the surface that this time around “feels different”, we believe it is not only normal and similar in nature to the two other minor drawdowns we’ve experienced so far this year, but this October drawdown is virtually mirroring the last mid-term election year, 2014.

Source: Strategas Research Partners
Drawdowns we've experienced so far this year:

<table>
<thead>
<tr>
<th>Period (2018)</th>
<th>US Stocks</th>
<th>International Stocks</th>
<th>After</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/26 through 2/8</td>
<td>-9.9%</td>
<td>-7.8%</td>
<td>+8.3% / +2%</td>
</tr>
<tr>
<td>3/9 through 4/2</td>
<td>-7.1%</td>
<td>-1.8%</td>
<td>+14.5% / -1.6%</td>
</tr>
<tr>
<td>9/20 through 10/24</td>
<td>-10.0%</td>
<td>-8.3%</td>
<td>???</td>
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So where might markets go from here? Well, here's where they went the last mid-term election:

Source: Strategas Research Partners
And further out beyond the mid-term election\(^5\)....

![Bar chart showing historical S&P 500 index percentage change by quarter of the presidential cycle.]

Source: Ned Davis Research

We shouldn't really be too surprised with what has transpired this month as historical. October has proven to be the most volatile month of all months\(^6\):

![Bar chart showing S&P 500 average monthly high/low range from 1928 to 2017.]

Source: Bespoke Investment Group
Potentially more important than what happens over the next couple of months is that one year post mid-term elections, stocks (S&P 500) have been higher on average by a huge 15.3%. In the 17 mid-term election years since 1950, 100% of all subsequent years have been positive for the S&P 500.³

![S&P 500 Price Return 12 Mo. Period Following Mid-Term Election 1950 - 2014 Avg = 15.3 Pet.](source: Strategas Research Partners)

We believe the fundamentals that have underpinned this economic recovery and market expansion for the last year and three-quarters, remain solidly in place. I’ve outlined many of these fundamental characteristics in my Q3 2018 write-up, “Finishing Strong Despite the Noise”, so please reference for additional detail. While information and data changes minute-by-minute, day-to-day, I thought I would summarize some key fundamentals that in my mind make this recent bout of volatility a temporary downturn, rather than the start of a Bear market:

**If this was the start of a bear market…**

- …hard economic data in the US and abroad would be unwinding more rapidly and to a more significant magnitude. US GDP, the labor market, and industrial production just to name a few, remain in an up-trend.

- …broad-based corporate earnings, sales, and revenues would be deteriorating. Additionally, forward guidance would (in aggregate) be more pessimistic – so far, it has not been.⁷

- …you would very likely see US and global high yield and investment grade (IG) fixed income spreads widening out. Fixed income spreads across both high yield and IG remains tight, with IG continuing to actually tighten.⁹

- …derivatives hedging volume would be significantly increasing, indicating institutional / sophisticated investors are fearful over a more intermediate term time horizon. Not only are they not rising, they’re falling.⁸
...safe-haven vehicles would be reacting more strongly, like:
- Japanese Yen still trades above 110 (vs. the US dollar)
- US Treasuries tend to fall before recessions and bear markets – yields are still higher.
- The outperformance of TIPS vs. Treasuries also suggests the recent drawdown in stocks is likely not consistent with the return of a deflationary backdrop like we saw in 2015.\(^3\)
- Gold would likely be rallying more significantly (only up 2.3% from 9/20 through 10/23\(^2\))
- The Swiss Franc like the Yen, would be strengthening vs. the US dollar (only up 1.4% MTD\(^2\))

...economically sensitive assets like Copper and emerging markets currencies and credit would continue to get hammered. Copper has not taken another leg down. EM currencies have stabilized and EM credit has also firmed.

...cracks in the consumer would begin to show more readily\(^2\):
- Consumer balance sheets are still strong.
- Jobless claims are the lowest in 48 years.
- Wages are up, and the JOLTS job openings have hit a new all-time high.
- Home prices while receding slightly, are still above pre-Great Financial Crisis levels.
- Retail sales would be falling – they're stable.
- US personal savings rate would be rising – it's not. It has been in decline since February.

I'm sure I could think up another dozen or so reasons, but I'll stop here. I'd like to leave you with a couple of last thoughts as you behaviorally reconcile your feelings on the markets and what to do with your money. The below is an excerpt from my step-by-step guide to managing your money through crisis, “A Strategy for How NOT to get Eaten by a Bear”

Steps for Success: Points of Clarity First

1. Consistently timing when to get out of the market and then conversely back in, is a nearly impossible task. NO ONE to date has successfully proven they can consistently do it.\(^9\) Be wary of “financial experts” who profess that they can.

2. The ultimate long-term success of your money is steeply rooted in a well-constructed financial plan – we call this holistic Wealth Planning. This, in our opinion, is arguably the most important step you can take to ensure you, your business, and/or your family’s financial health and well-being is properly addressed. As such, it should be the first step before you invest ANY of your hard-earned money.

3. First Citizens constructs your portfolio and dynamically adjusts and/or reviews that portfolio quarterly to match both what we believe the future market environments may throw at us, as well as the needed outcomes your plan entails. Your personal portfolio is designed to attempt to give you the highest probability possible in achieving the returns necessary to reach your stated goals and objectives.

Please commit these three points to the forefront of your memory, as they will help you behaviorally anchor your thoughts when irrationality creeps in during times of market crisis. If you have any questions whatsoever, or just want to chat, please feel free to reach out to your First Citizens Bank partner and we can arrange a conversation.
1 US stocks represented by the Russell 3000 index which is a market-capitalization-weighted equity index maintained by the FTSE Russell that provides exposure to the entire U.S. stock market. The index tracks the performance of the 3,000 largest U.S.-traded stocks which represent about 98% of all U.S incorporated equity securities

2 Bloomberg, FCB CMG Research
3 Strategas Research Partners
4 Bank of America Investor Sentiment Survey, Financial Times
5 Ned Davis Research
6 Bespoke Investment Group
7 FactSet Insights
8 Chicago Board Options Exchange (CBOE) average daily put/call volume for month of October through 10/22, Bloomberg NYSE daily put/call volume MTD through 10/22
9 Vanguard, Stockton and Shtekhman, 2010, Hulbert Financial Database which monitors more than 100 market-timing newsletters and web-based forecasters.