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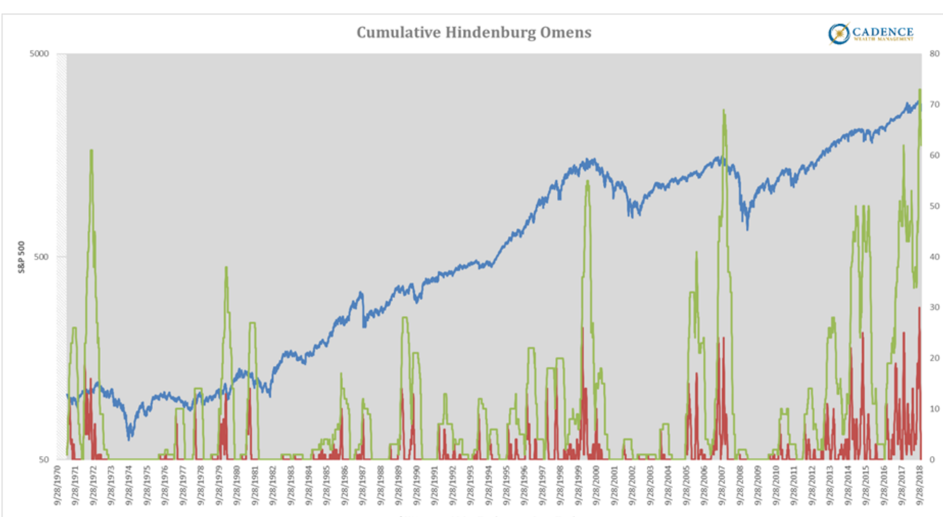
Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Thoughts on Markets Past, Present and Future

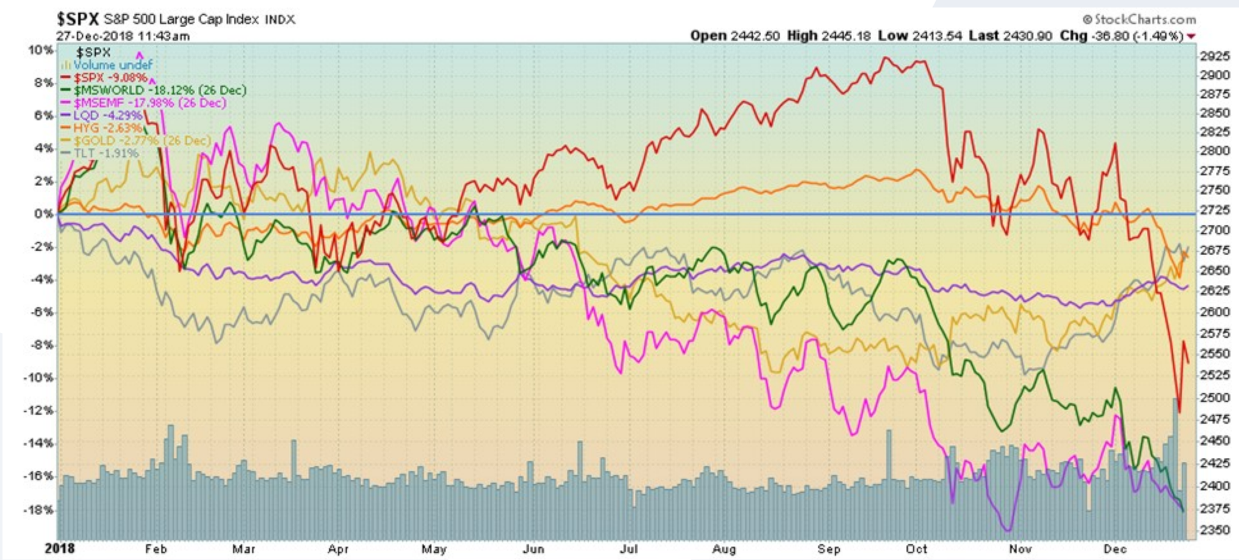
What started off as an extraordinarily positive year for stocks ended in exactly the opposite fashion. Through late January the S&P 500 was up 7.5% and emerging market stocks up almost 10% - a continuation of the Trump Bull Market that seemingly could not be arrested. Stock investors quickly received a splash of cold water however, when in late January over a two-week period, the S&P 500 plunged 9%. This was followed by a couple months of volatile price movement until in April, the uptrend appeared to resume. There was only one problem however. International stock markets did not follow along on this upward march to new highs. Rather, as the S&P 500 reclaimed its prior high-water mark up 8% on the year by early September, international stocks were down over -6% while emerging market stocks were -13% lower on the year. This is what we refer to as divergence - categories that generally rise and fall together aren't.



This divergence was taking place against the backdrop of very poor market breadth here in the U.S. We've discussed a number of breadth indicators in past letters, one of which being cumulative Hindenburg readings – defined as days in the market where there are simultaneously a large number of stocks making both new 52-week highs and lows. Coming into 2018, we saw an unusually high number of Hindenburg readings and then again by the end of summer. In fact, the readings through September surpassed all of those seen in over 40 years of data. Translation – under the surface, a vast portion of the U.S. stock market was actually going down. In this respect, U.S. markets were in fact mirroring international markets. Most investors just didn't know it yet.

By the time U.S. stocks reached their "second peak" in late September, it was already abundantly clear that the rest of the investment universe was singing a different tune. In addition to foreign stocks being negative, so were most of the bond (with the exception of the highly correlated high yield category) and commodity categories. In fact, not since the 1920's had so many categories been negative at the same time. Despite the level of the Dow Jones Average, by late summer an investor with a properly and broadly diversified portfolio would have been lucky to have a positive return – most investors were nursing losses at that time. Worse, investors who shifted more toward less expensive and typically "safer" asset classes would have been down the most. Markets can be cruel this way, but time almost always favors the prudent and patient. Since September, this has been the case.

As seen in the chart below, beginning in October, the U.S. stock market cracked (the red line). With a day to go before the end of the year, the S&P 500 sits -15% lower than it did three months ago. It has, in rather short time, joined the rest of the world's stock markets in their struggle. Now the one category that was keeping most diversified portfolios from being more deeply negative has begun contributing to negative performance. Investors have been quickly reminded how risky stocks can be. What goes up with ease can come down even easier. This is the lesson we hope most carry with them into 2019.



The Prudent and Patient

As U.S. stocks rose over the summer months, just about everything else struggled. What's typical of the final months of manic markets – those that seem to disregard all information and input except recent upward price movement – is that the "other" categories that haven't been in favor tend to struggle. Usually these are the ones that have already been struggling and don't offer the same recent evidence of rapid wealth creation. Regardless of how good a deal (value) these categories may be, they tend to get passed over and thus struggle to appreciate in price.

This was the story for investors in 2018 who chose high quality bonds, gold, and mining stocks as an alternative to high-priced U.S. stocks. Seemingly month after month these categories declined in price as U.S. stocks rose – until October. As of now, with U.S. stocks down -15%, these categories that created so much angst up until October have finally garnered some interest. As we can see very clearly below, fortunes changed very rapidly for both sets of investors; those invested too heavily in stocks as well as those who invested more cautiously. The red line is the S&P 500, blue is treasury bonds, gold is gold, orange is mining companies, and green is silver. The advantage now lies with the investor who paid more attention to price and value than recent returns. Prudence and patience are beginning to pay.

What to Expect in 2019

Rather than play the fools game and make specific predictions for 2019, we'll focus on what we feel is most likely to occur given the evidence in front of us currently. As we have become keenly aware in recent years, timing is the wild card. Conditions that lead to eventual outcomes can be stretched further, extended, delayed. This fact leads us to where we are now – a stock market that is more expensive than any other in history in a world that has never been more indebted. Think about that for a second. Before trying to rationalize it, just keep it simple. That first thought, the one that didn't get manipulated and twisted by a narrator who has an interest in obfuscating the facts, is the correct one. I can't tell you how many times we hear things like, "the market should be just fine as long as the economy keeps growing", or "with a jobless rate this low, the market will be fine". These are comments completely devoid of truth and are the equivalent of "stocks should go up because I got a new pair of shoes today". If something's too expensive, what the economy does is irrelevant. Price can and does adjust regardless. Regarding the jobless rate comment and others like it, good economic growth and statistics often present themselves right up until the end of a bull market in stocks. In fact, that data is usually at its best as stocks peak and begin their subsequent bear market decline. Stocks tend to lead the economy, not follow it. So, trust your gut. If you think the combination of a huge bubble and unprecedented debt levels is dangerous, you're probably right.

We wrote last month about bear market math and how it's not very kind to investors' portfolios. Here's an update. If we expected a -60% decline in the S&P 500 at the peak (which we did), since losing -17%, we have another -52% to go. If you need a reminder on how this math works, take a look at last month's letter. The bottom line is that although 17% seems like a big loss, it's a drop in the bucket. New money put to work here thinking we've hit bottom still has the potential to get destroyed. Whether this remaining -52% loss (which brings us to average valuation levels) plays out in 2019 or over a longer period of time remains to be seen. Theoretically the longer it takes to play out, the smaller the loss has to be to get us back to average valuation levels. We think the most likely scenario given that bear markets tend to last around 2 years from peak to trough, is that this loss plays out over 2019 and 2020. However, given the complexity of the financial system today and the sheer magnitude of derivative investments and debt in the system, the possibility that it plays out more quickly and acutely must be considered. The last three months can either be viewed as an aberration or a final reminder to evaluate the risk you're taking in your portfolio and whether it's more than you can withstand given your goals and timeframes. 2019 could get very real, very quickly.

Where to Hide

No investment that provides the potential for gain is incapable of loss. Everything gets its turn when it comes to losing money. This is just reality and it's okay. It's also why attention must always be given to price and value. If something represents good value, then losses over short periods of time don't matter and will likely be temporary. This must be kept in mind when building a portfolio to endure what we're likely facing dead ahead in the stock market. When things get ugly, even the "safe" categories can lose money. However, over the duration of the stock market decline these ups and downs usually sort themselves out leaving investors significantly better off in asset classes that are safer and more reasonably priced than stocks. We fully expect this to be the case over the course of the next bear market.

U.S. Government Bonds will likely hold up very well leading to lower rates by the end of the next bear market decline. In addition, we see precious metals and mining shares holding up very well over this period. We feel this way based on their current valuations coupled with the fact that we think central banks will be very active throughout the next stock market and economic decline. Confidence in central banks and markets will likely be waning or lost completely which should bode well for these categories. Of course, as we mentioned, there will be ups and downs along the way. It won't always be obvious where the right place to be is. Circumstances could change, but given the facts present at the moment, this is our assessment. The last three months look as though this process may already be underway.

Cash. In the environment we're likely entering, it's king. It not only protects principal from decline, but gives the investor optionality as other asset classes rise and fall in price. It's investment capital at the ready that can be deployed when opportunities present themselves. In this respect, it matters little that it doesn't pay much interest. Return of capital matters more than return on capital. Our feeling is that 2019 will be a good year to have more cash than usual in your portfolio.

Opportunities

A stock market in decline doesn't necessarily mean there won't be opportunities for investment gain. In fact, quite the contrary. As we've preached to our clients over the years, a market that is beyond fair value and still rising may create gains in the short term, but longer term those gains will likely turn to losses as prices come back down to earth. As the next bear market plays out (we're likely in it now), investors will have an opportunity to begin investing in stocks at prices that should generate returns that stick over the long term. Investors who are prepared for what lies ahead will be able to capitalize.

There are also a handful of investment asset classes that don't require additional discounts for us to consider them cheap. We've written rather consistently over the months about commodities in general being at multi-decade lows relative to financial asset prices and more specifically about how gold, silver, and precious metals mining shares are priced almost identically to where they were in 2001-2002 before their ten-year bull market surge. These categories are certainly not risk-free and come with their share of volatility, but for the patient investor who is looking to invest in something that is priced attractively, it rarely gets better.

Finally, bear markets never follow a straight path lower. Part of what makes them so devastating for investors to navigate is the messy up and down nature of them. Some of the biggest "up days" in the market take place on the way down making them almost irresistible to those who are eager to call the bottom and wave the "all clear". This phenomenon has a tendency to suck more money into the disposal for the eventual trip lower. Without a plan, it can be harrowing. With a plan however, it can work to one's advantage. If one can eliminate emotion in favor of a disciplined, rules-based strategy that can help them anticipate and react to these inevitable ups and downs along the way, below average or negative returns don't necessarily have to be destiny. After a long period where unnatural market forces rendered most actively managed, risk-conscious strategies impotent, we may finally be entering a more normal environment where that active management contributes positively to portfolio performance once again.

2018 was a year that ended in exactly the opposite fashion in which it began. What started as a manic surge higher for stocks ended in a meltdown. One of the worst Decembers on record. Based on our assessment of valuation, market internals, and a host of other data, there's a good chance 2018 marks the topping process of the bull market and the beginning of the subsequent bear market. 2019 will likely bear the brunt of this trip lower, but not all of it. Although the downward phase of the market cycle plays out much quicker than its more welcomed upward brethren, it still tends to last about two years from peak to trough. It's a process.

Given such, it's important that we enter 2019 with proper expectations. Expect volatility. Expect those investments that have performed the best over the years to perform the worst. By contrast, expect those cheaper unloved categories that have performed the worst to begin performing. Tides change. Focus on principal preservation over the duration of the upcoming and inevitable bear market, not from month to month. That's unreasonable. Every investment worth owning fluctuates. And finally, keep the bigger picture in mind. There will be tremendous opportunity as asset prices fall. For those who are prepared, this is something to feel very, very excited about. 2019 could be quite the year.