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Look Back- 2nd Quarter 2017 & Black Swans

The April to June time frame provided very solid, but unspectacular, stock returns in major U.S. markets during the second quarter 2017; in contrast, however, global stock markets (including U.S. markets) saw their best opening six month gains since 2009. All but four of the 30 major world indexes rose in the first half of 2017. In the past twenty years, only four first-half market rallies have eclipsed or have been as far reaching as the current global surge. Of interest to note is that two of the aforementioned rallies preceded sharp market crashes. The other two came at the start of long bull markets. Specifically, a first half market surge in 1999 preceded the burst of the tech bubble and the six-month rally to start 2007 came before the global financial crisis. That sounds a bit scary but similar world-wide gains in the first half of 2003 and 2009 were the prelude to extended market rallies. What will happen in 2017? Only hindsight will provide us with the answer on which side the current six month market upturn will fall (Source: Wall Street Journal, 7-1&2-2017). Stay tuned!!!

As mentioned above, second quarter returns for U.S. stock markets were very good but not great. The NASDAQ was, by far, the best performer of the major indexes with a +3.9% gain in quarter two and up +14.1% since January 1, 2017. Perhaps we have been somewhat spoiled by Federal Reserve stimulus era returns. As a risk manager, I would be more than willing to take a low volatility +3.9% return every quarter since that translates into a yearly gain of +15.6%. In second place was the Dow Jones Industrial Average with a respectable +3.3% quarterly gain and up +8.0% for the year. The S&P 500 index was next in line with a gain of +2.6% and up +8.2% since January 1. The small company Russell 2000 ended the quarter with a +2.1% return and up +4.3% for the year. Just to show that there are almost always some losers in every market, the PHLX Oil Service Index was down -28.8% in the six months ending June 30. (Source: Wall Street Journal, 7-1&2, 3-2017).

In the second quarter, U.S Stock Mutual Funds were somewhat in the middle of the major market indexes with a +2.7% average return. The Health/Biotechnology mutual fund sector was the big winner with an average second quarter gain of +7.1% while Natural Resources Funds were the biggest losers with an average -11.0% downturn. Among World Stock Funds, Pacific Region Funds had an average gain of +7.6%. The average Taxable Bond Fund was up +1.2% with the High-Yield Muni category up an average of +2.3% (Source: Wall Street Journal 7-10-2017).

After reviewing investment returns over the last six months or more it would be fairly easy to draw a conclusion that all is well in the world of high finance. Despite the challenges to President Trump's economic campaign agenda and political jolts from North Korea, Russia and even the Brexit vote of the United Kingdom, stock markets around the world have remained unusually calm, quiet and almost boring. And therein lies the potential for a big problem. Just because complacency exists and volatility appear to be almost non-existent, the potential for a severe market downturn has not been eliminated. And that idea leads to our discussion of Black Swan theory.

In 16th century Europe it was presumed that all swans must be white because all historical records of swans were reported to have white feathers. In that era, a black swan was an impossibility or at least nonexistent. That truism remained until 1697 when, lo and behold, Dutch explorers discovered black swans in Western Australia. After that discovery, the term "black swan" came to encompass the idea that a perceived impossibility might later prove to be true by only a single event - such as seeing a black swan.

In financial circles, the concept of a Black Swan event was developed by author Nassim Nicholas Taleb in his book: The Black Swan: The Impact of the Highly Improbable. Taleb argued that Black Swan events are highly improbable, are impossible to predict and can have catastrophic ramifications. As a result, we should always assume a black swan event is a possibility and plan accordingly.

What does the Black Swan theory mean for us today? While it is impossible to know and predict when a Black Swan event may occur, there are certain events in financial markets that make it more likely to occur. Events such as investor complacency resulting from low market volatility which, in turn, causes overconfidence which, in turn, supports the idea that low volatility and great returns will continue. We have no idea what the eventual catalyst may be to change current low volatility into high volatility and send the markets over the cliff, but it will happen at some point. We need to be prepared for that possibility or suffer the catastrophic ramifications that Taleb wrote about. In my client money managed accounts, I am already thinking about a strategy for when a black swan event happens. You should have a plan as well.

In closing, I mentioned in the last newsletter that this issue would contain the checklist for Settling an Estate. Due to the length of this article, it was not possible to include that checklist. It will be included in the August issue. The back page article for this July newsletter is titled: *What I've Learned About Bear Markets* by David D. Moenning. Dave is a member and former president of the National Association of Active Investment Managers (NAAIM) – a group that I belong to. I do not know Dave personally but I receive his periodic market letters and thought that this would be a good one to share with you. Hope that your summer is going well and take good care!!!

What I've Learned About Bear Markets by

David D. Moenning, Chief Investment Officer, Sowell Management Services

As you are likely aware, I've been at this game for a fair amount of time now. Starting in the financial services business straight out of college in 1980, I began gravitating toward the stock market and by 1987 my colleagues and I were managing "OPM" (other people's money) on a discretionary basis. As such, my first introduction to a bear market was very early in my career.

Needless to say, the "Crash of '87" and the ensuing volatility over the next few years shaped my thinking about the need to manage risk in this game. And to this day, I view myself first and foremost as a manager of risk.

I bring this up on this fine summer Tuesday because stock market investors have enjoyed the second longest period in history without a -20% decline. Heck, this is also one of the longest stretches without even a -5% correction. So, using history as a guide, the key point I'd like to make this morning is simple. The bears are due.

The problem however is that trying to "call" a bear market in advance is a fool's errand. First, it is important to understand that they just don't happen very often. And second, please note that there is generally some sort of catalyst to get things moving in earnest to the downside - a "trigger" that most don't see coming.

So, this morning I'd like to share some of the things I've learned about the bear markets I've experienced in my 30+ years of managing money in the stock market.

For starters, long-term investors should remember that bear markets tend to be few and far between. During my career, the bears took control in 1987, 1990, 1998, 2000-02, 2008, 2011, and then most recently between August 2015 and February 2016.

<u>Below are some of the key things to know about bear markets.</u>

- Per Ned Davis Research, there have been 36 cyclical bear markets since 1900According to NDR, 14 of the bears occurred during secular bull phases (such as 1982-2000 and 2009-present), and 22 within secular bear cycles (examples include 1965-1982, 2000-2009)
- The average loss experienced by the Dow Jones Industrial Average during all bear markets is -30.6%
- The average duration of all bears has been 399 calendar days (or about 13 months)
- During the secular bull cycles, NDR tells us that bears are less severe (the average decline is -21.8%) and much shorter (283 calendar days)
- So, the good news is that, using history as our guide, the next bear market ought to be shorter and shallower than average
- In terms of how bears begin, it is important to understand that bull markets tend to last longer than expected (especially for those in the bear camp)
- The internal momentum of the market historically peaks long before the indices
- Very few see the ultimate top happening (except for the "boy who cried wolf" types, of course)
- Market leadership tends to narrow as bull markets age (this explains why active mutual fund managers struggle to outperform - especially during latter stages of long bull markets - and why passive investing becomes uber popular as bulls age)
- Technical divergences tend to occur among indices, sectors, styles, etc.
- Earnings expectations for the coming year are usually robust near the ends of bull markets
- Economic growth tends to be sound with "no one" calling for recession
- Volatility tends to be low and investors begin to believe that stocks can't go down
- The public tends to be completely onboard the bull band wagon
- Stock market valuations don't matter - until they do, and then they matter a lot
- The Fed usually gets their way
- Rising rates represent competition for stocks - Again, at some point (or in this case, at some level), this matters
- Stock market cycles don't repeat exactly, but they do often "rhyme"
- Investors tend to be ready to "fight the last war" (I.E. the cause of the next bear market usually has nothing to do with the last one)
- External events - events that no one anticipates - happen
- Bear markets tend to occur when no one is looking for them
- The definition of investing genius is "a short memory in a bull market"

To be sure, the above is not an exhaustive summary of how bears work and/or begin. However, I find it useful every now and again to remind myself of how many bears have unfolded in the past.

I'd also like to make it clear that I am not "calling" for a bear market to begin. But given that (a) valuations are high, (b) rates are on the rise as global central bankers end their stimulus cycles, (c) stock market momentum has peaked, (d) the cycle projections are calling for a decline in the second half of the year, and (e) the last 20% decline is now a long time past, I don't think it hurts to recognize that risks are elevated and that perhaps this is not the time to have the pedal to the metal in one's portfolio.

The good news is that the secular bull remains intact and therefore, a "buy the dips" strategy continues to make sense.