January 14, 2019

Corrections and Opportunity, Strategy and Tactics

2018 was a disappointing year for investors, with virtually all major asset classes experiencing negative returns. Although the US stock market declined, it again significantly outperformed foreign markets: the S&P 500 returned -4.4%, compared to -13.3% and -14.5% for Developed and Emerging Market international stocks, respectively. REIT stocks returned -4%, high yield bonds posted a 2% loss, and commodity indices (led by oil's 25% decline) posted double digit losses. Even high grade bonds, which typically gain when stocks decline, provided no return. As a result, most diversified portfolios ended the year with mid-single digit losses, the worst result in 10 years.

Interestingly, 2018 ended with markets focused on the same concerns that dominated during the modest but swift correction of January/February: higher interest rates as the Federal Reserve normalizes monetary policy, trade conflicts, and the risk of slower economic growth (particularly in China). Other concerns include simmering issues in Europe, with Brexit terms unresolved, fiscal disputes between the EU and Italy, and mounting social discontent in France. Finally, lower company earnings forecasts and momentum-based algorithmic trading strategies have been cited as contributing to market declines. The year ended on a particularly sour note as US stocks declined 9% in December, which wiped out what had been a modest gain and marked the worst December since the Great Depression. As of Christmas Eve, the S&P 500 had lost 19.3% from the all-time high reached on September 20, just shy of the 20% decline that is considered a bear market.

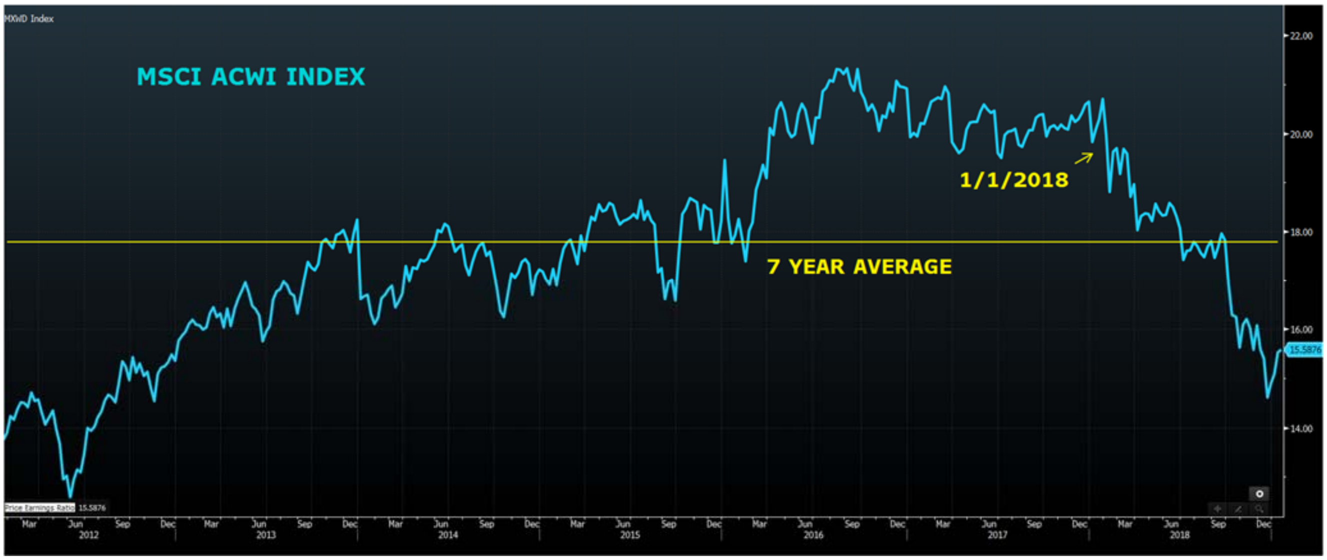
****

While losses are never pleasant, there are a few key takeaways that are important to keep in mind during periods of market volatility, and there are silver linings in the current environment.

First, the volatility this year has been well within the range of historic norms; in fact, the ***lack*** of volatility in recent years has been the exception. Investing involves taking risk, market declines are normal and inevitable, and successful investing requires sticking with an appropriate strategy throughout market cycles. There is no strategy that can successfully time the market with regularity, and wholesale changes in investment strategy and positioning based on news headlines and prevailing sentiment almost always fail.

Second, there is currently a significant divergence between economic and stock market performance. This is particularly true in the US, which is enjoying broad-based strength, with surging job gains and accelerating wages, low inflation, and high business and consumer confidence. Though the housing market has cooled, home prices are still up significantly compared to a year ago. And it appears increasingly likely that the Fed is close to being done hiking interest rates. Corporate earnings have risen dramatically, by 19% in 2018 compared to 2017, and by a remarkable 29% in Q3 (vs Q3 2017), and corporate bond defaults are at about half the historical average rate. While the economy could turn south for a number of reasons (including failed trade negotiations with China), lacking a material downturn, it's likely that markets will recover.

Third, volatility and price corrections create opportunities. As a result of higher earnings and lower prices, stocks are far cheaper (and therefore less risky) than they were a year ago. The S&P 500 ended 2018 at a price/earnings (P/E) ratio of 17.1x, compared to a P/E ratio of 22.3x when the year began - in other words the US stock market became 23% cheaper relative to earnings, a very significant shift in valuation. Foreign markets have adjusted even more. Graph 1 shows the P/E ratio of the aggregate global stock market, which ended the year 27% lower.



Source: Bloomberg

Graph 2 shows a 7 year history of US high yield bond yields, which increased 2.5% in 2018. This is another very significant move in investor compensation that makes the sector far more attractive.

Source: Bloomberg

208 Delgado St., #1, Santa Fe, New Mexico 87501
PO Box 1471, Santa Fe, New Mexico 87504-1471
www.santafeadvisorsllc.com, 505.501.6200

Differentiating Between Investment Strategy and Tactics

We often remind clients of the importance of distinguishing between investment strategy and tactics. It is a bad idea to make strategic (long-term) investment changes for tactical (short term) reasons. Setting an appropriate investment strategy involves determining the level of portfolio risk that is suitable for a client's circumstances, and designed to achieve the investor's personal financial goals. Strategic decisions about portfolio risk should be made jointly between advisors and clients, and should be periodically reviewed for appropriateness.

The process should include the consideration of factors such as age, time horizon, liquidity, income, spending needs, and personal risk tolerance. As these factors change, it is appropriate to consider changing investment strategy accordingly. **Unless the factors that led to the original strategic decision have changed, it is usually wise to stick with a strategy throughout market and economic cycles.**

In contrast, tactical investment decisions involve portfolio changes in response to market moves, which change asset sector valuations and opportunities. At SFA, we implement tactical portfolio changes when we see opportunities arise, but we are careful not to let tactical considerations override the level of strategic risk appropriate for a client.

While it's impossible to tell when a correction is over (other than in hindsight), the recent market declines have created increasingly attractive opportunities. Should the correction continue in coming weeks, we are likely to tactically add to "risk assets" such as equities to our client portfolios.

Thank you for your business, and don't hesitate to contact a SFA team member to discuss our tactical views in more detail, or to review your strategic portfolio risk profile.

David E. Marion, CFA
Partner
(505)501-6201
dmarion@santafeadvisorsllc.com

Disclosures