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CRAIG PULLIAM CFP®, AIF®, CLU, REBC | MICHAEL R. COMSTOCK CFP®, AIF®
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"Waiting for the Shoe to Drop"

By Craig Pulliam, CFP® and Michael Comstock, CFP®

In our April 2015 Commentary we mentioned that the U.S. markets are sort of overdue for a correction (a drop of 10% or more).

While we don't wish ill for anyone's portfolio, and few people really enjoy that "buying opportunity" that is presented when equities take a dive, we are realists. Even though the *long term* track record of indices like the DOW Jones Industrials or S&P 500* present the picture of an almost inexorable advance upward, there are those moments (some of them painfully lengthy) when things tumble.

If all we did was look at the calendar, we'd be telling you that a correction must be imminent. Since 1900, they occur –on average- almost once a year . . . and the last one we had was in 2011 (Capital Research and Management Company). We came close in 2012, but the worst dip since then has been 7% in 2014. We are waaay overdue, according to the calendar.

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But those averages are exactly that. Averages. Some corrections had *years* between occurrences, and some just months. We frequently discuss the regularity of these nasty occasions simply to remind our clients that dips –even bear market dips of 20% or more- are normal, and that we shouldn't overact when they arrive.

So, even as abundant as corrections and bear markets are (bear markets every 3 ½ years!), they remain unpredictable. There are –however- mitigating economic circumstances that often present themselves during these market upheavals. Understanding them might give us a clue as to whether we're getting ready to take one on the chin soon. There *are* factors that have a positive relationship and correlation to these declines. And they demand some scrutiny here.

And so we recently reviewed historic economic data with some respected market strategists and economists. We found that certain "stressors" are often present during or preceding significant market declines. Movements in oil prices, Federal Reserve policy, manufacturing rates, consumer behavior and sentiment, inflation, and stock valuations have all – at times- been shown to keep company with big market shifts.

Usually investors who are fearful of a stock market slump will point to stock valuations as the cause of their concerns. We've been hearing that recently, as the markets have consistently set new highs for months. People say, "We're too high, it can't keep going up." True, U.S. stocks – in aggregate- are not cheap right now. The S&P 500 is hovering around a 16.9 forward price/earnings ratio (FactSet), which is significantly higher than the 13 level after the great recession of 2008-2009. But, you'd expect this as things could almost go nowhere but up after that.

The 25-year average is 15.7 times earnings, so we're not too far above that. Perhaps you'd even say we're fairly valued, but with fewer bargains in the marketplace. The last 25 years includes a number of years during which P/E ratios were far above today's averages and continued rising before the market fell back to more normal levels (notably from 1997-2001, and 2003-2004). The market is not frothy, especially considering the overall financial strength of most companies.

Nor is inflation a risk presently. According to research by Strategas Research Partners, when inflation (Consumer Price Index) has been between 0% and 4% over the last 65 years, a higher stock market P/E has been supported: well over 17 times earnings. Today, inflation is under 2% (Bureau of Labor Statistics), well within that 0% to 4% range.

Interestingly, since the early 1970s 11 of the last major market corrections (a 15% or more drop within 6 months) have been preceded by –or coincide with- sharp rises in oil prices (MFS Investment Management; Cornerstone Macro). Today, we've seen oil prices move in the opposite direction. So, just like stock valuations and inflation, oil prices aren't putting undue stress on the markets.

What about the Federal Reserve raising interest rates? Every time Chairwoman Yellen opens her mouth, the markets react. But, the Fed will look at a lot of data before they move. If GDP strengthens and/or inflation ticks up considerably, they'll probably make a move.

We think it's probable that they do it this year. It is also likely that the stock market will react negatively when they do. Such a dip would probably be short lived though, as *slowly* rising interest rates (which is what the Fed will probably do) from very low existing rates (where we are), have generally been accompanied by higher stock returns over the last 80 years (RBC U.S. Quantitative Survey Strategy; J.P Morgan Asset Management). And so, it is unlikely that slow, methodical Fed interest rate moves will kick the stock market into the abyss.

We mentioned consumer confidence earlier. People often get euphoric when they think things are good, and maybe getting better. Sometimes this euphoria leads people to make crazy decisions, to buy more than they need, to use too much debt, to pay too much for stocks, and to buy awfully big houses. The University of Michigan Consumer Confidence Index endeavors to measure how people are feeling about the future. Generally, over half of the big stock market declines in the last 50 years were preceded by readings greatly in excess of “90”. We’re around 93 now, after hitting the 50s in 2008 and again in 2011. Sounds like we’re pretty high, doesn’t it? Well, we spent about 7 years above 90 on this scale in the 1980s, 5 more years in the 1990s, and a few years in the earlier 2000s. Being above 90 is not uncommon, and most economists and policy analysts would call our U.S. consumers anything but “euphoric”. Hopeful, maybe? Skittish, probably. Today, there are no discernable bubbles in the economy driven by crazy consumerism.

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Lastly, let’s consider once again just how long it’s been since our last doozy of a correction in 2011. We’re about 900 days beyond that, which ranks this 8th among such periods since 1940 (Cornerstone Macro). Are we due for a nosedive? Not according to Cornerstone’s research: all 7 of those correction-less market stretches that lasted longer than our current one–every one- shared the same sort of low inflation and interest rate environment that we enjoy now. Those 7 lasted an average of 1,348 days (averages again!). We are not going to have a correction simply because it seems like it’s been too long since the last one.

In summary, we don’t see any confluence of events or economic factors pointing to an imminent and significant market drop. But, you’ve got to be diligent and aware of market nuances when handling client money. Who among you could stomach a 40% drop in your account? That could collapse a retirement. We will continue to guard against those things that can ruin lives, even when they seem remote. Russia, the Middle East, natural disasters, terrorism . . . there are events that can’t be predicted. For us, it makes sense not to get complacent, and that’s good for you too. Because, as we know, “Winter is coming” at some point.

We can be reached at 615-777-2125.
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