The Market in Review

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This week's articles and insights

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"No matter how great the talent or efforts, some things take time. You can't produce a baby in one month by getting nine women pregnant."

- ***Warren Buffett***

Your Index Report

	Current	Last Week	Year-to-Date
Dow Jones Ind. Avg.	23,139	+ 3.09%	- 6.39%
S&P 500	2,489	+ 2.99%	- 6.91% (+0.78% in $CDN)
TSX	14,165	+ 1.65%	- 12.61%

A Heavy Pen

There are weeks when this letter almost writes itself. Weeks when ideas and thoughts flow, and the markets are calm.

Not so this week. Christmas has been stolen for anyone employed in the investment business this year, for there has been no warm milk nor cookies for Santa. Christmas Eve's decline was the largest in that day's history. As a result, the newsletter pen is especially heavy as the final trading days of 2018 wind down.

Throwing Gas on the Fire

There is no question technology has changed our lives for the better. We can peer inside the human body to find diseases and we can take better pictures with our telephones than we could with handheld cameras. We can order almost anything we want and have it delivered within a few days, and we can even track down our ancestors through our DNA.

Technology does have its downsides, however.

Between 80% and 85% of all trades on the stock markets are now done by computer algorithms. While this has made buying and selling incredibly quick and virtually free, machines do not behave like humans. Where people would panic, wallow in despair, then turned optimistic again over a few days – which gave us "oversold markets" that led to market turns – computers have no emotions. They will sell down to zero, if that is what their programming says. On some days, it has felt like that is exactly what they have been doing.

Much of this computerized trading has to do with the passive baskets of stocks called Exchange-Traded Funds, or ETFs. These are packages of stocks often designed to mimic the index. They are very cheap to manage and give investors wide diversification. Designed to be bought and held, they have become the favourites of the day (and hour) trading crowds. If you buy or sell the S&P 500 unit, for example, all 500 stocks are bundled up for you and delivered for settlement in the last trading hour of the day, which is why there is often so much turmoil in the last 60 minutes. Few foresaw how such a mundane creation could be so weaponized.

We have also hamstrung human intervention in the markets. A decade ago, and for the century before that, the big investment banks would step in and buy for their own accounts when stocks went too low. This was called "making a market" and it provided a floor when stocks fell too far, too fast. Because of the Volcker

Rule that forced de-risking moves on banks, they can no longer trade for their own accounts. This means there are fewer institutional buyers on bad days to cushion the blow.

So if you ever wondered why stocks seem to move so much more these days – down 600, up 1,000 – the computers and the regulators both share some of the blame.

There has been an incredible amount of selling done by machines at any price. Valuations may have now fallen to the point that people will be attracted back, suggesting we may be closer than we think to a bottom.

All corrections and bear markets are painful. We never know how long they are going to last and how bad they will be. We do know one thing, however*: they end*. And once they do, we eventually end up wealthier than before the decline began – as long as we hold quality investments and don't panic.

The Market's Woes

To avoid panic, one has to have some sort of an understanding of the market landscape. Without sugar-coating it, let's have a look at today's conditions, warts and all.

1. The US is now in a Cold War with China. We mentioned this in our last letter and little has changed. Both US government and industry have been riddled with cyber-attacks by the Chinese, Russians, and others to steal state and corporate secrets. This is now recognized at the highest levels, but effective prevention is still years away. It also means trade will be both the weapon and the casualty of ongoing tensions – and will be for years to come. The sanctions against Huawei and ZTE are the most visible battlefronts today.

2. The economy is clearly slowing down. The question is, how much? Is it a "growth slowdown", like we saw in 1998 and 2011, or a full recession, such as in 1990, 2001, and 2008? We normally get at least one recession in each decade. This has happened every decade since 1860, which is 47 recessions since 1781. Since we have not had one in this decade, we are overdue.

The Federal Reserve Bank of Richmond – one of the US Federal Reserve Districts – reported weak numbers yesterday. Manufacturing was expected to show slow growth, but unexpectedly fell below zero.

Source: Richmond Federal Reserve

3. Interest rates have been climbing. The US Federal Reserve has raised interest rates twice since September and stated there would be at least three more in 2019.

4. Valuations of stocks were above the long-term average. A bit too high, in other words.

5. President Trump and his tweets are an unpredictable phenomenon. The government shutdown is yet another U-turn in a very rocky presidency.

And the (Eventual) Cures

✓ Both the US and China need a trade truce. China's economy has slowed to the slowest pace since 2009 even as the US economy is moderating. China just dropped tariffs on US autos as an opening gesture during the 3-month tariff delay and restarted soy imports. Hours ago, they announced the first imports of US rice ever. There are now rumours of a face-to-face meeting between US and Chinese trade officials in January. There cannot be a total elimination of the trade tensions, but any indication they are declining will be welcomed.

✓ While we have not yet had a recession in this decade, we have had slowdowns in 2010, 2011, and 2015 without a recession occurring. These were just “growth slowdowns”, in other words.

Retail sales just reported for December were outstanding, suggesting there is little evidence of a recession yet. The Ned Davis Research analysis of State Conditions shows just a 1.9% likelihood of a US recession in the next 12 months. Also, Raymond James’ own US Recession Checklist remains upbeat:

US Recession Checklist				Indicators			
Recession Start	Manufacturing	Unemployment	HY Spread	Yield Curve	Housing Starts	Cons. Confidence	Inflation
January 1980	☒	☒	☒	☒	☒	☒	☒
July 1981	☒	☒	☒	☒	☒	☒	☒
July 1990	☒	☒	☒	☒	☒	▤	☒
March 2001	☒	☒	☒	☒	▤	☒	☒
December 2007	☒	☒	☒	☒	☒	☒	☒
Current	☑	☑	☑	▤	▤	☑	▤

☒Recessionary territory; ☑ Expansionary territory; ▤Neutral

✓ Interest rate hike expectations are dropping fast. One month ago, the probabilities were almost 25% that there would be two more rate hikes in 2019. Today? **Just 0.9%.** In other words, we may have seen the end of the rising interest rate scare.

✓ By some measures, US stocks are now selling for slightly below “fair” value, based on forward earnings and historical levels. That’s what a 20% decline since September will do to valuations! Canada’s stocks are even less expensive. Based on historical valuations going forward, the cheapest areas in the world are international and emerging market stocks. Few investors over here want to go there, but that is where the best values are.

× The irony is that America is rapidly becoming energy self-sufficient, is pulling out of unnecessary war zones, and is actively engaging a nation intent on its demise. These are policies that would have made any other president popular, but not President Trump. His methods, character, and communication style have made him vastly unpredictable and under threat of impeachment. This is an unknown that is not going away.

Economies and markets ebb and flow over time. We are in the “ebb” stage, which could last several more months. Most bottoms are formed through a retest of the climax lows, just as we saw in 2015-2016:

Bottoms are a process. We would not be surprised to see a January rally, followed by a similar retest before markets can resume their uptrend.

Plan accordingly!

U.S. and Canadian 2019 Top Picks

These lists are available now – please reply and we will be happy to send them out

Thank you for your referrals this month! They are always handled with great care and discretion.

2019

Years ending in 8 have historically been some of the most positive of all years in any given decade. According to the Stock Trader's Almanac, 10 of 13 of years ending in 8 since 1881 have been positive, tying it with years ending in 9 for second place. Only years ending in 5 are more profitable.

2018 will obviously bump the 'year 8' group to third place with a negative return. However, in every instance when year 8 was negative, year 9 was positive (1948-49, 1978-79, and 2008-09). A small sample size, to be sure, but we'll take it.

We wish everyone a Happy New Year for 2019 as we bid farewell to 2018.

Finally, we have seen a number of medical breakthroughs in cancer research this year, from drugs that stimulate the human immune system to vaccines that do the same thing. Now, British researchers have discovered that immune cells can be transplanted without triggering an immune response, leading to the idea of a blood bank of immune cells to treat anyone at any time. It will be amazing if it works.

https://nationalpost.com/health/health-and-wellness/cancer-may-no-longer-be-deadly-in-future-say-british-researchers-announcing-breakthrough

http://www.dividendvaluepartners.com

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Prices shown are as of close December 27th, 2018.