April 2018

As you well know, the U.S. stock market has been selling off for about ten weeks now. From some of the calls I've been getting, one would expect that another Great Crash is upon us. There is little evidence to suggest, however, that this is anything more than a normal correction in the context of a bull market. Rather, the emotional response we've been hearing is, in my opinion, largely a result of the lack of volatility we have experienced over the last two years.

As Ned Davis Research recently reported, over the last 90 years the stock market has averaged 3.4 corrections of 5% or greater per year. Over the same time frame the market also averaged 1.1 corrections of 10% or greater per year. From February 2016 to January 2018 (23 months), the market saw neither of these rather common contrary events. It seems that during this time of stock market nirvana (consistently upward sloping with nary an adverse wiggle), investors began to believe this was normal.

It surely was not normal, but abnormal in the extreme. The great financier J.P. Morgan was regularly asked what stock prices will do. His standard response: "They will fluctuate." Sometimes the simplest answers are the best. (This quote is included in Benjamin Graham's classic work, The Intelligent Investor. That book and many others are included in our new Reading List of recommended books that you can find on our website, www.confluenceinvestment.com/research-news/reading-list/.) Indeed, stock prices will and do fluctuate in wide ranges all the time. Stock prices are among the most volatile asset prices most people will ever encounter.

This shouldn't be a revelation, but corrections such as the current one always seem to catch people by surprise. We rather welcome such downward volatility for a couple of reasons:

1. When the market doesn't sell-off periodically, investors do really crazy things like bid prices up to outrageous levels, resulting in eventual horrendous sell-offs. Examples of this phenomenon are 1998-2002 and 1987.
2. We like to buy stocks of great companies at a discount. Sell-offs provide that opportunity.

But could this correction be the start of something much worse? While we certainly cannot predict the future, our response is "probably not." Why? Because stocks are a reflection of economic reality, not a perfect reflection, but a fairly reliable one. And the economy is growing rather steadily, at a sustainable pace. There are only a few evidences of excess, but that's normal for an expansion over nine years old. A recession a few years from now would not surprise us, but it is not imminent, in our opinion.

We are experiencing a completely normal correction for completely normal reasons, in our view. Stocks sell off after an extended advance when investors worry about growth that might be too rapid, which might induce inflation, thus prompting the Fed to raise rates. Throw in a government that's unhappy with the behavior of trading partners and you have all the excuses you need for a correction. This is the stuff of a healthy economy and a normal bull market. Thus, we intend to treat it as such and look for opportunities to buy good companies at good prices in our equity portfolios, and add equity exposure, where appropriate, in our asset allocation portfolios.

As always, we appreciate your confidence in us.

Gratefully,

Mark A. Keller, CFA
CEO and Chief Investment Officer

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