January 2019

If you're like most investors, you're probably delighted to see 2018 in the rearview mirror. It was a year in which the stock market began on a euphoric note, in a January that proved to be the last month of a nearly two-year rising market. Indeed, from February 2016 to late January 2018 the S&P 500 rose 59% (bottom-tick to top), without even so much as a 5% pullback along the way. It was enough to turn even a confirmed old bear into a frolicking bull.

But after that high on January 26, the market spent the next nine months seesawing back and forth. There were three corrections of 12%, 9%, and 12 %, respectively, with nice little rallies in between. One of those rallies lasted six months, travelled 15%, and even took the market to a new high. As we noted in our October letter, that sort of volatility, though rare in recent years, is actually normal market behavior for those with a multi-decade point of view. But then came December…

From its intraday high on December 3 to its low on the morning of December 26, the market (basis the S&P 500) fell 16%. From the September 21 peak, this decline totaled 20%. This was a much greater than normal sell-off, and caused many investors (perhaps you) to wonder if a recession was upon us. Many conversations with both advisors and clients indicated to us that is exactly what many were worried about; in particular, many were (and, perhaps, still are) worried about a return to 2008. Is that likely?

In our opinion, no. Not only do we not see a recession on the near-term horizon, whatever its character, but it most likely will not look anything like 2008. That recession was triggered by a *national* decline in residential real estate prices, preceded by record household debt levels (as a percentage of income), and exacerbated by a lack of liquidity (i.e., cash) throughout the economy and financial system. What's the situation today? Real estate prices are declining in several previously "hot" markets, but that's not unusual and it's certainly not a national problem. (Come to St. Louis!) Household debt as a percentage of disposable income is down more than 20% from its 2008 peak, and cash is "stacked high" as banks, corporations, and households hold large quantities of cash.

This state of affairs does not mean a recession is impossible, just that it's most unlikely that a 2008-style liquidity crisis is upon us. The next recession will more than likely be similar to those of 1991 and 2002, when prior bad investments went sour on a broad scale (commercial real estate in the former, telecom/internet investment in the latter). These recessions hurt wealthy investors, but did not produce injury to average Americans on the scale of 2008-09. We worry about recessions (a lot!), but we really don't see one in 2019.

As noted above, the sharp sell-off last month was unusual. In fact, it's the only 20% sell-off of the S&P 500 *in the absence of a recession* since 1987. That was some year! In the space of two months, the market dropped 36%; in five days it dropped 31%. It dropped 20% in one day! What do I remember most about that sell-off (besides the knot in my stomach)? It was one of the best buying opportunities of my lifetime. Sharp, steep, emotion-laden sell-offs in the absence of recessions typically produce outstanding opportunities to buy high-quality, long-term investments at quite reasonable prices, which happens to be what we at Confluence enjoy doing most. It's emotionally difficult to be a buyer in the face of such fear, but, historically, it's the smart thing to do.

We appreciate your confidence in us.

Gratefully,

Mark A. Keller, CFA
CEO and Chief Investment Officer

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