DM Portfolio commentary

4th QUARTER 2018

On market swings and the behaviour of crowds

While taking in a recent NHL hockey game, we got to thinking about the peculiarities of human nature and how group dynamics might be making an outsized contribution to the recent plunge in stock prices. During a stoppage in play midway through the first period, the team mascot made one of its frequent appearances in the lower bowl, this time wielding an air-powered bazooka designed to fling tightly wrapped t-shirt balls across the arena and into the hands of lucky fans. Though we've never had the fortune to snare one of these garment bombs – *and must confess to never having seen one in its unfurled form* – we're reasonably confident that the shirts being given away many times each night aren't crafted of fine pima cotton or painstakingly hand-embroidered with the team's crest. Still, when the barrel's pointed their way, patrons with the means to sit in the rink's best seats are suddenly overcome with desire for a memento that they wouldn't likely think twice about in any other circumstance. The hopeful feed off each other's energy, shedding restraint as they wave arms, whistle, holler, and jump up and down, trying desperately to catch the eye of the gun-toting stuffy.

Around the same time that we were watching the relatively well-heeled jostle for attention in a t-shirt toss, a run-of-the-mill equity market correction was rapidly taking on a more bearish tone. In the space of just a few weeks, the collective perception of stock valuations and underlying business conditions was upended and measures of investor sentiment shot from mildly positive to deeply pessimistic. As recently as late summer, investors worried that the economic backdrop was *too* good and that central bankers would be forced to raise interest rates several times to get ahead of potential inflation; now, though, the market convulsed when a mere 25 basis point hike by the US Federal Reserve was accompanied by comments which were perceived as not quite sufficiently dovish.

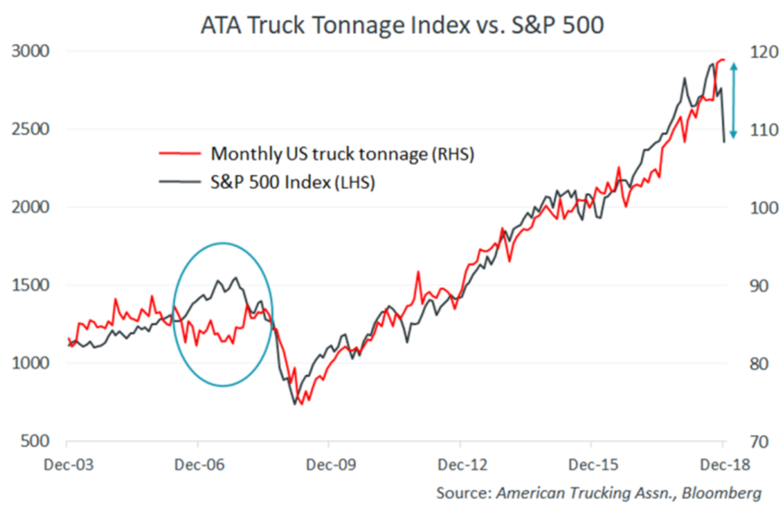
Because the drop in equity prices was relatively sudden and hasn't coincided with a corporate earnings slump or a significant deterioration in reported commercial activity, we're inclined to believe that the swoon represents more of a market event than an economic one. Several markers from the front lines of the US economy support this view:

- Costco reported same store sales growth significantly ahead of analyst expectations, including a jump of more than 32% in e-commerce;
- Target enjoyed a similar lift in recent months, with the CEO commenting that the present "consumer environment is perhaps the strongest I've ever seen";

- In early December, Darden restaurants (parent of Olive Garden, Longhorn Steakhouse, and others) said that not only have sales been strong, but customers are purchasing add-ons and upgrades to standard meals at a record clip;
- At the depths of the market plunge, DM holding Nike reported blow-out earnings, with management commenting that it "wasn't seeing any impact from friction on trade between the US and China" and that it's "incredibly energized about 2019";
- According to Mastercard SpendingPulse, the jump in retail sales from November 1st to Christmas Eve made this the best holiday shopping season in six years.

None of these suggest a failing economy or capitulating consumer, yet several commentators have suddenly piled onto the idea that we're set for a meaningful slowdown – *maybe even a recession* – in the coming year. Even from a broader view, though, it's difficult to find much in the way of deceleration. In December, the US economy created 312,000 jobs, blowing past expectations of 180,000 additions, while the chart below shows that trucking tonnage in the US has remained robust right up to its latest reading (we could substitute trucking volumes with rail data, air freight, or aggregate industrial production and the chart would look about the same).

As you can see, the amount of goods shipped by truck south of the border and the performance of the S&P 500 have borne a close correlation over the past 15 years. While stocks plunged by as much as 20% in the fourth quarter of 2018, however, trucking volumes were climbing to an all-time high, resulting in a rare divergence of trend and opening up a significant gap between activity in the real economy and the behaviour of equity prices.



When stocks decline as sharply as they have in recent weeks, talking heads are quick to declare that "the market is telling us something", as if the collected wisdom of the share trading crowd necessarily carries some economic clairvoyance. We put less faith in the foresight of the broad investing public, however, and much as fans at a hockey game will behave less rationally than otherwise when swept up by the fervour of those around them, it's almost certain that market players are just as likely to discard their better judgement when excitement or anxiety are running high. In fact, disproof of the market's predictive power can be found in the circled area of the trucking chart. When volumes flat lined in 2007, stocks ignored this tangible omen and climbed steadily to mark new highs, unfortunately oblivious to the economic and market nose dive that would begin just a few months later. Sometimes, in fact, the market *is* wrong.

As wild price swings and incendiary headlines challenge confidence, there are at least a few things worth remembering. First, no matter how persuasively commentators, journalists, and strategists present their predictions and prescriptions, the fact is that none of them really knows. As the saying goes, if they truly had such prized knowledge, they wouldn't be writing a blog, or talking on TV, or working for a bank. A couple of years ago, a consulting firm (CXO Advisory) decided to test the forecasting ability of Wall Street's best known investment gurus by collecting data on more than 6500 predictions by these financial luminaries and grading each for its accuracy. The result? Only 47% of forecasts were correct … a score that would have been beaten by a coin toss.

Second, despite what the market is purportedly telling us, the world's most important economy (and a significant contributor to Canada's economic well-being) is doing just fine. Yes, there have been pockets of difficulty – Apple had a big stumble in China, but it's unclear how much this shortfall had to do with trade troubles or halting growth, and how much just reflects the fact that the country is still far from wealthy on a per capita basis and only has so much capacity to purchase or upgrade $1000 luxury items. Back on our shores, companies are hiring, consumers are confident and behaving that way, and recent commentary from most corporate management teams has been decidedly positive. Earnings growth in the US almost certainly won't be as high in 2019 as it was last year when a massive tax cut provided a tangible boost, but it should be relatively strong nonetheless. At the same time, equity market valuations are now below 60-year averages, even though interest rates are significantly lower now than in virtually every year of that six decade span. Against this backdrop, it's difficult to envision the current market setback swelling into a prolonged, grinding downturn.

Finally, quarters like the one just passed are unfortunately the price of admission to the upside of equity ownership. The risk being realized at the moment is merely the flip side of the same coin that generates the long-term compound growth that most of us require to stay ahead of inflation and meet our investment goals. Without fear of periodic decline, however, stocks would be bid up to the point that they offered the same meagre returns as other risk-free assets, such as treasury bills and government bonds.

The fourth quarter of 2018 was unquestionably a bad one and, absent a post-Christmas rally, it would have ranked amongst the worst since the beginning of the Second World War. Two points should be noted about horrible market intervals, though: first, they scare a lot of people out of the market and, second, in doing so they often set the stage for a big comeback for those who remained committed to their investment plans (see table below).

We can't say whether 2019 will bring a recovery similar to those listed here, but given the reasonable level of equity valuations, interest rates that remain historically low, and an economy which continues to create jobs and support consumption growth, such a result wouldn't be surprising in the least.

Worst S&P 500 Quarters Since 1940		**Ensuing Total Return**		
	Quarterly Performance	**1-year**	**3-year**	**5-year**
Q3-1974	-25.2%	38.1%	72.7%	117.5%
Q4-1987	-22.6%	16.8%	48.8%	109.0%
Q4-2008	-21.9%	26.5%	48.6%	128.2%
Q2-1962	-20.6%	31.2%	69.2%	94.8%
Q3-1946	-18.0%	6.5%	24.5%	115.4%
Q2-1970	-18.0%	41.9%	57.4%	56.3%
Q3-2002	-17.3%	0.3%	27.0%	66.3%
Averages	**-20.5%**	**23.0%**	**49.7%**	**98.2%**