Monthly Commentary

December 16, 2014

SELECTOR
Real-Time Money Management

"Good investors gather information, put that information into current and historical context, then make sound decisions."

At this writing, domestic equity markets are involved in their fifth correction of the year. The first three corrections were mild, generally falling in the -5% range, and occurred in January, April, and July. All three were followed by equity markets recovering their losses in a couple of weeks then continuing on to new yearly highs. The frequency of these corrections did not represent a serious impediment to annual gains, which were consistent albeit modest. The fourth correction was more severe, dropping major market indexes by -10% and more. The declines occurred over a five-week period, but were recovered in just two weeks, once again followed by new yearly highs as markets rallied into the first week of December. This brings us back to our current correction, which may be the most interesting of them all.

The timing of this fifth correction is unusual, occurring just two months after a very significant correction and smack dab in the middle of what has historically been the three most profitable contiguous months of the year. Even more interesting will be the magnitude of and length of this correction. We have just seen a -4.3% decline in the S&P 500 in the first week of the correction. If it reverses right now, it will be the shortest-lived correction of the year and will have reversed perfectly at the 150-day moving average. This is almost a fairy-tale scenario, but remember how quickly the previous correction got wrapped up. The long-term trend remains positive. The intermediate-term trend remains positive. The short-term trend is positive and equity markets were mildly over-bought, which is no longer the case. The proof will be in the pudding, which should be popping out of the oven in the next couple of days.

We have been maintaining a 'bond cushion' in managed equity portfolios for the past two months. If equity markets find support at or near current levels, the necessity of the cushion would be diminished by the technical improvements. Market volatility is markedly higher, but positive volatility would definitely be trumping negative volatility if the pattern continues to find new highs. We may be tightening our seatbelts a little bit but the best market runs historically occur at the beginning and the end of Bull Markets. We definitely are not at the beginning of this nearly 6-year old Bull Market. It is possible that we will be in for some fireworks, from a positive perspective.

Another possibility is that equities could pull back all the way to test the October lows. That drop was very quick and very strongly reversed. In other words, significant buying interest surfaced quite quickly. That buying interest was rewarded with new highs in a reasonably short time. Certainly, it is conceivable that a repeat scenario could once again attract more buyers.

Finally, there does exist the more challenging scenario that a test of the October lows is not successful, and that significantly lower prices are on the horizon. In reality, this scenario is always somewhere in the deck of cards yet to be played. To continue that 'deck of cards' analogy, much of the deck has already been dealt over the past 6 years. We know that every Bull Market is followed by a Bear Market which is followed by a Bull Market, etc., etc. It is true that equity markets have become more selective in the past few months, which may reward the investor that becomes equally selective. As we stated in last month's Commentary, this is a fast market, and the driving is best left to the professionals.

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We haven't spent much time discussing bond markets in this month's commentary. They remain important components of our portfolios, but are topical primarily as a counter-point to equities at this juncture. Interest rates have remained very low all year. Bond prices have risen slowly and steadily all year. There is very little to speculate upon except for the same old story that interest rates will rise someday, which they will. Bonds will reward investors with single-digit returns in 2014, and there is very little that will change that. Perhaps equities will do the same, but with a fast market that could change quickly, so the attention rests with stock markets for the next few weeks. We hope that all of you have the opportunity to pause and reflect on the many positives in your lives as we flip our calendars to 2015. See you next year!

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Sources: Bloomberg, Marketwatch.com, StockCharts.com