Dow Drops 11775. Panic or Patience?

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Since starting the year up 7.6%, the S&P 500 has erased all of its gains and then some in early February. Based on what we are seeing after the close of the markets today, it appears that this trend will continue tomorrow and could potentially spill over into the days to come. This is not 2008-09 again. This is a correction. Bear markets (drops of 20% or more) rarely happen without a recession. And, our economy is experiencing anything but a recession. Just the opposite. This drop in stock prices has been triggered by positive, no - very positive, economic news.

So what happened over the past few trading days?

We think most of this pullback has been driven by three things:
(1) Panicked investors that forgot how volatile stocks can be
(2) Traders and their trigger-happy algorithms
(3) Interest rates popping higher

#1: The Return of Volatility

Investors have forgotten that stocks can be volatile. The recent selling has caused panic for retail investors and traders. Since early 2015, the market has been on an unabated path higher. We haven't seen a 10%+ decline in two years. And until now, we hadn't had a 5% decline in stocks since 2015.

Over the past week, investors have been reminded that stocks don't go up every day. These selloffs aren't fun, but they are completely normal and healthy in any bull market. Stocks have historically declined by 5%+ three times per year, on average. And they average at least one 10%+ drop every year.

Not only are selloffs normal, but they are healthy. Stock price declines allow short-term traders to get out of the way. These low-quality stock owners get replaced by longer-term, value-oriented investors. These investors tend to stick around for longer periods and drive stocks higher. Market corrections never feel good, but they are necessary for a healthy future.

#2: Traders and Computers

Most of the daily movement in stocks is nothing more than noise. Short-term traders and their computer algorithms drive most daily trades. When stocks fall enough, they can sometimes trip the algorithms to sell automatically. This "sell first, think second" (or not at all) mentality can often cause selling to beget more selling.

Eventually, the traders drive stocks down too far. Calm, rational investors eventually return to buy good companies at better values. Who are the buyers? Well, you are. Long-term investors view short-term volatility as an opportunity to buy -- not sell.

#3: Rising Interest Rates

Many have blamed interest rates for the selloff in stocks. Higher rates do tend to attract money away from stocks, but rates are still historically low at under 3%.

The recent increase in 10-year yields from 2.2% to 2.8% signals that bond investors believe economic growth and inflation is picking up. Faster economic growth is good for earnings and ultimately the stock market.

We would be far more worried if we saw interest rates falling sharply in coincidence with stocks. We don't see that right now.

Short-term Volatility = Long-term Opportunity

Stock prices are ultimately driven by earnings and dividend growth. Both of which are driven by growth in the economy. So let's step back and think about what's going on in the economy and with earnings.

#1: Strong Economic Underpinnings

There has only been one instance since 1926 that stocks have gone into a bear market without a recession. That was the flash crash of Black Monday.

The odds of a recession over the next 12 months are extremely remote. Economic data seems to suggest economic acceleration in almost every sector. Manufacturing data across the globe is strongly positive. Leading economic indicators are all rising. And unemployment is nearing 4%.

With those data points, it's hard to imagine a recession in 2018. And without a recession, it's unlikely we see a 20%+ decline in stocks.

#2: Accelerating Earnings

Imagine the stock market as a manic dog held on its master's leash. The dog bolts off one way, then the other. Forward, then backwards. It jumps, digs, and dives every which way. But the dog can only go so far before it gets yanked back by its master.

Who is the master? Underlying earnings and dividends. As long as the master is moving ahead, the dog must eventually follow. Not necessarily right away, but when the leash gets too tight -- the dog has no choice.

Earnings growth has accelerated in 2018. Expectations from analysts and CEOs are for even more growth than expected. So we have the master going from a steady walk to a jog -- as earnings accelerate. And we have the dog now making a quick bolt backwards.

The Master is telling us we have a bright future ahead of us. The dog is running for cover. Who are we to believe? The dog or the Master?

Bottom Line

These are real businesses and they are not going through tough times. Quite the contrary. They are selling more and making more money than they ever have. It may not feel like it right now, but that makes this one of the best times ever to own stocks. These prices will settle out. And great bargains will remain.

Will the market go down more from here? Maybe. We don't know where stocks will go tomorrow, next week, or next month. But we can know that eventually stock prices will follow dividends and earnings. And both of those are pointing in the right direction driven by a strong underlying economy.

Our focus has been and will continue to be on Security first, Income second, and Growth third. We fill our portfolios with high-quality companies for times just like this. The companies we own have strong cash flows and bulletproof balance sheets. Whether their stock goes up 5% or down 5% the day before doesn't make a bit of difference to their underlying businesses.

If the markets continue to move lower, don't panic. You are in this for the long-term. Your dividend and interest income is not related to stock prices at all. Even in 2008-09, almost all your companies continued to pay and increase their dividends.

If you are still feeling nervous, don’t hesitate to call your Portfolio Manager. We know these bumps in the road are not fun to go through, but know that you don’t walk through them alone. We are always here to walk through these rough spots with you.

Blessings,

Your Investment Policy Committee