Daniel Wildermuth's
MARKETCOMMENTARY

November, 2018

- Presented by Wildermuth Asset Management

Markets Down, Volatility Up as Economic Future Grows Murkier

Once again, the month of October inflicted an unwelcomed beating on investors. At one time during the month, the S&P 500 was down 10%, although a rally in the last couple days pared some of the month's losses. The tech heavy Nasdaq index suffered an even greater decline with losses of 15% before an end-of-month rally.

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Historically, October has seen its share of large corrections including large declines in 1929 (the stock market crash), 1987 (Black Monday), 1989 (failed buy-out of United Airlines), 1997 (Asia economic crisis), 2002 (last of the big dot.com bust), and 2007 (housing crisis). Looking at this history, the month of October appears to suffer from higher volatility given its location on the calendar. After returning from vacations, it takes investors and traders a few weeks to digest data which frequently result in portfolio changes and occasionally significant sell-offs. September also suffers a similar fate and actually produces the worst historical monthly performance since 1926 although trading during the month has historically been less volatile.

This year's correction could be short-lived, but several trends lead us to guess that the market's future is a bit more tenuous and struggles could continue. We have noted several areas of concern in past newsletters despite numerous strengths in the economy, and we have been adding concerns to the list.

Over the past several months, data produced by our stock rating system suggested that the market would suffer a significant pullback in the relatively "near-term" future. We rate every stock that trades on the market on a weekly basis. Historically, stocks that earn an "A" rating have significantly outperformed companies earning an "F". The pattern has reversed four times since the mid-1990s – 1998/9, 2003, 2007 and 2017/18. The reversals in 1998/9 and 2007 proceeded significant market corrections, suggesting that the run-up in stocks toward the end of the cycle appeared to be driven by factors outside of traditional value measures such as profitability and growth. The 2003 anomaly following the dot.com bust resulted from rapid reporting changes as companies recovering to profitability after the technology bust, and the system simply returned to normal in 2004. In the past year or so, the system's reversal after a long run-up has suggested to us investors are pushing values up based on unsustainable factors that are unlikely to continue. History suggests that markets revert back to values based on fundamentals, but predicting the timing is difficult.

We see some other concerns as well. On October 26th, the Commerce Department reported that U.S. GDP grew at an annual rate of 3.5% for the third quarter following a 4.2% growth rate in the second quarter. The combined six-month growth logged one of the strongest stretches in the past decade. Yet this seemingly good news was tempered by growing concerns about the future. Economists surveyed by the Wall Street Journal project growth slowing to 2.5% by first quarter of 2019 and 2.3% by the third quarter. The Fed expects growth to slow to 1.8% by 2021. Fears appear to be increasing that US growth has peaked and earnings growth will inevitably decline, or worse, reverse. Offering supporting data, business investment grew at an 11.5% rate in the first quarter on broad-based gains across many categories. Since then, it has faded, registering only 0.8% growth in the third quarter without the ongoing tax-cut cash infusion.

The current economic expansion is also growing old with the very tepid nature of the recovery contributing

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to its longevity. Yet, inevitably, human nature appears to ensure that the market will go through a cycle. When people believe the world is safe, they inevitably grow more confident and do things to make it riskier. The long period of low rates and market increases has provided ample time during which people can use cheap money to make investments that may not perform well in a higher interest rate environment.

Circumstances also appear a bit less positive when considering the Fed's track record regarding increasing rates and recessions. Since the 1960s, a series of rate hikes has ended in a recession in all but one case, leading many to the obvious conclusion that a recession is coming, we just do not know when.

Housing gains are also slowing, although from a fairly high level. Annual home-price gains fell below 6% for the first time in a year in August, marking the fifth straight month of decelerating price gains. Yet, the slowdown is a mixed signal since growth is still strong, remaining higher than wage growth or inflation.

Unemployment also continues to decline, falling in September to 3.7%, the lowest level since the Vietnam War. The rate fell despite lower monthly job gains offering further signs of a very tight labor market. Many continue to voice concerns that a lack of labor must inevitably create problems for the broader economy, while others argue productivity gains could offset the tight labor market.

Still, against all this sentiment, Federal Reserve Chairman Jerome Powell noted recently that the U.S. economy is experiencing "a remarkably positive set of economic circumstances." These and other comments suggest that the Fed Chairman sees little risk the current economic expansion will be knocked off course. In addition, he noted that he does not believe the labor market is at risk of overheating or of price pressures accelerating despite record low unemployment. Hence, more rate increases are expected.

Internationally, the October drop in markets has also made international stocks more attractive. Unlike US markets, foreign markets were already underwater for the year before October's carnage. At the low point of October, emerging markets in aggregate were down over 20% on the year while developed markets as a group were down over 12%. Emerging markets in particular now offer attractive valuations, and if US economic data shows more weakness, investors could see these economies as increasingly attractive.

October's volatility has likely heightened investor awareness of potential problems in the late stages of this economic expansion. The good times may continue, but numerous signals suggest we are getting closer to the end of this expansion, making market volatility and pullbacks more likely. In addition, stock valuations that appear to have departed from more traditional fundamental measures suggests that a reversion to the mean could be more painful for investors using less fundamentally-based logic to build their portfolios.

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