CREDO WEALTH

Good news turning into bad news?

Deon Gouws - Chief Investment Officer - 12 October 2018

A number of clients have asked for our thoughts in the wake of turbulent financial markets over the past few weeks, in particular following Wednesday 10 October when the US market fell more than 3% in a single session. At the time of writing, the S&P 500 is trading at a level some 7% below its all-time high which was reached three weeks ago.

Firstly, we would like to reiterate that we are long-term investors at Credo, and we try to ignore most of the shorter term noise and volatility.

Accordingly, we try not to get worked up too much when we see drawdowns that are ultimately considered to be normal in financial markets. In this regard, two summary statistics stand out – as pointed out in separate blog posts / tweets by US financial advisors *Michael Batnick* and *Charlie Bilello* in the past 48 hours:

- Going back to 1900, **a daily decline of as much as 4%** (or more) in the US stock market has happened on average **once every 82 days**; and
- This is the **23rd correction in the S&P500 of 5%** or more **since the recent March 2009** stock market low.

Having said that, we also accept that the long term is the sum of the short term, hence we'd like to offer some points of commentary in the wake of this recent volatility.

Firstly, it should be borne in mind that financial markets – especially equities – have been in expensive territory for some time now; we have been pointing this out to clients in an attempt to manage expectations. In fact, we were probably early when we started making this point a few years ago; having said that, it has always been our philosophy that one should stay invested through the cycle and we never try to time the market, so clients have benefited from strong markets in the past, in accordance with asset allocations that reflect their agreed risk profiles. When a correction happens as we see playing out now, one can thus argue that it is in fact a healthy development, at least to some extent: markets end up being less over-priced as a result, enhancing the returns outlook going forward from this point onwards (especially relevant to those who may be putting "fresh" cash at work now).

In trying to offer reasons for the sell-off, it needs to be pointed out that the "good news has started turning into bad news", specifically as far as the US market is concerned. Whether or not one is prepared to give President Trump any of the credit (most of the positive momentum started a number of years ago, i.e. during the Obama days), it has become evident in the past few months that the American economy is now healthier than practically anytime in the last two decades or more: unemployment is at all-time lows, as a result disposable income is up and consumer confidence is high. This is likely to have an accelerating impact on inflation, hence the Fed is expected to respond in the form of interest rate increases that could end up being more in number and ultimately higher in level than previously anticipated; in turn, this has started being reflected in the yield curve, with US 10 year rates now being in excess of 3% (higher than any time since the global financial crisis). Ultimately, interest rates are relevant in terms of discounting future returns from any investment, hence higher rates translate into lower capital values – which explains inter alia stock market declines.

Should one turn bearish as a result? The other side of the coin is simply to focus on the good news itself, i.e. a stronger economy should lead to increased profitability which is obviously good for share prices once all is said and done… the trick is simply to identify those sectors and companies that are likely to benefit quickest and/or most. Speaking about profitability, the same Charlie Bilello referred to earlier, also pointed out earlier this week not only that overall S&P 500 earnings are expected to increase by as much as 26% this year, but also that, if this expectation is in fact met and the index ends the year at current levels, its P/E ratio would go from 21.4 to 18.3; this would be the first year of multiple contraction since 2011.

We'd also like to point out once again that we are value investors at Credo, and as a result we are not invested in some of the sectors that we have considered to be the most overvalued, specifically the so-called FANG stocks (Facebook, Amazon, Netflix and Google) – all of these are down well into the double digit percentages from their highs in an overall market which is "only" 7% down from the top. If nothing else, this should help the relative performance of our portfolios as we live through this market dislocation. As financial author Jonathan Tepper tweeted in tongue-in-cheek fashion on Wednesday: you can pick up bargains in this sell-off... Netflix is trading at 104x EV/EBITDA and 80x forward PE (this stock has declined even further since then, and is now trading nearly 25% lower than its all-time high a short three months ago).

One more thing: we have always steered clear of direct emerging market exposure in building our discretionary equity portfolios at Credo, simply because we do not want to incur unnecessary risk for a small uplift in potential return in our portfolios that are designed to be relatively low risk. In the past few months, this has also proven to be value-adding, as emerging markets from Argentina to China to Turkey have gone through a particularly torrid time (both in terms of currencies as well as individual securities).

Which brings me to the main question: what should investors do at a time like this? Our advice is always the same: on the basis that one had a diversified portfolio of good quality investments (bought at reasonable prices) to begin with, the best strategy is to ignore the volatility and to sit it out until markets recover. The worst thing to do would be to "blink at the bottom" and sell out at the worst possible time (and of course no-one knows exactly when markets will start to turn again). For those with extra cash to deploy, this may be a good time to start "nibbling" again.

Jack Bogle, founder and retired CEO of Vanguard, recently said: **"I spend about half of my time wondering why I have so much in stocks, and about half wondering why I have so little."** Market participants may be nodding their heads in agreement to the first half of this quote today… but as night follows day, the time will come when you worry more about the second part again.

PS: Why do we tend to focus mostly on the US market? Simply because it is by far the biggest and most important market in the world, and still represents approximately 50% of most global benchmarks; accordingly, it also represents about half of the discretionary equity portfolios that we manage at Credo. We could have focused on alternative indices such as the MSCI World, but the main conclusions would be exactly the same. ■