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Polaris Greystone Educational Series

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A December to Remember

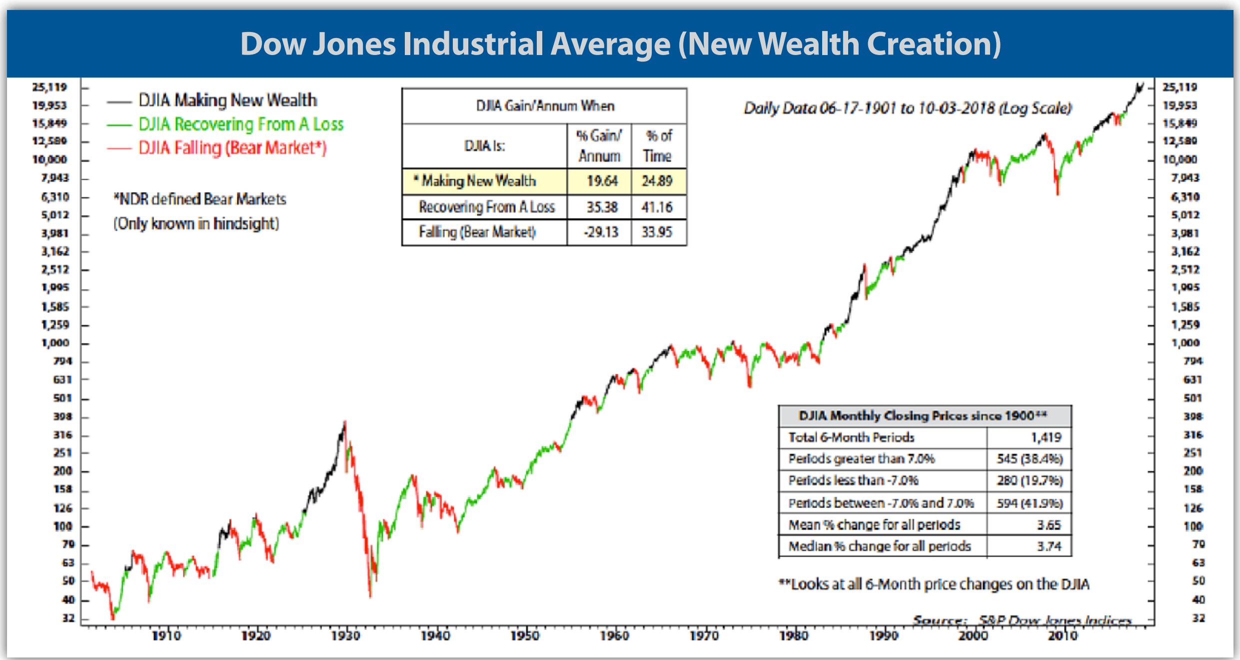
As of December 19th, the Dow Jones Industrial Average and the S&P 500 are on pace for their worst December performance since 1931. They are down 8.3% and 8.1%, respectively. The Russell 1000 Value, made up of large, dividend paying stocks, is down almost 10% for the month. Jim Cramer, of CNBC, has called this "the most treacherous market" he's seen since the financial crisis.

While I'm not sure that it is the most "treacherous market" I've seen since the financial crisis (we had bigger drops in 2010 and 2011), it has been the most challenging to navigate. The market is dropping despite the S&P 500 companies reporting record corporate earnings, record corporate dividends, record corporate share buybacks ($1.1 trillion), a very strong economy, virtually no unemployment, no inflation… The list goes on and on and on. And the markets continue to drop based upon what might happen in the future compared to what is really going on right now.

The Markets Recover Quickly

Understanding how the markets perform is one of the most important parts of investing. The chart below shows the performance of the Dow Jones Industrial Average from 1901 through the third quarter of this year. The Dow Jones has averaged a little better than 9 ½% returns during this time.

Here is what most people don't know…The Dow Jones has either lost money or recovered from its loss over seventy-five percent of the time. That's right. 75% of the time the market loses your money, or you are recovering from that loss. Here's how it works. About 34% of the time the markets lose money (red line in the graph below). An investor would have lost almost 10% per year when the markets are down. A little over 40% of the time the DJIA is recovering from a loss. When the DJIA is recovering from its loses (the green line in the chart below) it produces over 14 ½% return. When making new highs (the black line in the chart below), the DJIA produces less than a 5% return. In other words, if you wait until you feel comfortable about the markets to invest your money, you'll get the lowest return.



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We Are Extremely Oversold

The markets are incredibly oversold. The below chart is a monthly candlestick chart of the S&P 500. As you can see, we are currently as oversold as we were back in the Great Recession. Typically, when the markets are this oversold they rebound and go up a lot.

We are Undervalued

We have referenced this graph many times in the past to measure if the S&P 500 was over or undervalued. This graph is dated as of November 30th, before our December to remember. The S&P 500 is now trading at 14.26 times its forward P/E ratio. This means that the S&P 500 is about a ½ standard deviation undervalued compared to how it has traded over the past 25 years.

S&P 500 Index: Forward P/E Ratio

Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	15.7x	16.1x	-0.1
CAPE	Shiller's P/E	30.6	26.8	0.6
Div. Yield	Dividend yield	2.1%	2.0%	-0.3
P/B	Price to book	3.0	2.9	0.1
P/CF	Price to cash flow	11.6	10.7	0.5
EY Spread	EY minus Baa yield	1.1%	-0.1%	-0.6

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

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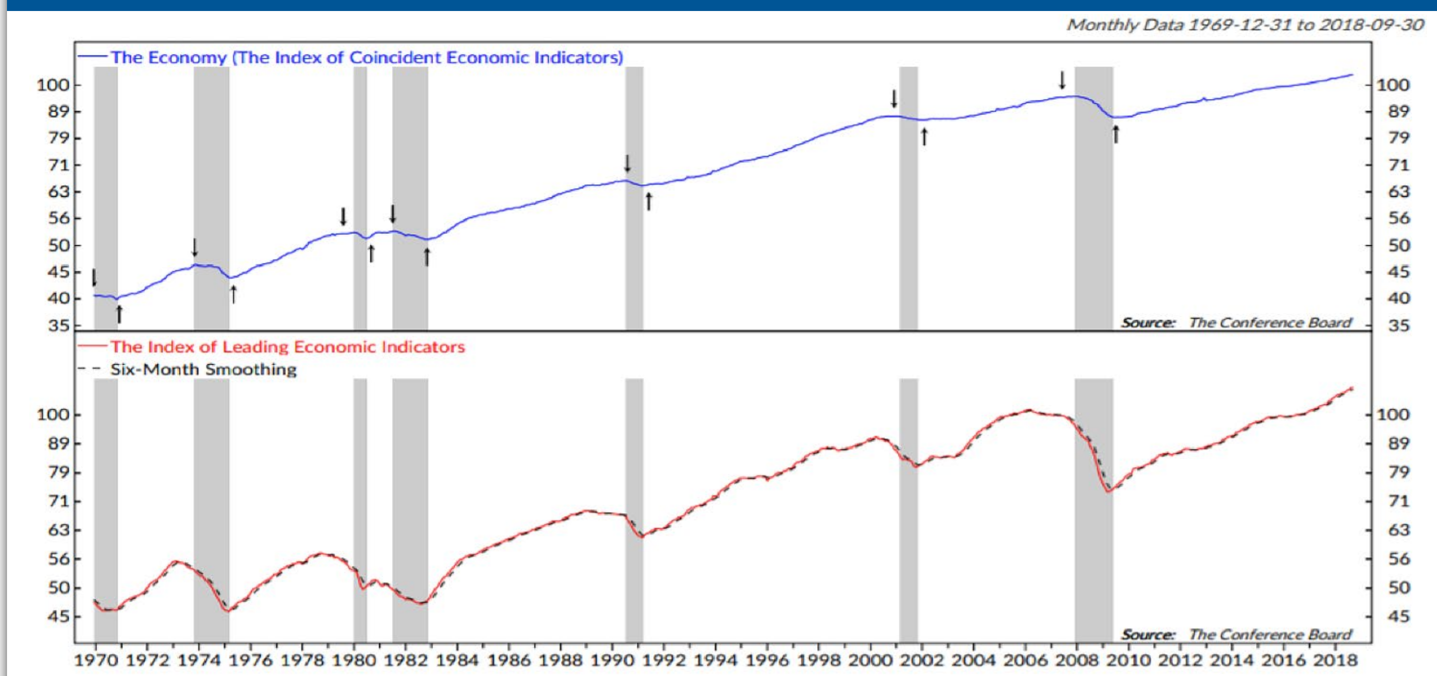
Irrational Sentiment

This market has been driven down based upon irrational sentiment. There is no new news that should be driving this market down. What is driving the markets down?

- The Fed? No!. They haves been slowly raising rates for two years. They already told us what they were planning on doing this year. Rate hikes are only occurring because the economy is strong enough for us to reset this lever. It's a good thing, not a bad thing.
- An inverted yield curve? Maybe, but we don't have one. One news agency recently reported that the three year and five year treasuries were inverted. First of all, no one compares the 3 vs. 5-year treasury yields. It's the 2-year and 10-year treasury that are compared… and they aren't inverted. The other thing that the press doesn't tell you is… All recessions have been preceded by an inverted yield curve, but not all inverted yield curves lead to a recession.
- A looming U.S. recession? Absolutely not. Our economy is now growing at an annualized rate of 3% per year. This is well above our average 2.3% growth rate since the Great Recession. Our 50-year average is 2.7%.
- The Index of Leading Economic Indicator (below), which has accurately predicated every recession over the past 60 years, shows slow and steady growth with no signs of a recession (but keep in mind that past performance does not guarantee future results).
- Trade War with China – We've discussed this before. Trade wars are not good for anyone. The longer this trade war goes on the more this could impact major economies. This is not, however, new news but it is impacting global economies.

I personally think investors started fearing the unknown and threw in the towel. This is purely a sentiment driven correction. All it takes is a thawing of this fear and the markets could quickly reverse and begin going up again.

The Index of Leading Economic Indicators



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Our Patience Has Hurt Us

As we discussed above, all fundamentals point toward a great market. Macroeconomics are very positive for the United States. Our technical indicators were mixed (they just went negative). It was only sentiment that was driving the markets down. Typically, sentiment driven corrections are short lived and shallow. Selling into most sentiment driven corrections typically leads to getting out at exactly the wrong time.

This correction has been extraordinarily difficult to manage risk. There has been no place to hide. Bonds are down for the year. Small-cap is down over 20%. Many areas of the international markets are down 15-20%. Dividend payers are down more than growth companies, very atypical during a correction. Investors have thrown the baby out with the bath water.

What's Next?

You've heard me quote John Maynard Keynes by saying, "The markets can remain irrational longer than you can remain solvent." It doesn't seem like the markets want to hold in here. Investors are being completely irrational. But it doesn't pay to fight the tape. And as much as I have tried to be patient we are going to get more defensive, ride out this storm, and we will be ready to step back in to take advantage of what should be a quick recovery. We are confident that this will be a short-lived storm and that the "secular" bull market remains fully intact. We are just going through a short-term bear cycle inside of a secular bull market.

During these times it is more important than ever to remain focused on your goals and not on the short-term performance of your portfolio. This short-term detour is nothing more than that… a little delay in making progress towards your long-term financial goals. We are confident that we can get you there, on time.

As always, I welcome your questions or comments.

Sincerely,

Jeffrey J. Powell
Managing Partner, Chief Investment Officer

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- **Information from forms that clients fill out and send to us in connection with a new account application (such as name, address, and social security number).**
- **Information a client gives to us orally.**
- **Information about the amount clients have invested (such as initial investment and any additions to and withdrawals from a capital account).**
- **Information about any bank accounts clients use for transfers between accounts.**

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