Polaris Greystone FINANCIAL GROUP, LLC

Polaris Greystone Educational Series

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This is Normal

As you can imagine, we've received a few more calls than usual over the past week, after a tumultuous drop in the broader markets on Wednesday and Thursday. Clients are calling, concerned about this drop and wondering if it is the beginning of a more substantial sell-off in the markets. I don't believe that this sell-off will be long-lived, nor do I think that this is the beginning of a much larger sell-off. If I'm correct, then we are very close to the bottom of this sell-off. This forum, however, is a great way to discuss what Polaris Greystone will do if I'm wrong. For this explanation, you'll have to read on.

Psychology of Investing

I'd like to begin by explaining a bit about what you feel. The S&P 500 peaked on October 3rd at 2,925.51. It has since dropped to 2,750.79, as of October 15th (as I write this). This is a 5.97% drop in the markets. I think that most investors would agree that it was irrational to "freak out" at a 6% decline in the S&P 500, or you shouldn't be investing in stocks at all. The reason you are feeling so much discomfort is that there is a 3 to 1 pain to euphoria ratio when losing money in the market. In other words, this 6% decline feels more like an 18% decline (three times the real loss). Being nervous is ok. What you don't want to do is act upon what most seasoned investors would consider being a routine pullback in the markets.

Why Did the S&P 500 Drop?

I find it amazing and nauseating that the media must rationalize why the markets corrected off their highs. They claim that the market corrected due to remarks made by Fed Chairman Jay Powell when he said we're "a long way" from neutral on interest rates. The reality is the Fed gave us their "playbook" in 2013 when they announced that their long-term plan was to raise rates to 3%, so long as the economy was strong enough to withstand the hikes. Forex traders took advantage of this announcement by shorting the Euro, strengthening the dollar 25% to the Euro in 2014 and 2015. The strong dollar negatively impacted exports and slowed our economy. This delayed the Fed from moving from a zero-interest rate policy until December of 2015, raising rates for the first time in almost a decade. They have been slowly raising rates since. The Fed raised rates another quarter-percentage point on September 26th to a range of 2% to 2.25%. This is the third rate hike this year, and the eighth hike since 2015. There is an 80% chance, based upon fed futures that the Fed will make one more 25 basis point (0.25%) hike in December. The question I ask of you is, "did Fed Chairman Jay Powell's comments send the stock market down 6%?" I would argue "no!" We already know that the Fed is going to continue to raise interest rates while the economy is strong enough to withstand their moves, thus resetting one of the most valuable tools the Fed has to combat future recessions.

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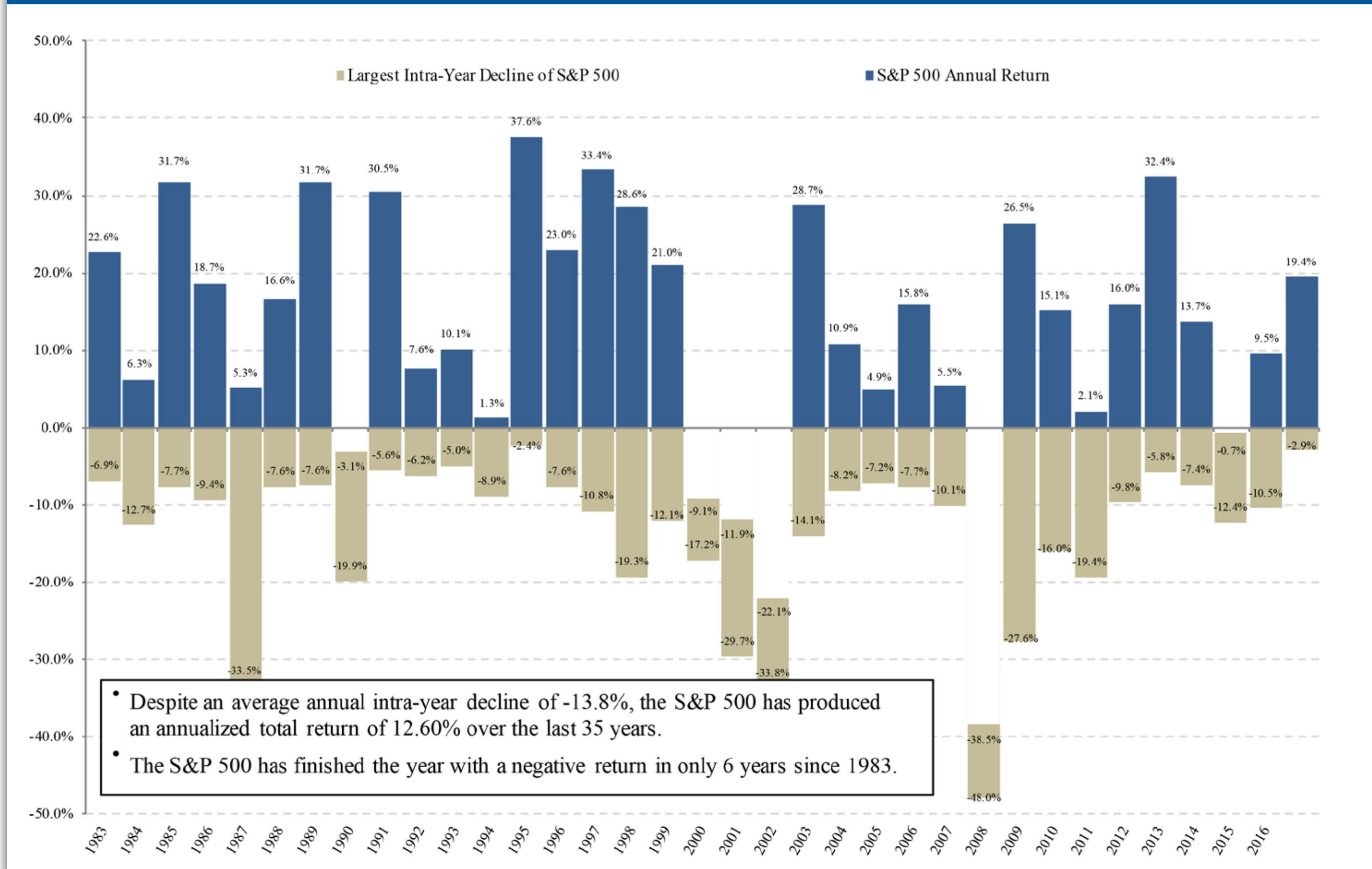
Putting This into Perspective

Historically, the S&P 500 drops 5%, four times a year. One of these drops turns into a 10%+ correction. If you look at the chart below (which should look familiar, as we have shown this chart often), from 1983 through 2017, the intra-year decline in the S&P 500 averaged 13.8%. Despite these normal drops, the S&P 500 has averaged a 12.6% average annualized return (well above historical norms).

S&P 500 Annual Returns vs. Intra-Year Declines
1983–2017



Source: Polaris Greystone Financial Group, LLC, Standard & Poor's. All information contained in this presentation is considered to be accurate but cannot be guaranteed for its accuracy. Thus, all information contained herein is provided "as is" and without warranty of any kind, either expressed or implied. Investments are subject to risk. Past performance is not indicative of future returns. Data as of 12/31/17.

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What is Really Going On!

I don't know why the media can't get behind all the good things currently going on in the market. It's as if they have made their minds up that they are going only to report the negative and forget about the positive aspects of our country. Let's put things into proper perspective. Here's what is going on:

The Good

- Our economy grew 4.2% quarter over quarter and 2.9% year over year. This is well above the 2.3% growth rate since the Great Recession and overshadows our 2.7% growth rate over the past 40 years.
- We've just experienced two straight quarters of record earnings (quarter over quarter of more than 25% growth in each quarter)… Amazing.
- Third quarter earnings are expected to be record breaking, with an approximate 20% quarter over quarter growth rate.
- The S&P 500 forward P/E ratio is now at 15.7, below the 25-year average of 16.1. Meaning the market is slightly undervalued.
- S&P 500 companies are experiencing record margins.
- S&P 500 companies are sitting on record cash reserves.
- S&P 500 companies are buying back their shares at a record pace, with over $700 billion in commitments through the first three quarters of the year. We are expecting this number to break the $1 trillion for the first time ever.
- S&P 500 companies are rewarding their investors with record dividend payouts.
- Unemployment is at 3.7%.
- While below their 50-year averages, wages are increasing at a 2.8% annualized rate.
- Inflation is completely under control, with core CPI at 2.2% and headline CPI at 2.7%. These are well below the 50-year norm of 4%.

The Not So Good

- Intermediate and long-term bonds are finally capitulating, being negatively impacted by the Fed action and a waning demand from foreign investors.
- Financial stocks are experiencing margin compression due to the flat yield curve.
- Interest rate sensitive sectors of the markets are coming under pressure, namely real estate, utilities, and parts of the new communications services sector.
- Oil prices are creeping up, which could impact inflation rates.
- International markets have been weak, with the All-Country World Index ex. U.S. providing a negative 2.7% return, with developed nations dropping 1.0% and emerging markets plummeting 7.4% in U.S. dollars. Major economies have posted significant negative returns, including: China (-9.0%), India (-9.6%), Germany (-7.3%), United Kingdom (-2.6%), and Brazil (-12.1%) in U.S. dollar losses.
- Our trade wars are starting to have an impact on other country's economies. Look at what is happening in China. Look at Europe. Their lack luster economies could impact our ability to sell our goods and services into their countries.

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What is Polaris Greystone Doing?

It is close to impossible to try to avoid smaller moves in the market, especially when they are sharp and short-lived corrections. A six percent correction is considered a minor correction. Over 85% of this small decline was experienced in two days, with half of the total loss being felt on Wednesday, October 10th. It would have required a great guess, not an investment strategy to have removed yourself from the risk in this market over those two days.

The S&P 500 is currently oversold. Typically markets revert to the mean, or to put it differently, the markets should rebound. We've already recouped half of the losses experienced on Thursday. This market is set up to rebound and finish the year strong, given everything that we've previously discussed that is going well. We have chosen to be patient and wait out this retraction before reallocating your portfolio in a way that we feel will best take advantage of what we expect to be a strong performing market through the rest of the year.

What if We Are Wrong?

I'm a big believer in stating "price doesn't lie." If we believe the markets should be going up and no one else agrees with us (meaning they are selling), then we are wrong. If we experience a further sell-off, we will be forced to get defensive with our portfolios by selling positions to lower our exposure to the stock market. None of our technical or fundamental indicators are currently signaling to sell, but this would shift soon if we were to see additional weakness in the markets. As you already know, we would sell the higher risk portion of your portfolio first. It would be sold incrementally, typically in 10% increments, until risk subsided. We'd reverse this same protocol to bring the portfolio back to its proper allocation once we felt that the risk in the markets was behind us.

Conclusion

It's never fun giving back profits to the markets, but it is part of investing. No market goes straight up, just like no market goes straight down. The fear that investors feel is often because of their past experiences, often dating back to the great recession. We rarely get calls or emails from clients that hired us before the Great Recession. They know what we do. They trust that we know what we are doing, and they believe that we will help them navigate the uncharted waters ahead of us as successfully as we steered them in the past. This does not mean that you shouldn't voice your concerns, nor does it mean that your concerns are not valid. You have hired us to be clinical about managing your portfolio, often during uncertain and challenging times. We know that managing money in a clinical manner removes us from making mistakes that often creep into investment management when allowing emotions to get the better of good judgment. While quantitative and technical investment management doesn't ensure that you are correct at all times, it ups the percentage chances that we will be successful with our investment management, and it increases the probability of us helping you to accomplish your financial goals.

As always, I welcome your questions and comments, and I encourage you to meet with your Polaris Greystone wealth advisor to keep up to date with our service of f ering.

Sincerely,

Jeffrey J. Powell
Managing Partner and Chief Investment Officer