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"The stock market has already had a terrible year, and the doomsayers see plenty of reasons things might get worse"

Headline, *New York Times,* December 16, 2018

I read this headline with my tea one recent Sunday, and noted a key point being raised – that of the opinions of doomsayers. It occurred to me that by their very nature, a doomsayer is going to see doom and gloom ahead! Thus the headline really didn't tell us much about what the future holds, and the notion that the markets have had a terrible year is one of perspective. If the writer assumes that a non-terrible year is one with gains by the time the ball drops over Times Square, then a loss – even a small one – is terrible. I suppose this teaches us mostly to ignore headlines and the breathless speech of cable TV commentators.

Since we like gains much more than losses, it can be said that 2018 hasn't been much fun. Trade issues have conspired with the rise of the dollar against most currencies to drive many types of investments down this year as I write this. Santa Claus could still show up and we could end the year with a rally, but there hasn't been any sign of a sleigh and reindeer over the corner of lower Manhattan's Wall and Broad Sts. Investors with cash aren't "buying on the dip" as they have done until October convinced them to stop. The market has been dominated by algorithm-driven trading and index fund activity, now estimated to be 85% of overall stock trading.

The fears of trade wars has caused investors to think again about how much shares of stock are worth, and the price/earnings ratio (P/E) of the market has dropped from about 22 at the beginning of the year to roughly 18 today. Many areas of the market are considerably cheaper than they were at the beginning of the year, and this is in part due to the excellent gains we have seen in corporate earnings. While the tax cut law of last December played a role in earnings, the underlying strength of the economy also did its part. However, fundamentals seem to be playing no real role in the current sell-off.

Normally bonds act as a counterweight to stocks by rising when stocks fall, but this has not been a normal year for bonds. The Federal Reserve has been marching forward with rate increases (4 this year) based on their assessment of a strong economy. Even the most recent meeting (Dec 18th – 19th) suggested that the wizards of the Fed don't see problems that are big enough to take down the economy. The rise in short term rates has not been matched by an increase in long term rates, so the U.S. Treasury yield curve has been getting flatter. Long term bond yields have still risen, so many areas of the bond market are showing losses for the year. Bonds can be down 2% in a year, and while this is like a bad day for stocks, it is a pretty bad year for bonds.

So then, what about next year? Economic growth is still steaming along in the U.S., despite the fears reflected in the stock market. The *Wall Street Journal* reported that holiday sales are up about 5% in the strongest performance in years. Wage growth is finally improving at a time when anyone who wants a job can get one – even convicted felons are being hired.

Corporate earnings growth is expected to slow in 2019, but remain positive as the stimulation of the tax cuts wears off in year-on-year comparisons. The recent decline in the stock market has brought values to more reasonable levels, suggesting that there may not be much further downside to owning stocks. Inflation has risen enough (to about 2.5%), but without much expectation that the rate will accelerate. Social Security recipients will get a 2.8% increase in January, helping seniors with their monthly expenses (especially health care!).

All of this seems quite reasonable, so then what could upset the apple cart? It has often been said that the economy doesn't die of old age, but rather is killed by errant policy. We saw a harbinger of this when the Fed decided to raise rates this month and then inform us that they see the need to continue raising rates in 2019. Fed Chairman Jerome Powell's press conference after the meeting on the 19th was not well received, and the markets dropped like a stone into a bottomless pit through Christmas Eve.

What happened next goes into the record books. The markets rose from the opening bell on the morning of the 26th and did not even pause for a glass of water. The day's rise was about 5%. We all thought it was a one-off wonder as the markets sank about 3% on the 27th until 2:30 PM when a rally began and pushed the market up about 1% on the day. As I write, the markets are flat today (Friday the 28th). The broad market indexes have narrowly avoided a 20% drop from September's peak, and riskier areas of the market (like small caps) are in a bear market. Santa Claus finally seems to have appeared out of the clouds, but his gift basket isn't as nice as we hoped and perhaps there are bits of coal in it.

What do we make of all this? While a recession is not on the near horizon, the risks to the economy should still be our prime focus. The Fed's action seems to have been geared towards what they believe is necessary for the economy, and have ignored whatever signals the markets may be sending about the future. While we have lots of positive economic statistics to consider, they may not be very good at predicting the future. The market's signals represent the sentiment of millions of participants, and as investors we cannot ignore them even as we avoid over-reacting to the news of the day.

The prudent course may well be to look at the riskier investments in our portfolios and decide to reduce or even eliminate them as we prepare for what will likely be an uncertain year. While cash is becoming a more attractive investment, core holdings such as large cap U.S. stocks and high-quality bonds should be considered as necessary given that we could still have a decent year in 2019. Market declines are often considered to be harbingers of bad times, but they can be just as unreliable as everything else.

So, what do we do? Out comes the Magic 8 ball...and the little bit with all the sayings on it is stuck. If you were hoping to rely on an oracle for advice, the truth is that there isn't one. It is probably best to make sure your boat is sound and you are well provisioned for the storms, and keep sailing on your course to the future.

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