Bank of New Hampshire
New Hampshire's local bank
WEALTH MANAGEMENT

Private Banking

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A Correction Or A Bear Market?

The average intra-year stock market decline over the past 37 years has been more than 14%. In 2017 the largest decline was less than 3%. Corrections are inevitable and healthy for a bull market to sustain itself. Corrections are generally defined as a stock market drop of more than 10% but less than 20%. When declines reach 20% or more the conventional view is that we would be in a bear market. The market activity of the last few days only proves to confirm to us this is a correction, as bear markets do not typically develop in a matter of days, especially given the backdrop of improving economic fundamentals.

David Letterman always had his celebrity guests share a Top Ten List. They were usually witty and made us laugh. I don't believe this list will be witty or make you laugh; rather the intent is to calm your nerves and help you understand what we are seeing in the economy and markets. I hope it also helps you turn off the TV and not listen to the market "talking heads" that will rile up the conversation to a fever pitch.

Chart courtesy StockCharts.com and RBC Wealth Management

Top 10 Reasons this is just a correction

10. There is still a lot of money on the sidelines. The fear of missing out will soon hit the markets once earnings improve in the first couple quarter of 2018 and the general optimism of Wall Street begins to take root. The small, less experienced investors are always late to the party and, along with the momentum investors, will help carry the bull to new highs because the fear of having missed out on once-in-a-lifetime gains since the last recession will finally entice them into the market that grows ever nearer its top.

9. The Fed and central banks around the globe continue to keep interest rates low fueling more capital spending and higher asset prices. We believe that unless inflation picks up a lot more than it already has there will be little change in policy as central bankers aspire to avoid rocking the economic boat and promote continued growth.

Central bank policy is complicated but we think the doves will win the day and keep interest rates from rising too fast to dent the economic growth. Europe and Japan especially do not want to let loose of the reins until those respective economies are on sounder footing.

8. Employee bonuses. One of the immediate results of tax reform has been approximately three million working people receiving bonuses of $1,000 to $3,000 from corporate America, as a show of support for passage of the bill. This is money that may be used to either spend or pay down credit card balances making room for more spending in the future. We also suspect that wage increases are coming.

7. Small business optimism in the U.S. hit an all-time record in 2017. It appears we are at the beginning of a great resurgence in small business growth. This segment of the economy has lagged for nearly a decade under the rising burdens of regulations. That is all changing as businesses below a certain size are being exempted from many costly regulations that otherwise made starting or conducting a small business prohibitively expensive.

6. The US Dollar has been weakening and looks ready to continue to do so for the foreseeable future. U.S. exports become more affordable to overseas consumer and industrial buyers. The increase in exports of U.S. goods should result in higher corporate profits and cash flows. In addition, the US should experience increased foreign investment with weakness in USD since foreign currencies that have increased on a relative basis will buy more in the U.S.

5. The global economy is growing faster now than a year ago and some laggards of consequence have finally pulled out of recession, namely Brazil and Russia. Most notable is that Europe seems to be growing better as a whole and even Japan is growing again, albeit slowly. But positive growth always helps the average more than contraction.

4. U.S. GDP growth is poised to grow at perhaps the fastest rate in several years. After a decade of GDP growth of 2% or below, the consensus is that the economy will grow above 2.5% and potentially hit near 3% this year. It would be hard to make a case for stocks entering a bear market during a year of strong GDP growth.

3. Inflation should remain low for 2018. With the auto industry sales cycle having peaked and credit tightening, albeit at a very slow pace, inflation should remain tame this year. Stocks usually do well during periods of low inflation and above average growth.

2. Tax reform should help to lower corporate tax rates which should boost corporate profits and in turn bring the current stock multiples back down to earth. The repatriation of overseas cash by U.S. multinationals could bring up to $2Trillion back to the U.S. Corporations will likely use this cash in multiple ways; Stock buybacks, increase dividends, mergers and acquisitions and capital expenditures. The first three can provide direct support to equity valuations, while the additional capital expenditures will add more growth to the economy, a more indirect support to the equity markets.

1. Earnings estimates are rising for 2018. Wall Street analysts are raising earnings estimates for the coming year. Wall Street optimism generally spreads well across the investing spectrum. Forward multiples will begin to appear to be at more normal levels. When the reality of rising earnings sinks in a lot of stocks will start to look cheap or at least reasonably priced.

Conclusion

There are always wild cards to be considered and pondered. First, war can be a wrench in the economic machinery but until one happens the mere threat will do very little to dampen growth. Second, the mid-term election is coming soon. If the economy is humming, unemployment and inflation are tame, and interest rates rise slowly, stocks are likely to reach highs then the probability of the incumbent party being ousted is pretty low.

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The market is due a correction but not necessarily ready to turn bearish. We believe that the case for continuing this bull market advance is stronger than that for an immediate bear market. We could get a correction of more than 10% but we could also get a pull-back of less magnitude. The market needs to take a breath and rest so it can build a foundation from which to launch another leg higher. So, we still believe that the bull market will remain intact.

Over the past year, we have discussed with our clients the possibility of a 5% to 10% correction. Our view is that this would be a normal and healthy event within the context of a continued Bull market. Portfolios are appropriately allocated to meet the unique risk tolerances, time horizons and goals of our clients.

Our long-term outlook has not wavered, neither should yours. Trusting the process and maintaining investment discipline is a key factor to achieving your financial goals. Should you have questions, please feel free to contact us.

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Wealth Management Investment Team