Independence Asset Advisors, LLC

Thoughts on the October Correction

Thursday, November 1, 2018

The sharp correction is causing some to misread the market's message. We believe stocks have returned to fair value as the Fed makes clear its intent to normalize monetary policy. With prices now in line, forward progress will depend on future trends in interest rates and earnings growth.

-Tower Bridge Advisors

Following the substantial increase in stock market volatility over the past two weeks, we wanted to provide a brief update on our current thinking.

As of Monday's market close, the S&P and DJIA were effectively flat for the year but down 9.8% and 8.8% from their prior peaks, respectively. The more technology-oriented and growth-heavy NASDAQ was down 12.1% from its peak, so "officially" in correction territory (> 10% decline).

For context, since the market lows of March 2009, this has been the fifteenth "correction" of 5% or more in the S&P 500. Four of those fifteen declines have exceeded 10%. The chart below, produced by Morgan Stanley, shows the magnitude and duration of these declines and, for the more substantial "corrections," the major catalysts. This illustration can serve to remind us that the long-term, upward sloping trajectory of equity markets is often interrupted.

Catalyst	Begin	# Days to Trough	% Decline	Recovery Date	# of Days from Bottom to Recover to New High
	3/26/2009	4	-5.44%	4/2/2009	3
	6/12/2009	28	-7.09%	7/20/2009	10
	10/19/2009	11	-5.62%	11/11/2009	12
	1/19/2010	20	-8.13%	3/11/2010	31
Concerns about Greece's debt problem	4/23/2010	70	-15.99%	11/4/2010	125
	2/18/2011	26	-6.41%	4/26/2011	41
End of the first round of the Fed's QE program	4/29/2011	157	-19.39%	2/24/2012	144
	4/2/2012	60	-9.94%	9/6/2012	97
	9/14/2012	62	-7.67%	1/4/2013	50
	5/21/2013	34	-5.76%	7/11/2013	17
	1/15/2014	19	-5.76%	2/27/2014	24
	9/18/2014	27	-7.40%	10/31/2014	16
Concern over slowing GDP	5/21/2015	266	-14.16%	7/11/2016	151
Rising rates and bond yields	1/26/2018*	9	-10.16%	8/24/2018	197
	Average	**57**	**-9.2%**		**66**

Source: Morgan Stanley

308 E. LANCASTER AVENUE | SUITE 110 | WYNNEWOOD, PA 19096 | 610.649.9840 | WWW.IAADVISORS.COM

We try to focus on the fundamental issues which may be at play rather than transient price movements. The four most popular culprits for recent market weakness have been:

(1) midterm election uncertainty,

(2) tariffs / protectionism,

(3) higher interest rates, and

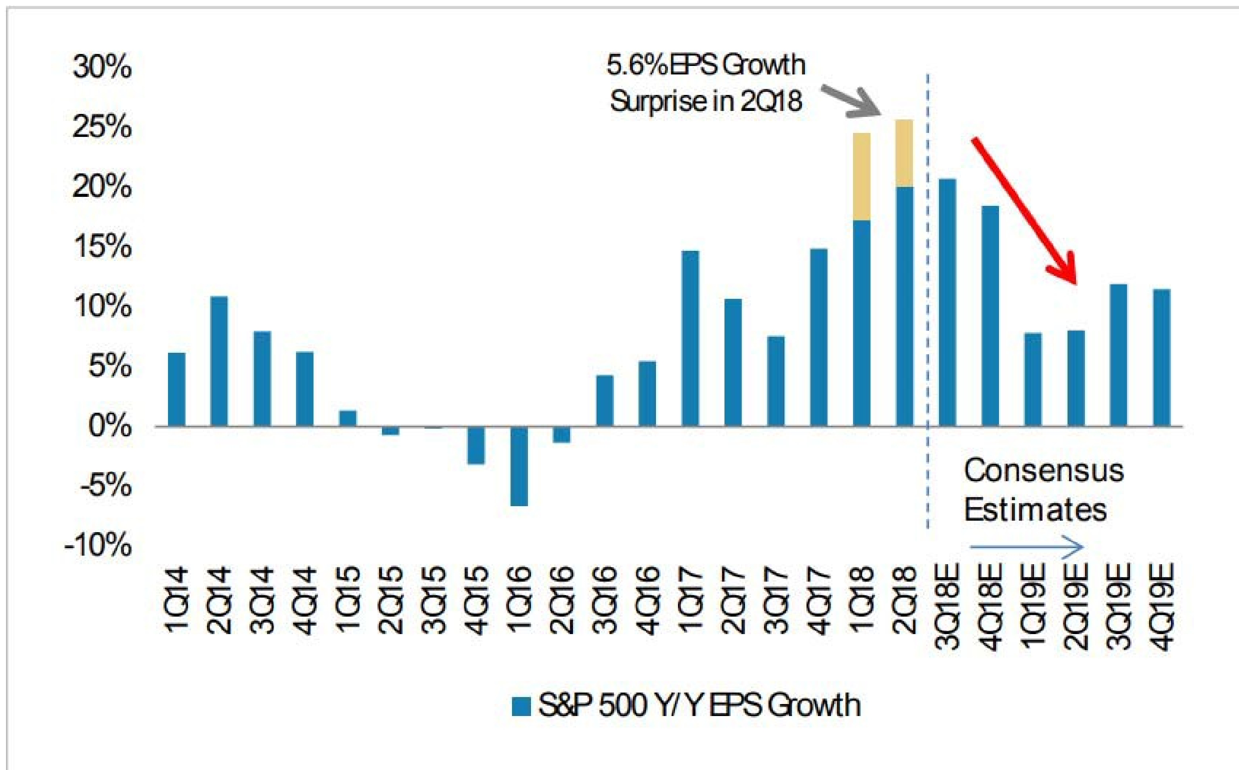
(4) S&P earnings growth.

The first issue is political noise. While politics can have a short-term impact on stock prices, this does not speak to the underlying strength of the economy nor to the long-term trajectory of stock values.

Rising production costs, whether due to inflation, tariffs (or other taxes), or higher funding costs concurrent with interest rate increases, do have an impact on earnings growth, so we tend to focus our attention here. The entire discussion of “rising rates” represents a double-edged sword. Markets tend to perform well when a healthy degree of inflation exists, which signifies a strong economy. Thus, the modest and methodical upward trend of interest rates (especially off a historically low base level) is not inherently bad. However, over time, substantially higher rates do move money away from equities and towards higher yielding bonds, so this deserves our attention. Higher borrowing costs also negatively impact profit margins of borrowers, but they improve results for lenders, including investors.

The pace of earnings growth is the factor we feel will weigh most heavily on equity valuations and prices in the coming months and years. Q2 S&P earnings came in 5.3% higher than consensus estimates and up over +20% year-over-year. We believe this impressive performance may well mark the peak of the trajectory of **earnings growth**, and in fact Q3 earnings reports so far have demonstrated mixed results relative to expectations.

S&P 500 PER SHARE EARNINGS GROWTH



Source: Morgan Stanley

308 E. LANCASTER AVENUE | SUITE 110 | WYNNEWOOD, PA 19096 | 610.649.9840 | WWW.IAADVISORS.COM

Research shows that peak market multiples are typically attained six to twelve months after the peak in earnings growth. If this is correct, the risk reduction measures we took heading into this year, while early, will be helpful as valuations begin to compress and high quality, dividend paying stocks are rewarded.

The overarching issue we monitor closely is the risk of economic recession. There are four reliable recession indicators, most of which flip as economic growth stalls.

(1) inverted yield curve,

(2) declining leading economic indicators,

(3) declining earnings growth, and

(4) widening credit spreads.

Currently, we see only one of these indicators as flashing a warning - declining earnings growth. We look forward to reviewing this data in detail when we conduct our year-end reviews.

In summary, we believe that after several years of strong performance, the market is undergoing a period of consolidation. Equity market valuations are not excessive (post-correction), economic indicators are largely healthy, and investor sentiment is not euphoric. All of these factors suggest that we are experiencing a normal correction in a late cycle bull market. Looking at multiple valuation metrics from an objective point of view, we conclude that U.S. stocks are currently valued fairly. Said another way, the 10% correction may have been quick and painful, but it was rational. Of course, markets and the economy are fluid, and, in recent months, we have been positioning client portfolios to get slightly more conservative should things deteriorate further or faster than expected.

The steep correction has created some individual bargains while other stocks remain overvalued. 85 stocks within the S&P 500 now trade at less than 10x estimated 2019 earnings. I do not know when the FANG correction might end, but I would make the case that some of the more excessively valued names remain overvalued.

Finally, we believe that periods of short-term declines such as these are a good opportunity for us to re-evaluate our risk tolerance levels and rebalance where opportunities exist. As always, we are happy to schedule time for a more detailed one-on-one conversation.

Scott D. Renninger

308 E. LANCASTER AVENUE | SUITE 110 | WYNNEWOOD, PA 19096 | 610.649.9840 | WWW.IAADVISORS.COM