"Late Cycle" Markets

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Late in the summer we sold several fully valued stock positions and kept the proceeds in cash. We had trouble finding attractively valued alternatives, were alarmed about the falling prices in everything except large capitalization US stocks, and worried about the high degree of optimism in the stock market.

The S&P 500 did stumble early in the fourth quarter but has since staged a remarkable recovery and is back in record territory. During the correction we continued to sell highly valued stocks and currently have a fairly sizable cash position. There are several reasons for this stance.

First, a significant portion of long-term equity returns can be determined based on initial valuations. Currently valuations are quite high suggesting long-term returns will be modest. We believe it is time to move from a more passive approach of generally being fully-invested to a more active approach with the goal of improving returns and reducing risk. We have had quite a bit of success with this strategy in the past. Most of our periods of significant outperformance occurred during market downturns.

Second, the important characteristic of stock market volatility is that it clusters. The stock market will go through periods of calm (like the last 2 ½ years) which will encourage investors to take on more risk, eventually undermining the health of the market leading to increased volatility. An example that perhaps rhymes with today's market - after the tech correction from 2000-2002 the S&P 500 rallied impressively for almost five years with very little volatility until February 27, 2007. Investors woke up to the news that the Chinese stock market had plunged by 9% overnight sparking a 3.2% decline in the S&P 500. While both markets recovered quickly that day was a clear signal there was rot in the financial system and was a portent of much more volatility ahead.

Third, ignore the argument that stocks cannot correct while the economy is growing. Recessions are determined after the fact and most economists have trouble recognizing a recession in real time. Ben Bernanke kept assuring us the bursting of the housing bubble would be contained. Many of these soothing pronouncements occurred during what is now known as the Great Recession. Plus, the stock market is a leading indicator for the economy and generally falls before the economy turns down. Most importantly, the excesses in our modern economy are found in financial asset prices not the general economy. Money printing by the world's central banks was supposed to cause massive inflation by this time. However, deflation seems to be the bigger risk today. What happened? There is inflation - it is just not in the real economy; it is in the stock and bond markets. Chances are high the next economic recession will be caused largely in part due to a cooling off of asset prices.

The stock market is unpredictable and it is impossible to forecast market moves with precision. However, we believe the stock market sent a strong signal in October, like it did in February 2007, that the easy money has been made and navigating the volatility of the market will become more important.

