October 20, 2014

Change of the Seasons

Change is in the air. In the Midwest, the days are getting shorter, the nights cooler and the leaves on the trees are changing color. It is beautiful and the Kansas City Royals are in the World Series for the first time since 1985. It is a great time to be in Kansas City.

The world's stock markets are also changing. For some time, we have been calling for a correction in stock prices, as the last 5%, 10% or 20% decline had occurred quite some time ago. We were holding the view that it was not whether a correction was going to eventually occur – but when the correction would occur. Well, now we know. From the highs registered on September 19th at 2019, the S&P 500 Index corrected by 7.8% through the close last Thursday.

The real price declines haven't occurred in the U.S. – but rather in the foreign markets. The "big four" foreign equity markets have all underperformed the S&P 500 during the current swoon. Frankfurt's market is down 14.4% from its high, Paris is down 14.7%, London is down 9.9% and Tokyo has retreated by 10.0%. From a pure valuation standpoint, the European markets appear cheap.

Is there More Downside to Stock Prices?

As many are aware, stock market history shows that the old saw – "Sell in May and Go Away" tends to work more often than not. This old saying reflects the fact that the stock market, on average, has struggled from May through October. Historically, the period of September through October has been a very scary time for the market. This year is proving to be no different.

Now that we have had (or are having) our correction – what normally follows a weak October period?

Another very strong tendency is for the market to generate strong returns during the months of November and December following a negative return in October. Below are some data points which market historians may find useful. The data reflects PRICE ONLY returns for the Dow Jones Industrial Average from 1945 to 2013.

- Number of times ***stock market was down during the month of October***: 27 (40% of observations).
- Dow Jones ***price change when the index return was negative***: -3.73% (so far this October, the index is down 3.9%).
- Number of ***positive returns during the period of November – December, following a negative return during October:*** 24 out of 27 occurrences – a batting average of .890!
- Average ***return during the noted November – December timeframe***: +4.02%.
- Number of ***positive returns during the November – April timeframe following a negative return experienced in October***: 23 out of 27 occurrences – a batting average of .850!
- Average ***return during the following November – April timeframe***: +7.01% - again, this is a price only return and does not include dividends.

Now, to answer the question raised above – is there more downside to stock prices as we move forward? Perhaps. But, history shows the stock market normally rallies following a poor showing during the month of October.

Growth "Scare"

Some are asking why the world's stock markets have corrected in value – Ebola? The Ukraine? ISIS? In my opinion, all of these factors have had an impact on the current market environment, but I believe the real driver of why the markets have corrected has to do with the fact that the world is

starving for growth. We, too, share these concerns as we highlighted the growth issues in our piece last week, entitled "Correction". You can find this piece at www.firstpointfinancial.com.

The U.S. is currently one of the stronger performing major economies, as Europe teeters on another recession and China's economic growth continues to slow. ***This is the fundamental reason many are giving as to why the world's stock market prices have been contracting. Oil prices have come down dramatically from their highs –some are saying in reflection of weakening oil demand. We are not yet convinced that oil price weakness is specifically due to a downturn in demand. If there hasn't been a major downturn in demand – but rather an increase in supply – which has driven oil prices lower, then perhaps the current growth concern is actually a growth "scare" rather than an outright growth shortfall.***

Oil Price Decline

Some say the world's economic slowdown is reflected in oil prices – or that weakness in oil prices *confirms* global economic weakness***. Commodity price weakness can, of course, occur due to one of two reasons – demand is declining or supply is rising***. If overall economic weakness was occurring on a sustained basis, demand would be falling for oil. This would lead to the lower oil prices that we are currently witnessing. On the other hand, if oil supplies were rising more rapidly than the world's energy users demanded, oil prices would too be falling.

While this issue will seem to be a technicality to some, in reality understanding and uncovering ***why oil prices have been weak leads to different conclusions about overall global economic growth.*** Below are changes of various energy and industrial commodity prices over the last 3 months:

Commodity	Price Change – Last 3 Months
Crude Oil	-19.2%
Heating Oil	-13.7%
Unleaded Gasoline	-17.7%
Average Energy Commodity Price Change	**-16.9%**
Copper	-4.6%
Lead	-6.2%
Steel Billet	+7.5%
Zinc	+2.3%
Aluminum	-1.0%
Average Industrial Metals Commodity Price Change	**-0.4%**

Notice that over the same period of time, while energy prices have declined by almost 17%, industrial metals have barely budged. ***If indeed the world's economies are slowing as rapidly as some believe to be the case, why aren't all commodities falling in price? One would think that if the reason oil prices are falling is due to a decline in the demand for oil due to an economic contraction, then prices for all industrial commodities would be following suit.***

This variance in pricing activity leads me to wonder if the real reason oil prices are declining has to do with a surge in the supply of oil instead of economic weakness. If true, this is likely due to increased drilling activities in the U.S. and other areas of the world and not necessarily to a rapid decline in the demand for oil.

Now, what does this mean for investors? The current rationale many market pundits are giving as to why stock prices have been weak is due to the sharp slowdown in economic activity in Europe and in China. Frankly, simply looking at a market-basket of industrial metals prices, you wouldn't see evidence of a significant global economic slowdown. Therefore, the current economic slowdown may not be as sharp as some currently believe. If this proves to be the case, adding to equity positions in various markets may make sense at this time. Please talk with your Wealth Advisor prior to making any decisions regarding your current or planned exposure to any asset class.

Just For Fun

As noted at the beginning of this piece, this is the time of year for change. This past weekend, my wife, Pam and I made a quick trip to her hometown of Carthage Missouri, attending their Maple Leaf festival, which is replete with high school marching bands and floats. A true slice of Americana.

Carthage is in southwest Missouri and, at one time, was the home of more millionaires per capita than any other town in the U.S. The original wealth in Carthage was the result of mining activities in the early-to-mid 20th century. Carthage has block after block of restored, old Victorian-age houses, gingerbread and all. For those of you without the colors of the fall season, I have included scenes from Carthage. Oh, you guessed it – my wife, Pam, took these pictures – Enjoy!

We will be back next week.

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