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TRANSITIONS

IRRATIONAL EXUBERANCE REVISITED

In 2019, there was no shortage of market headwinds. The year started off with talk of a global recession. Then we began a trade war with China, the world's largest trading partner. Add to this a politically weakened President being impeached, and the markets were set up for a bona fide correction. If not, then at least some volatility. Yet there were no real material pullbacks in 2019. The opposite happened, with the markets rising nearly 29% for the year.

The impact of deregulation and tax reform certainly helped the market. Another important component was the Federal Reserve abruptly changing monetary policy. From increasing rates in an attempt to normalize interest rates, they switched to reducing interest rates to avoid a recession. Although this move lowered borrowing costs for companies, it also harmed investors relying on fixed income securities for a return.

Herb Diamant
PRESIDENT & SENIOR PORTFOLIO MANAGER

Are we seeing irrational exuberance? Have investing dynamics changed so markets no longer decline? Anyone whose investment experience has been limited to the last ten years would answer yes. They simply put cash in stocks and they always go up....until they don't. Unfortunately, a number of younger investment managers, who handle large individual and institutional portfolios, have never experienced a market correction. It will be most interesting to see how they collectively react to a real pullback.

The real value of decades of investing experience is the wisdom earned during market declines. The objective then is more towards preserving capital. There are several approaches we use. One method is to avoid chasing stocks. Several high-flying stocks moved 50% higher in price over 2019. This would make sense if they discovered a cure for cancer, developed a new business model, or their revenues and earnings were moving 50% higher. Yet most of price moves were more about everyone

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deciding to buy the stock at the same time.

Another method is to look for fairly valued stocks. Stocks with high Price/Earnings ratios (P/E) are vulnerable to sharp corrections in price. When a correction occurs, and the markets reflect a Price more in line with their Earnings, these stocks drop fast. When a stock is trading with P/E of 100 and the market adjusts the stock to a 40 P/E, assuming earnings remain constant, the stock price would decline by 60%. We generally avoid buying such highly valued stocks, because it is always better to buy them on sale. This takes patience, but this is where wisdom is so important in the business of investing portfolios.

As we look ahead to 2020, we remain bullish on the U.S. economy. Yet we also expect some market volatility, along with more modest and normal 5% to 7% investment returns, as we navigate what most surely will be an interesting election year.

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Visit our Resource Center for more market commentary and insights.

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