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Market plunges in early February after surging at start of '18

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After a 19-month melt-up, the equity market had a stunning start to the New Year. The market experienced a trifecta, beginning with the "Santa Claus rally" during the seven-day stretch that ended Jan. 3, continuing with a rally in the first five days of 2018 and on through January, when the S&P index gained 5.62 percent.

A market axiom is that past performance is no indicator of future success. However, 29 times since 1949 all three of those events have occurred in January, and 90 percent of the time the market rose in the final 11 months of the year. The average gain was 12.9 percent.

Support for the market gains have come from a worldwide surge in growth, a weak dollar and strong earnings reports in the U.S. The U.S. manufacturing index is above 50, which signals an expanding economy. Employment numbers are growing, and wages are expected to follow. Unemployment is at historic lows, suggesting that consumer confidence will remain strong. Gross domestic product growth is expected to be around 5.6 percent – well in excess of the 2 percentish growth that we have had for years.

But wait! Didn't the market hit a stumbling block and start February on a down note? What's that all about? It is about the already jittery market getting jitterier.

First there was the Trump State of the Union address. As the address approached, investors began to worry about what would be in the speech. Fortunately, the speech was largely benign, and the market rallied.

But then there was the Federal Reserve meeting. The Federal Reserve was transitioning leadership from slow and steady Janet Yellen to a new person who has yet to establish his policies. His policies are said to be like Yellen's, but if so, why replace her? The Fed kept rates steady, but noted concern over inflation.

Interest rates surged even though the Fed announced no change. Still, the hint of inflation made the bond markets nervous. Add to that the fact that deficit spending has caused the Fed to have to sell more bonds (a lot more than usual) and short maturity bonds because long maturities are more expensive.

Additionally, a fairly accurate contrary indicator is the amount of money flowing into the markets. January saw very heavy inflows. Retail investors, who usually get it wrong, were investing.

The recent tax package possibly will result in a $1.5 trillion deficit over 10 years, and the markets are having difficulty adjusting. Furthermore, the president proposes a $1.5 trillion spending package for infrastructure, adding more fuel to the inflation and deficit spending fire. The self-styled "King of Debt" has found a way to stimulate the economy at the expense of the future. The need for more bonds, deficit spending, and budget busting spending has caused interest rates to rise, spooking the stock market. The strong employment numbers were seen as inflationary. Investors saw the good news as bad news, as expectations for more and faster rate increases permeated the market.

All of this has frightened investors and caused an air pocket. But we believe it is temporary and even overdue. It is also a dose of reality. While these setbacks can cause anxiety, they are also constructive. Six months from now they will be forgotten.

The State of the Union address signals the start of election season. The midterm elections will be on us before we know it. The jockeying for positions has already begun. The number of incumbents deciding not to return to Congress is near an all-time high; the only time it was higher was the end of World War II. Currently, the Republicans have a 45-seat majority in the house, but already 40 Republicans have said they will not run. That doesn't mean Republicans will lose all 40 seats; indeed the electoral map favors the Republicans. Still, the president has offended enough voters that there is an energized opposition ready to vote his supporters out.

The Russian investigation is in the background and affecting the whole process. At this point it is hard to know the election outcome, but it's clear that if the Democrats take back the House, an impeachment proceeding will begin. If the Republicans hold the Senate, the impeachment will likely fail, but Richard Nixon had to resign in the face of opposition even from his own party. The Republicans have only a one-seat majority in the Senate now, so it is not impossible for the Senate to flip too. If the president has to rely on a vote or two to survive, he may find that he has offended too many people.

Through it all, when considering all investment choices, the equity market is still the best place to be.

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