DJC
THE DAILY JOURNAL OF COMMERCE, PORTLAND, OREGON

William Rutherford

Red October: market shrugs off positive earnings

Published November 9, 2018

October is a notoriously difficult and volatile month from an investment point of view. This October was no exception, with the market down 6.8 percent on the month – the biggest monthly drop since 2008.

The October effect, according to Investopedia, is a theory that stocks tend to decline during the month of October. It's considered mainly to be a psychological expectation rather than an actual phenomenon, because most statistics go against the theory.

Some investors may be nervous during October, because that is when some large historical market crashes occurred. They include the Panic of 1907, Black Thursday (1929), Black Monday (1929), Black Tuesday (1929) and Black Monday (1987). The latter crash, which occurred on Oct. 19, 1987 and saw the Dow plummet 22.6 percent in a single day, is arguably the worst single day. (See reference in my book "Who Shot Goldilocks?") The other black days, of course, were part of the process that led to the Great Depression – an economic disaster that stood unrivaled until the mortgage meltdown nearly took out the whole global economy with it.

The October effect is overrated. Despite the dark titles, this seeming concentration of days is not statistically significant. In fact, September has more historical down months than October. From a historical perspective, October has marked the end of more bear markets than it has the beginning. This puts October in an interesting perspective for contrarian buying. If investors tend to see a month negatively, it will create opportunities to buy during that month. However, the end of the October effect, if it ever was a market force, is already at hand.

What is true is that October has traditionally been the most volatile month for stocks. According to research from LPL Financial, dating back to 1950, there are more 1 percent or larger swings in the S&P 500 in October than in any other month. Some of that can be attributed to the fact that October precedes November, when elections take place in the U.S. Indeed, in the current month the market had swings of 1 percent or more as many as four times in a single day.

Some historical market sell-off events have fallen in the month of October, but they have mostly stuck around in the collective memory because Black Monday sounds ominous. Many investors today have a better memory of the dot-com crash and the 2008-09 financial crisis, yet none of

those days were given the black moniker for their particular month. The Lehman Brothers collapse happened on a Monday in September and marked a large increase in the global stakes of the financial crisis, but it wasn't reported as a new Black Monday. For whatever reason, the media no longer labels sizable downward movements of the market as black days, and Wall Street doesn't seem eager to revive the practice either.

Moreover, an increasingly global pool of investors doesn't have the same historical perspective when it comes to the calendar. The end of the October effect was inevitable, as it was mostly a gut feeling mixed with a few random chances to create a myth. In a way, this is unfortunate, because it would be wonderful for investors if financial disasters, panics and crashes occurred only during one month of the year.

The sell-off was long anticipated, but the precise time unknown. Was it a correction or the beginning of a bear market? According to Morgan Stanley, over the past 65 years sharp sell-offs are the hallmarks of run-of-the-mill corrections (drops of between 10 and 20 percent). On average, recovery follows within six months and a market rally occurs within a year. Conversely, bear markets typically start with gentle drops. If history is any guide, the bear market, when it comes, will start with a whimper.

What are the reasons for this sell-off? The market has been facing many headwinds, which is normal. Principal among them are rising interest rates, trade conflicts, a strong dollar and general uncertainty. In addition, the sheer volume of algorithmic trading of index funds and ETFs adds to market volatility.

It has often been said that bull markets do not die of old age; they are murdered by the Fed. Our current bull market is one of the longest in our history. There is no certain life span for a bull market. Australia currently has a bull market that has lasted 27 years, but rising interest rates could hasten the end.

However, this is not the end of the rising market. Interest rates are increasing, because they have been historically very low for a very long time. The economy is currently strong, with GDP growth of greater than 3 percent, rising employment and wages, and strong consumer confidence. With consumer spending accounting for 70 percent of GDP, the consumer has the wind at its back. Inflation, though benign, is knocking on the door. So the Fed has every reason to raise rates; the pace is what is worrisome.

Rising interest rates mean a rising dollar, which makes sales of U.S. products in global markets more difficult, and we are witnessing a slowing in international revenues.

More worrisome are the continued trade tensions with our usual trading partners, and especially China. The market has shown its sensitivity to this issue by reactions to pronouncements or tweets by the president. Each time some news comes out, the market gyrates. Eventually we will get through this turmoil, but it cannot come too soon. Trade tensions are self-inflicted and can be resolved at any time.

The elections created another form of uncertainty, but that is behind us now with the Democrats winning control of the House.

With the earnings outlook still strong, GDP growth and a strong consumer base, the economy and the markets should continue on an upward trajectory, in spite of occasional setbacks. The Fed, while no longer “accommodative,” is only one rate hike from a policy accident. We are sure they know it.

In the meantime, the market is priced lower and the price earnings ratio is lower. Some observers may view this as a buying opportunity.

William Rutherford is the founder and portfolio manager of Portland-based Rutherford Investment Management. Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com. *Information herein is from sources believed to be reliable, but accuracy and completeness cannot be guaranteed. Investment involves risk and may result in losses.*