Stocks' recovery from December massacre holds important lessons

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The following is an excerpt from Kirr, Marbach & Co.'s first quarter client letter, available at www.kirrmar.com.

"Way back" in December, stock prices collapsed as investor anxiety reached a fever pitch over the Federal Reserve raising short-term interest rates too quickly, the threat of a tariff spat with China morphing into a full-blown trade war and the inability of our political leaders to prevent a government shutdown.

As always, the financial media was quick to fan the flames of panic with headlines screaming about December 2018 being the worst December for stocks since the Great Depression, Christmas Eve being the worst in history and 2018 the worst year since the Global Financial Crisis a decade ago.

Fortunately, after witnessing the S&P 500 plummet 6.2% from the December 19 announcement of the fourth rate hike of 2018 and signal of 2-3 additional hikes in 2019 to December 24, Fed Chairman Powell performed an abrupt 180 degree turn by first assuring investors the Fed is "listening carefully to the markets" and then indicating no further increases in 2019. Investors were cheered this will be a pause that refreshes. Additionally, a long-awaited trade deal with China could be imminent.

The doom and gloom headlines from December turned suddenly ebullient in the first quarter as the S&P 500 posted its best performance since the third quarter of 2009 and strongest first quarter since 1998. The Wall Street Journal trumpeted ***"Stocks Post Best January in 30 Years"*** to ***"Stocks Set Torrid Pace to Open Year"*** and finally ***"Stocks Surge to Cap Banner First Quarter."***

Understand ***stock prices fluctuate wildly, but the underlying business valuations don't.*** According to Crandall Pierce, Corrections (drops between 10-20%) and Bear Markets (drops > 20%) occur once every two years, on average, so are part of the normal investment landscape. The frightening drop of -19.78% for the S&P 500 between the peak on September 20, 2018 and December 24, 2018 was the 37th such occurrence since 1945. There will be a 38th, but nobody can tell when it will happen.

If you had taken a 6-month nap from the end of last September through the end of March, you'd find the S&P 500 had declined less than 3%. You would have missed the panic in December and rocket ship rebound in January-February. In other words, you would have witnessed very little fluctuation.

This teaches us an important lesson. ***If we aren't comfortable with the amount of fluctuation in our investments, the best thing we can do is stop looking. We may not be able to control the amount of volatility in the markets, but we can control how much we experience. It is simply a function of how often we look.***

As Sir Edmund Hillary said, "It is not the mountain that we conquer, but ourselves."

When trouble appears, pundits are quick to pour gasoline on the fire. Don't fret, it's what they do. You don't get mad at a dog for barking.

The most recent example was the yield curve inversion that occurred on Friday, March 22, which unleashed an immediate 2% decline in the S&P 500.

The yield curve plots the yield on U.S. Treasury securities from shortest- (like 3-months) to longest-maturity (like 30-years). ***Most of the time***, the yield curve has a positive slope, which means longer-maturity securities have a higher yield compared with securities with shorter-maturities. When the economy is growing, investors holding longer-maturity securities assume increased risks of inflation, which can lead to the Fed raising interest rates.

Bond prices go down when rates go up and the longer the maturity, the more sensitive the price is to a change in interest rates. It's confusing, but trust me.
Occasionally the yield curve "inverts" as long-term rates fall below short-term rates. This occurs when investors believe the economy is slowing, leading to expectations for lower inflation and the Fed reducing interest rates. The reason this is important is many investors view inversions as infallible predictors impending economic recessions. They're not.

While it's true each of the seven recessions since 1962 was preceded by an inverted yield curve, there were also instances when an inverted yield curve was ***not*** followed by a recession. Not only can an inverted yield curve prove to be a "false positive," it tells you nothing about how long it will be until a recession appears (typically 9-24 months) nor the severity.

Human nature is to seek simple answers to complex questions. As legendary investor Paul Samuelson said about another fallible indicator (stock prices), "the market has predicted nine of the last five recessions."
