MID-CONTINENT CAPITAL

CONSILIUM*

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*advice; judgment; resolution; wisdom

That's Shocking

Investigations by special prosecutors, failed health care reform efforts, White House staff firings, social unrest, and threats of nuclear war…. The US equity market saw it all this summer and proved incredibly durable, falling just 2.95% at its worst, and generating a 4.5% total return for the quarter just ended. Despite an array of news events that might normally be expected to move the market meaningfully in the short term, the S&P 500 index has failed to move down or up by as much as 2% in a week for 41 consecutive weeks – the third longest such streak in history. And the month of September, which is the only month of the year with a negative average return historically, ended as the quietest September ever in terms of average daily volatility. As the month closed, all major US stock market indexes were at or near all-time highs.

Even if you are a skeptic, the 2017 stock market can only be described as "resilient".

But one day, some news event that is not currently being discussed will upset the market's calm and generate a price "shock". The latest consistent worry is North Korea – and indeed, news from the Hermit Kingdom has generated some frequent market indigestion recently. But the fact that it is the source of so much speculation actually makes it less likely to be the cause of a meaningful selloff.

A price shock is a significant short-term market reaction to an unexpected external event, and they are surprisingly common, particularly in response to economic news. However, the biggest shocks typically follow geopolitical events, such as the election of Donald Trump or Brexit.

Negative price shocks are much more common than positive price shocks, simply because fear is usually a more strongly motivating emotion than greed. Further, the majority of investors are, by definition, "invested" in the markets – not short, nor holding gigantic cash balances. If they are to be shocked into any action at all, the likeliest action investors could take would be to sell.

Although predicting price shocks is impossible, predicting the market's response is more straightforward: by the time the most highly motivated sellers have done their damage, over the course of a day or two, there is little additional selling left to do. Therefore, most price shocks tend to end surprisingly quickly (considering the magnitude of the news events that generated them) and are followed by a substantial reversal. This suggestion is supported by numerous studies, the most recent by Ned Davis Research and LPL Financial, which showed that short-term price shocks following "crisis events" since 1950 (minimum price reaction of 2%, and average price decline of 5.6%) were followed, on average, by price gains of 9.5% and 14.7% over the subsequent 26- and 52-week periods. These returns are well above normal performance for those time frames.

It's important to note that how well the market rebounds from a price shock depends heavily on economic conditions at the time – a price shock during a recession is less likely to generate an immediate rebound than one occurring during an economic expansion. For this reason, **investors are much better served by focusing on economic and business fundamentals than by attempting to predict the unpredictable.**

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If price shocks are inevitable and random, but have a history of creating good buying opportunities, how should you prepare? The answer is: diversify, hold some cash, and buy if you are able. If you have 100% of your investable assets in the equity markets, you are highly likely to experience a price shock that will test your nerves. Therefore, it is always appropriate to maintain some high quality fixed income holdings, as well as cash, no matter how robust the stock market outlook might be. Short of this option, a wise long-term investor must (1) recognize that price shocks are unavoidable other than via sheer luck; (2) understand that they are part of the volatility that must be endured to earn good returns; and (3) prepare for them by considering how they might respond emotionally to a few stomach-churning days of declines.

Under all market conditions, Mid-Continent Capital will continue to focus on investing in strong companies with good potential and safe, dependable fixed income instruments, in an appropriate asset allocation – the approach we have employed for clients since 1983 to generate solid long-term results with acceptable risk.

Sources: The Wall Street Journal; LPL Financial; Ned Davis Research; S&P Global