Market Pulse Report

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PATHSTONE
FEDERAL STREET

SUMMARY

It wasn't that long ago that computing power grew to such a level that it enabled the "Moneyball" era, a reference to modern statistical analysis used in baseball to identify the most valuable players. Can this approach work in predicting financial market outcomes?

In baseball, the decisions made based on a player's statistics are unlikely to alter the player's success. However, in financial markets, the actions of humans and machines (artificial intelligence) do impact market results. New data and interpretations emerge every day to tempt and challenge investors. Having a disciplined process is critical to long-term investment success, avoiding the Siren's song of the latest news headline.

International Herald Tribune, October 27, 1989, Kal, Cartoonists and Writers Syndicate, 1989

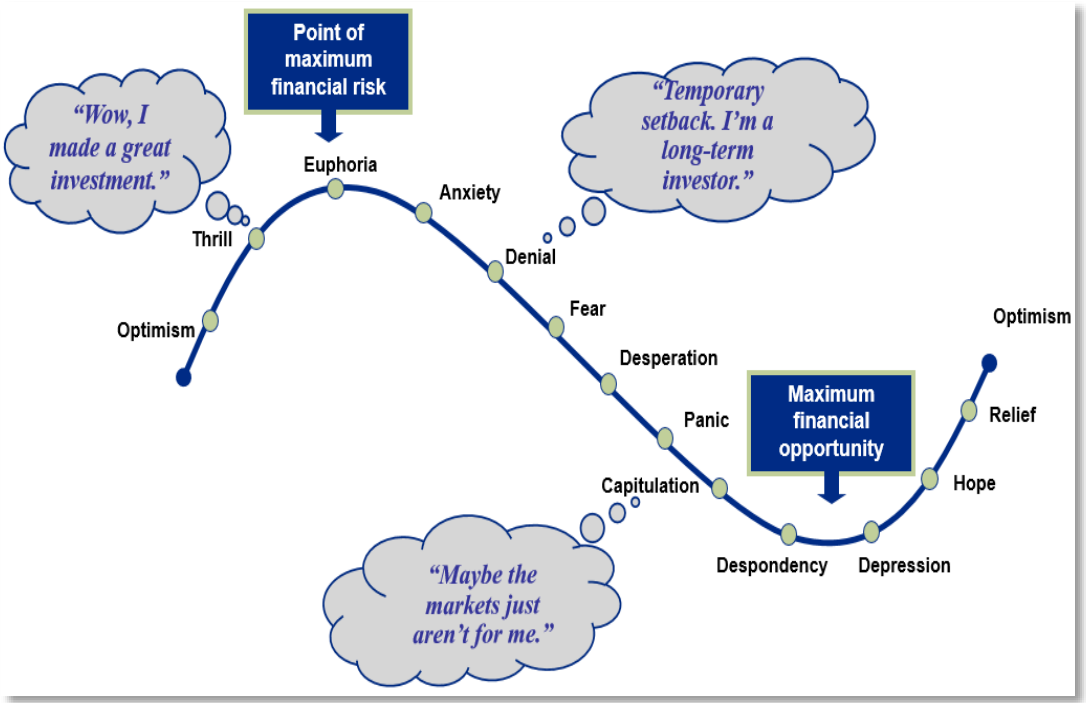
Avoid Being the Emotional Investor

We have not experienced a negative monthly return (total return) in the S&P 500 Index since October 2016, when the S&P 500 slid 1.82%. It has been a great run in the equity markets, despite a lot of teeth gnashing over valuations. In fact, our U.S. market cycle dashboard which evaluates five factors: economic, credit, valuation, momentum and sentiment, have had a negative reading for valuation factors dating back to October 2013. Mind you, the S&P 500 is up more than 71% since our valuation reading went negative.[1] While it is not so rare for us to see expensive markets get more expensive, what would be rare is if the S&P 500 Index were able to generate a positive return in December, thereby making it the first calendar year in 92 years[2] to have experienced all positive monthly returns. Typically, only about 60-65% of months tend to result in positive returns for the S&P.[3]

What is the significance of such an event? Nothing really, but it can entice investor psychology to lean one way or another. The average investor's returns tends to fall well below average market returns. Why? Because the average investor tends to act emotionally to volatility, panicking and selling when market is low, and buying when it is high. Successful investors take the opposite side of that trade.

In his seminal work "A Random Walk Down Wall Street," Burton Malkiel claimed that short-run changes in stock prices are unpredictable. Despite Malkiel's observation, investors continue to look for patterns in the market that they can capitalize on. Evidence suggests that most investors make the same mistakes over and over—in other words, reacting to the data, usually to their own detriment.[4] This highlights the need to have a thoughtful and repeatable process for making decisions in order to ensure you are prepared for whatever the market throws at you. This is not to say that there is only one right way to invest for success, but rather that it is critical to establish a discipline and stick with it.

The below diagram illustrates the emotional state of an average investor in response to a typical market cycle.



Barclays "Cycle of Investor Emotions"

For us, the process begins with our evaluation of the risk of recession. Why recession? Because the most common factor tied to bear markets (declines of 20% or more) is a recession. Yes, there can be other factors such as the Federal Reserve Bank tightening monetary policy too quickly or a commodity supply or price shock, but almost all bear markets are associated with a recession. Just as it is hard to believe (and predict) that 2017 could be the first calendar year in nearly a century to enjoy positive returns in all twelve months, it is equally difficult to predict and adequately time market corrections (declines of less than 20%) in order to make a meaningful difference in a portfolio.

How do we attempt to identify periods where there is a heightened risk of recession? We use a 36 factor, Market Cycle Dashboard, which is segmented in five categories: economic, credit, valuation, momentum and sentiment (See Chart Below). We evaluate the aggregate score of the 36 factors. The bottom-line today is that despite heightened valuations, all of the other factors remain supportive of continued economic growth. With the anticipated tax reform measures to top it off, 2018 is shaping up to be another solid year from an economic standpoint.

	Prior Month	Current Reading	Notes
Economic Factors	Bullish	Bullish	Despite tax cut delay, economy is looking healthy
Credit Factors	Bullish	Bullish	Yield curve flattening but remains positively sloped
Valuation Factors	Bearish	Bearish	Elevated valuations not a great timing tool but can magnify downside risks
Momentum Factors	Bullish	Bullish	Price uptrend is firmly entrenched for most equity segments
Sentiment Factors	Bullish	Bullish	Sentiment is positive; consumer confidence is soaring
Overall Market Cycle	**Bullish**	**Bullish**	Volatility may return, but stable economy & robust corporate earnings should provide support for stocks

Pathstone's Market Cycle Dashboard – 5 Categories

Despite 2017 having a chance to be the first calendar year to post positive monthly returns in all twelve months in the last 92 years, available data shows it won't be the longest winning streak for the S&P 500 Index[5]. In fact, we are in the midst of the fourth winning streak over that time period that has lasted for 12 or more consecutive months, with the longest being 15 months from March 1958 to May 1959.

Markets can produce some interesting results in the near term, many of which are not easily predicted. Over time however, markets tend to converge towards historical norms. As long-term focused stewards of multi-generational wealth, we want to remain focused on our discipline and avoid the Siren's song of the once-in-a-hundred-year type of event. It is easy to get caught up in the near term excitement of the markets, but we must remember that the most successful of investors tend to build wealth consistently over long periods of time, taking advantage of opportunities created by those that do not exhibit the same patience.

[1] Analysis is based on data available from Standard and Poor's.
[2] What is known today as the S&P500, was established in 1923 and included very few companies. At the time it went by the name "Composite Index". In 1926 the index was expanded to include 90 companies and in 1957, 500 companies. Since 1926, there have been no calendar years, in which the index has returned all-positive returns, (pending 2017 results).
[3] Standard and Poor's data
[4] Quantitative Analysis of Investor Behavior (QAIB), 214, DALBAR, Inc.www.dalbarinc.com. Average equity fund investor and average bond fund investor performance results are based on the DALBAR 2014 QAIB study. DALBAR is an independent, Boston-based financial research firm. Using monthly fund data supplied by the Investment Company Institute, QAIB calculates investor returns as the change in assets after excluding sales, redemptions and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses and other costs. After calculating investor returns in dollar terms, two percentages are calculated for the period examined: Total investor return rate and annualized investor return rate. Total return rate is determined by calculating the investor return dollars as a percentage of the net of the sales, redemptions, and exchanges for the period. Hypothetical balanced Investment based on the performance of an investment weighted 50% to the S&P 500 index and 50% to the Barclays Aggregate Bond Index and rebalanced monthly. Equity benchmark performance is represented by the Standard & Poor's 500 Composite Index, an unmanaged index of 500 common stocks generally considered representative of the U.S. stock market. Fixed income benchmark performance is represented by the Barclays Aggregate Bond Index, an unmanaged index of bonds generally considered representative of the bond market. Indexes do not take into account the fees and expenses associated with investing, and individuals cannot invest directly in any index. Performance of an index is not Illustrative of any particular investment. Past performance is no guarantee of future results.
[5] Standard and Poor's data