The Fast and the Furious Market Correction of 2018

By Bob Deitrick, CEO
February 20th, 2018

The recent resurgence in market volatility over the first week of February sent shock waves through the markets after what was a year of non-existent instability and a very low VIX. In fact, 2017 was the first year in history where the market appreciated in every single month of the year.

<u>The VIX shot up to multi-year highs over the past two weeks and the DOW briefly entered a correction zone – one we expected and one which was needed, in our view, as well…</u> But as <u>Fast and as Furious</u> as this correction was, volatility retreated over the past week and stocks rebounded, with the S&P 500 and the NASDAQ having produced their best week last week since the fall of 2011.

A shift in sentiment has clearly occurred; albeit in our view, the underlying fundamentals to this market rally and to our economy have not changed. We remain undaunted. We believe the speed with which the VIX has normalized is significant as this appears to be a similar dynamic we experienced in the late '90s – a phenomenon known as the "<u>market-up/volatility-up dynamic.</u>"

For those who remember the late '90's, P/E ratios were, relatively speaking, high then. Nonetheless, money managers poured money into stocks for fear they would lose out to their peers if they did not act. If energy returns to stocks this year, which we suspect will happen, we could see a <u>melt-up rally</u> which is where the market goes up simultaneously with increased volatility…

We at PFP suspect that the VIX will normalize back to the low teens over the next few weeks as we enter March. The <u>VIX, also called the "fear" index,</u> has already sunk from over 30 last Monday to below 18 last Friday. If the VIX normalizes rapidly, as it appears to be doing, a market-up/volatility-up dynamic could materialize. Indeed, this has occurred before.

Some experts and market participants appear to be worried about the recent rise in interest rates. The yield on the benchmark 10-year Treasury note is closing in on 3 percent, a psychologically significant level not seen since late 2013.

We at PFP are not worried about this rising rate dynamic to the extent the rise in rates remains gradual. Higher interest rates simply indicate that rates are normalizing and that our economy is prospering – so this is not a negative. Research shows that rising rates have not been a negative for equities over the intermediate-to-long term, so this is not a major concern to us. Keep in mind that the 10-year note ranged between 6 and 8.5 percent in the late '90's when we experienced one the most inspiring market moves in our history. The 10-year treasury is far below those numbers today.

The Equity markets have been higher over the past six trading days. As stated, this correction is quite similar to one we experienced in the late '90's. Steven and I are cautious, yet we remain very optimistic for 2018...

Our primary concern to the market is tangential. We are more concerned about the Sesame Street-like events taking place in Washington more so than what is happening with the economy. Our nation's economy is strong, and that will likely remain the case given the tax law now in effect. Earnings on the revenue side have been very solid this quarter and now with tax cuts in place, those earnings will be turbocharged as we get further into 2018.

It is clear to us today what sectors appear to be compelling this year. Here are our predictions for 2018:

- *PFP will be trading out of the dividend proxy sectors which we expect to underperform in an interest rate inclining environment. So, utilities, consumer defensive and staples, dividend and value stocks and real estate will be reduced from our client accounts.*
- *In 2018, we will over-allocate to the financial sector including insurance company and brokerage stocks, consumer discretionary stocks, media and telecom, the tech and biotech sectors as well as health care stocks. We also will over allocate to the international large-cap space this year as well.*

Please do not be surprised if the stock market does re-test the bottom or the 200-day moving average again over the next few weeks. We may not be out of the Cowardly Lion's Forest of Wild Beasts yet, but we are certainly getting closer to seeing the Emerald City. We hope you can attend one of our seminars at Eddie Merlot's coming up in March:

- ***A Wednesday Dinner, March 21st at 6:15 p.m. at Eddie Merlot's***
- ***A Friday Luncheon, March 23rd at 12:15 p.m. at Eddie Merlot's***

Please RSVP to Jace Dodge or to Steven Morgan. And please call us to the extent that any questions arise once reading this letter. We realize how frustrating these volatile events can be and Steven and I are here to talk about these occurrences with you. Having said that, please consider that the market needs to let some air out of the tires on occasion, and these bouts of volatility are part of a healthy bull cycle. Have a terrific President's Day Week as we commemorate two of America's great leaders, George Washington, and Abraham Lincoln. I must admit that I am glad they cannot see what is transpiring in our nation's capital today.