Kennebec Savings Bank
Investment Management & Trust Services

CAPITAL MARKET COMMENTARY

December 21, 2018

An Ebenezer Market

Just in time for the holiday season, stock markets around the globe have done their best Ebenezer Scrooge impression the last few weeks. In the last 13 trading days, the S&P 500 has declined nearly 14%. Stocks are off nearly 18% from their all-time highs of September 20 this year. Stock markets are again validating, as they have done countless times in the past, one of the oldest adages in the profession, "Stocks take the escalator up and the elevator down." Meaning that stock prices tend to go up more gradually over time but when they decline, they decline with more rapidity. It is a cycle that has repeated itself numerous times and is borne of consistent human behavior that is predictable in its occurrence, if not its timing. It has happened before. It is happening now. It will happen again in the future.

It can be quite instructive to analyze the history of market advancements and retrenchments. While we are not overly anxious to use a gambling metaphor, these market movements can be expressed in the context of odds or probabilities. In fact, the "odds" surrounding stock market returns have been quite consistent over time. Since 1928, 72% of the time stock prices rise and 28% of the time they decline. By that measure, we are actually **overdue** for a down year in the S&P 500, given that the index has risen for **nine** consecutive years since 2008. If 2018 does end the year in negative territory, it will mean that in the 18 years of this 21st century, we will have experienced five down years or exactly 28% of the time - precisely in keeping with historical precedent. This type of analysis and perspective is why we believe the study of history is such an important ingredient to successful investing.

As we indicated in our April and October Capital Market Commentaries, investors should continue to expect more volatility. A primary reason is that we have had very little volatility this decade. In fact, between 2012 and 2017, the S&P 500 experienced only 20 days where stock prices dropped 2%. The lack of volatility we saw in that time period is actually abnormal. In 2018, we have had 14 days with 2% drops, so far. While elevator rides such as we have witnessed this month are never pleasant, they are necessary to reset expectations and valuations. Expected returns for stocks are now the highest they have been in some time. The dividend yield on the Dow Jones Industrial Average is today over 2.5% and once again competitive with the 10-year Treasury Rate of 2.79%.

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There is no question that investor concerns exist. They always exist. The bond market is suggesting to Fed Chairman Powell that current and prospective monetary policy is too tight and that the economy may not be strong enough to handle additional rate hikes and quantitative tightening (QT). This is a part of why interest rates have fallen from 3.25% to 2.79% on the 10-year Treasury note in the last three months. (From a portfolio management standpoint, this is also a testament to the merits of having bonds in a balanced portfolio to counteract weakness in stocks.) Stocks are also expressing some near-term displeasure with the tone expressed by Chairman Powell. Questions surrounding corporate profits in 2019, inflation rates, valuation and global growth are also top of mind. Add in less than deliberative White House decision making this week around high profile military, foreign, fiscal and trade policy matters and markets are emotional.

However, we must remember that traders, who have time horizons spanning days and weeks, occupy the same market as investors, whose investment time horizons span decades. The short run is dominated by traders and emotion, while the long run is dominated by investors and fundamentals. Has the long-term intrinsic worth of some of the businesses in which we are investing (several of which have been around for 100 years) changed so much in the last two plus weeks that they are really 20% less valuable than they were just after Thanksgiving? We think not. This is why it is so important for investors to refrain from getting caught up in a "trading" mentality. We are not sure who first expressed the sentiment, but investors must guard against the stock market becoming a "giant distraction" to the serious business of long-term investing. Unsuccessful investors, often distracted, typically give up on a viable long-term strategy at the wrong time simply because it isn't working at the moment.

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We will continue to look for opportunities that offer the highest probability for investor success. We will stick to the processes and strategies that we have employed for clients in good markets and not so good markets for over 50 years. We steadfastly believe in American institutions, our system of checks and balances, as well as the ingenuity, creativity, resiliency and productivity of the American people. We are resolute in thinking the best way to capitalize on these beliefs is through sustained investment in, not trading of, the common equity of strong, innovative businesses, primarily American businesses. If you would like to discuss any of this at greater length, please let us know as we are available to serve and advise you.