CHARTER OAK
CAPITAL MANAGEMENT
Registered Investment Advisors

The Acorn

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What Just Happened?

Charter Oak strives to provide its clients with clarity and perspective in all aspects of their financial lives. Recent market volatility has caused an emotional year-end and a multitude of commentary on the future from prognosticators.

As advisors, we must be diligent to make certain that the media is not the only voice or advice our clients are hearing.

Our goal is to share a concise fact-based narrative to help you understand more about what happened, what may have been the catalyst, and an historical perspective to help determine "*what happens next*".

What just happened?

Since peaking in late September, the Standard & Poor's 500 (a broad measurement of stocks in the United States) has fallen 19.8%. The S&P 500 has fallen 15% in December alone. Yes, it was the worst Christmas Eve market performance in the history of the Dow Jones Industrial Average.

We believe that troubles in financial markets systems, rather than those present in global economies, best explain the recent losses. Perhaps you might ask how can that be?

In 2019 it may be a new reality to see more self-driving markets.

The media has not reported much on one of the most interesting and impactful stories about the last 5 years in the markets: the technology used to trade stocks has changed in a BIG way. While on the roads we now see more self-driving cars, in 2018 the markets now have more automated stock buying and selling.

According to the Wall Street Journal*, "roughly 85% of all trading (the buying and selling of securities) is on autopilot - controlled by machines, models, or passive investing formulas, creating an unprecedented trading herd that moves in unison and is blazingly fast. Today, funds rely on computer models much more than they do on research and intuition."*

According to Tabb Group, an international research and consulting firm, computerized trading has doubled since 2013 to the point where machines now trade more shares than individual investors.

Seemingly these approaches didn't cause problems during the bull market and may have even contributed to the market's extended calm. Rest assured, **the robots are not in charge**. They simply feed off certain trigger points.

What triggers started moving markets over the past few months? We believe they may have been:

- Suggestions the U.S. economy might be slowing.
- The end of an era of low interest rates and easy money now that the Federal Reserve Open Market Committee has pushed interest rates above the rate of inflation for the first time in 10 years.
- A potential decline in the growth of corporate profits.
- Geopolitical risks from the Brexit in Britain and contentious U.S. - China trade relations.

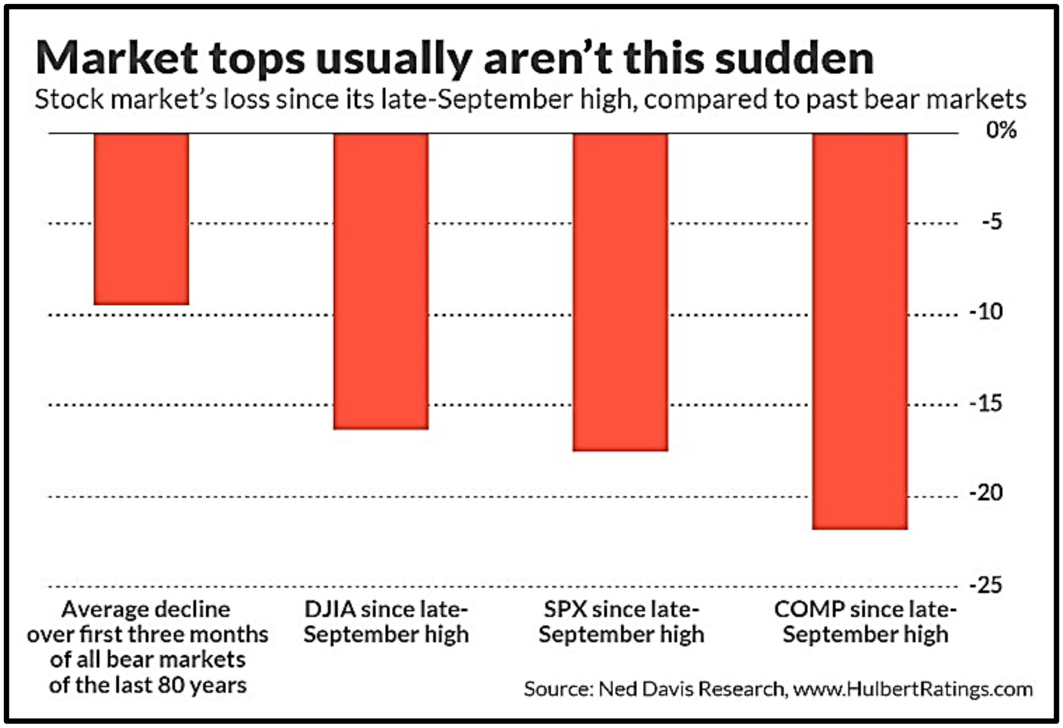
The broader question to ask is whether markets are having a "correction" or are they in the beginning of a full-blown "bear market"?

The current stock market decline has been more abrupt than we would expect if the market were in the early stages of a long-term decline.

Bear markets that follow a market top or high (like we saw in September) have historically been mild at the beginning, then pick up steam over the following several months. Corrections, in contrast, have historically been far sharper and more precipitous in velocity (like we've just seen).

For a broader perspective, consider the losses in the S&P 500 over the first 3 months of all bear markets of the last 80 years (illustrated using a bear market calendar maintained by Ned Davis Research).

When we compare this 3-month window in the chart below, we see its average loss over that period was 9%...**not 19% like we just saw**.



How does this compare to history? Is it 2008 all over again? Or Dot-Com?

Consider the stock market decline over the first 3 months of the 2007-2009 financial crisis (the worst since the Great Depression). The S&P 500 fell 10% over the 3 months following its top on October 9th, barely the official definition of a "correction".

In the first 3 months after the bursting of the internet bubble, the S&P 500 fell just 5.6%.

Using this historical perspective, we may conclude that this decline looks more like a correction than a prolonged bear market. Needless to say, there are no guarantees. However, these factors seem to indicate the herd-like behavior of computerized trading may have led to an overreaction to potential concerns.

Some analysts see similarities to the late 1998 pullback in U.S stocks that followed a year of turmoil in emerging markets, the Asian financial crisis of 1997, and the Russian bond default.

Others point to 2015. Like today, the sharp market decline then lacked an obvious trigger and was accompanied by fears of the Federal Reserve's plans to raise interest rates for the first time in a decade. Like this year, the 2015 retreat featured a sharp decline in oil prices and a significant market drop. Sound familiar?

In both those cases the market bounced back when investors regained confidence that the economic expansion was, in fact, intact.

We believe the stock market is not a complete reflection of the economy. For those in the audience who need reassurance from "*big name firms*", be aware Goldman Sachs economists agree and peg the chance of a recession in 2019 at just 10%. "We expect the current US expansion will continue for the next several years," according to Chief U.S. Equity strategist David Kostin.

We believe there is a disconnect between what the financial markets are signaling about the economy and what the data indicates.

The longer-term outlook isn't crystal clear. However, we believe a crisis generally comes from a known entity or cause. Seemingly, the markets have oversold on the unknown. History suggests markets will find an equilibrium in the future which encourages us to stay the course and not overreact.

We thank you for the opportunity to be your trusted advisor and to provide clarity and perspective during these times.

We look forward to a happy, healthy and prosperous New Year!

Charter Oak Capital Management is a registered investment advisor that provides retirement planning, financial planning and fee-based investment portfolio management to individuals and non-profit organizations. Our offices are located in Portland and Kennebunk, Maine and Portsmouth, New Hampshire.

The Acorn is written by the professionals of Charter Oak Capital Management exclusively for its clients. If you have questions or comments about anything you read here, or if there is a particular topic that you would like to see addressed, please let us know.