Market Update 1/20/2016
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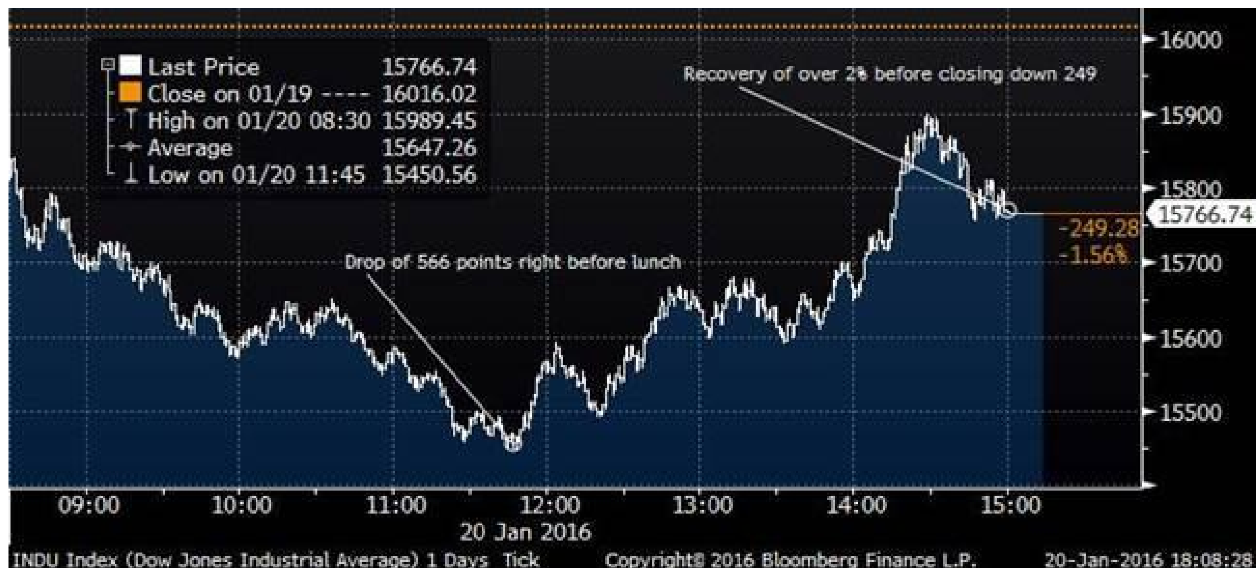
Good evening to you!

I wanted to check in tonight at the conclusion of a roller coaster day in the stock market. As the chart below from Bloomberg will attest, after opening modestly lower, the Dow Jones Industrial Average fell nearly 3.5% (or 566 points) before mustering up a 2% climb to close down “only” 249 points.



The usual suspects received much of the blame for today’s decline: lower commodity prices, (principally oil which closed at $26.55/barrel, down over 6%); Chinese economic weakness (or lack of strength) and persistent fears of a recession. So perhaps more puzzling than the drop was the bounce…..

With US stock market volume 82% above average today, there has been speculation that perhaps this was the near-term bottom in the market….that so-called cathartic and climatic selling condition that embodies panic and, excuse the expression, puking, of positions….tempting the previously patient opportunists to consider certain securities too cheap to ignore any longer.

It is not possible to say without the benefit of hindsight, but it is plausible. If you consider a list of Sentiment Indicators followed by Driehaus Capital and published this afternoon (the full report is attached to this email), one could perhaps make the case. A few to consider:

- The percentage of S&P 500 Index components above their 10- and 50-day moving averages is at 5% and 12%, respectively—below 20% and 40%, respectively, are considered extreme levels

- The CBOE Volatility Index (VIX) has remained above 20 for a few days—it spiked to over 30

- Forced selling—anecdotal, but massive sell programs are evident

- Individual investor fear—American Association of Individual Investors (AAII) bulls down to 17.9%, equal to 2005 and late 1980s extreme levels, notably worse than in 2008 and 2009

- BoA “Fear and Greed” index—yes, is at “extreme fear”

Again, we’ll not know for some time, but the buying interest that came in late today, in our opinion, was encouraging.

I’ve fielded a bunch of calls in the last few weeks – from clients, traders and the ever-popular peddler of products that your portfolios cannot live without - and a question I’ve fielded commonly is this: does a severe stock market decline presage a recession?

The answer is no. The evidence is below:

S&P 500 Double Digit Losses with No Recession		Plus 5 years	Plus 10 Years
1939-40	-31.9%	110.2%	231.2%
1941	-34.5%	120.6%	369.5%
1943	-13.1%	64.6%	267.7%
1947	-14.7%	139.0%	359.5%
1961-62	-26.4%	78.8%	155.4%
1966	-22.2%	48.9%	90.5%
1967-68	-10.1%	10.5%	37.6%
1971	-13.9%	27.9%	88.6%
1978	-13.6%	119.2%	346.2%
1983-84	-14.4%	152.1%	281.2%
1987	-33.5%	107.9%	419.0%
1998	-19.3%	-2.9%	-12.8%
2002	-14.7%	34.4%	32.8%
2010	-16.0%	103.6%	???
2011	-19.4%	79.1%	???
2015	-12.4%	???	???
Average	**-19.4%**	**79.6%**	**205.1%**

*Gains calculated from Jan 1 of the following year

Source: Morgan Stanley

I think that this data is encouraging as it is an indication that fire doesn’t always follow smoke.

And if you overlay the chart above w/ the graph below, it is helpful to be reminded that going back to 1980, the S&P 500 averages an intra-year drop of over 14% and yet finished positive in 75% of those years. I know most of you have seen this before but its impact is enduring and endearing:

Lastly, the issues of China and oil deserve some attention.

As I mentioned last week, I do not think that the Chinese markets and the steep drop in oil prices are the necessarily the causes of the market's decline. I think that both are offshoots of the absence of an identifiable global growth catalyst.

And in that absence their impact is much deeper. Think of it in the context of a classroom without a teacher: even children w/ only a mild tendency to act out would likely exacerbate such behavior.

But to put it into context and to lean again on the Driehaus research piece (highlighting is Kavar's):

> ***Why China shouldn't matter as much:***
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> *Typically, it is a US recession that causes the global economy to enter a recession, rather than the other way around. Emerging market economic weakness and recessions have never caused a US recession before. Certainly the world's economies are now more interdependent and an emerging market the size of China is clearly a new phenomenon. But, exports are only 13% of US GDP, the lowest of any major industrialized nation. Exports to China are less than 1% of US GDP. The bulk of US exports are to the EU, Mexico and Canada. Both the EU and Mexico are expected to grow in 2016.*
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> ***Why Oil shouldn't matter as much:***
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> *Overall, lower crude prices are a net positive for the US despite the negative effect on some sectors of the economy, and some regions of the US as well as globally. Similar to oil, weakness in transportation stocks has also been widely regarded as a recessionary indicator. There have been five times since 1983 when crude oil and the Dow Jones Transport Index together made new 52-week lows. Despite the logic that this is a negative and recessionary forward indicator, four of the five times the S&P was higher 3-, 6- and 12-months later after both had hit 52-week lows. However, I believe that crude oil prices must reach bottom before equity prices can find a sustainable bottom.*

I think that the ultimate bottom, if not already put in, will be a function of 2 things: a demonstration of US economic and profit growth (early signs of corporate profitability have been reasonably strong) and the valuations of stock markets being compelling enough (which typically follows large drops) to mathematically offer positive expected returns.

We're making our way through this market and want to thank you for the confidence you've placed in Kavar Capital. Have a great night, dc

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