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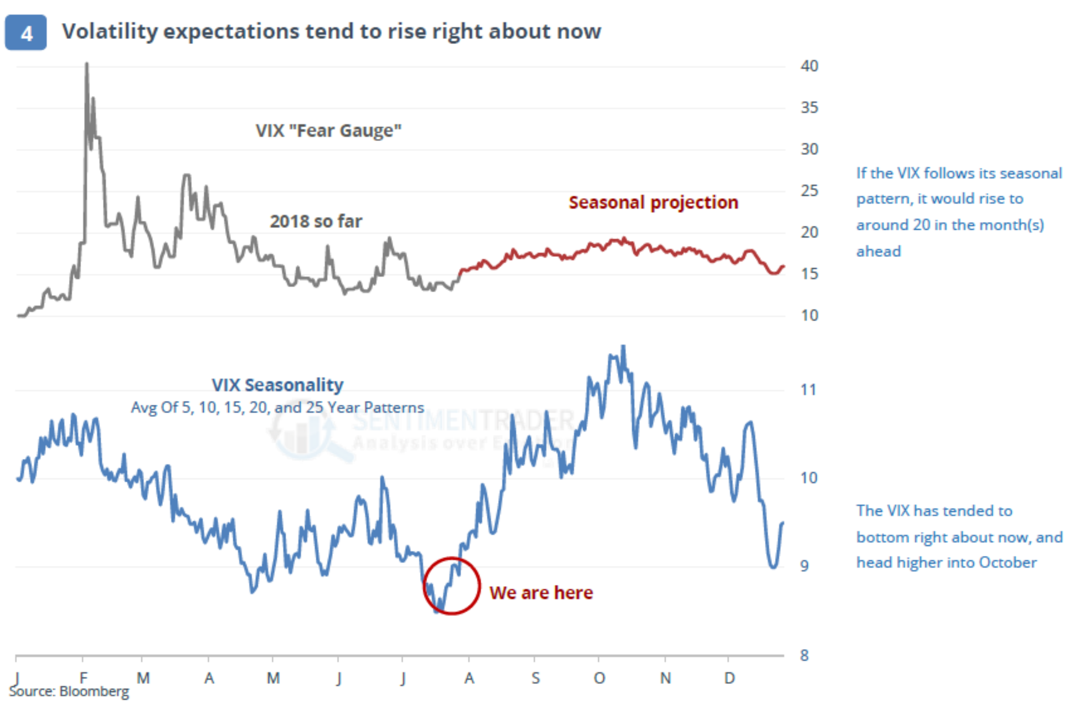
My fickle friend, the summer wind

The financial markets during the summer months can often be a reminder of the classic Frank Sinatra song, "The Summer Wind." Where one minute it's a nice sunny day and then suddenly a thunderstorm pops up on the horizon, only to be followed by perfectly blue skies half an hour later.

Many have heard the old market adages like "sell in May and go away" or "summer doldrums." In fact we wrote an article about this a couple of years ago (http://fa.morganstanley.com/harboroak/#commentaryfromourgroup) and there is actually some degree of validity to these theories in the long run, however clearly not something to follow religiously.

Recently, our friends over at sentimentrader.com performed a study on the volatility pattern of the stock market over the past 25 years and found that volatility does indeed pick up during the summer months (see chart below)*. However, do keep in mind that increased volatility does not necessarily mean a declining stock market; it simply means larger swings both positive and negative.



Although recent market performance has been a welcomed relief following the market correction we experienced earlier this year, it's more important than ever for investors to not get sucked into listening to all the market strategists and media pundits making their bold predictions about where the market will be in the near term. We promise you, NO ONE knows! There are just way too many variables to make such a prediction and we believe it is completely nonsensical and irresponsible to do so. All that one can do is simply weigh the current evidence and take it one a day at a time.

Considering the current evidence, there is no denying that the economy is quite strong. Corporate earnings have been growing at a double digit rate for the past 18 months, GDP growth came in above 4% last quarter, the unemployment rate is at the lowest we've seen in the past 10+ years**, consumer and business confidence are strong, and the list goes on. On the other hand, the Fed is raising interest rates, we are 9 years into this economic cycle, the potential for trade wars continues to be an overhang, the risk of inflation is unknown, the midterm elections are coming up, and once again the list goes on…

In our view, the market this year has been wrestling with the question of how much longer this economic cycle will last. Sure things are good now, but the market doesn't care about that. The market is forward looking and only cares about the direction of the economy; are things getting better or are things getting worse? If we continue to have strong economic growth, then stocks are reasonably priced but conversely, if this year is the high water mark for the economy then clearly stocks are expensive. Again, no one knows the answer to this, but we can certainly look back at history and see how bull markets tend to end …

First off, it's extremely rare to have a bear market that does not coincide with an economic recession. It has happened (i.e. 1987) but is still extremely rare.

Second, the last nine recessions have all been preceded by an inverted yield curve. Meaning short term interest rates become higher than long term interest rates, which is still not the case today.

Third, in recent recessions going back to 1978, once the yield curve does invert, the stock market did not peak for another 2 years, on average.***

Lastly, as Sir John Templeton famously pointed out, bull markets tend to "mature on optimism, and die on euphoria." Well, accordingly to Lipper and sentimentrader.com, investors have pulled more than $40 billion out of equity mutual funds and ETFs in the past 8 weeks alone! That's the most since November of 2016 and ranks among the most extreme in at least 15 years; hardly evidence of euphoria! ****

That all said, certainly this year could very well be the high water mark for the stock market as some have been calling for. Perhaps this time really is different. Perhaps the yield curve does not invert before the next recession or perhaps retail investors, for the first time in history, have finally gotten out of the market as the exact top before the next down turn. Or maybe, just maybe … Carmen Reinhart had it right …

"There has been more money lost because of four words than at gun point … *This time is different*."

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Sources
**Sentimenttrader.com 7/30/2018*
***Thomson Reuters 7/31/2018*
**** Bloomberg 2/28/2018*
*****Lipper 7/27/2018*

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VIX: *This is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options. Often referred to as the fear index or the fear gauge, it represents one measure of the market's expectation of stock market volatility over the next 30-day period.*

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