DANN ASSET ADVISORS, LLC

Current Market Volatility

October 12, 2018

<u>Additional Commentary to 10/12/18 Third Quarter Update</u>

As we write this before the market open on October 11, the market, as measured by the large company S&P 500 index, is down 5.3% from its September all-time high. Many individual stocks are down substantially more, with several of the large cap technology stocks that have been leading the market now down 10%-15% from recent highs. To put this in context, the S&P 500 index still has returned 5.8% year to date.

Explanations we've seen for the current decline include:

- Interest rates making another move up, with the 10 year Treasury yield increasing to as high as 3.25% from 3.06% on September 30, and the Fed indicating that more rate increases are probable
- A realization that our trade issues with China may be long term with unforeseeable consequences
- Worries over Brexit negotiations and Italian government economic policies with potential negative economic implications for Europe
- Several developing market economies/currencies coming under pressure, and fears that this could spread
- The International Monetary Fund cutting growth forecasts

In fact, neither we nor anyone else knows why the market has turned down. Further, a 5% decline is not significant, especially relative to the gains of the still ongoing bull market. If it weren't for the fact that we were distributing a usual Dann Asset quarterly update tomorrow, we'd probably wait a bit before commenting on the current decline and see how things develop.

As we've mentioned many times, we believe that over the longer term stock prices move with earnings, and earnings move with the economy. In recent weeks we've noticed changes in how certain sectors of the market are trading. Our takeaway from underlying sector moves is that the market is at best going through a "growth scare" (is concerned the economy may turn down) and at worst accurately predicting a significantly softer economy within the next year. Our <u>guess</u> is that the market trying to anticipate the economy is what's causing the current decline. With this observation, we believe it's worth noting Paul Samuelson's often-quoted comment in a 1966 Newsweek article that the stock market has predicted nine of the past five recessions.

In the main Dann Asset update, we observed that there were signs late in the third quarter that the trend of growth stocks outperforming value stocks might be changing. Specifically, we had noticed that some of the large cap tech stocks that have led the market over the past six or so quarters (e.g., Netflix, Facebook and Twitter) seemed to have peaked over the summer. We also mentioned in the update that consumer discretionary stocks (autos, homebuilders, RV manufacturers, jewelers, for example) have in some cases been under pressure for several months. Declines in these latter types of stocks – that are highly dependent on consumer discretionary spending – often are a lead indicator that the consumer and economy may soon weaken.

Not mentioned in the main report is that small cap stocks also were declining – the Russell 2000 index of smaller stocks off 9.6% from its peak as of this morning. Generally speaking, small cap

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companies are more domestically focused, and their weakness also could be signaling upcoming pressure on U.S. consumers. Finally, semiconductor stocks also have fallen significantly over the past month. Communications, industrial and auto businesses are big users of semiconductors, and the drop in semiconductor stocks also may be indicating upcoming weakness in the broader economy.

Unfortunately, we, like others, don't know where the economy will be six months from now. We are concerned about what stocks may be telling us. We hope management commentary around third quarter earnings and outlooks (beginning this week) provides some helpful insights.

Taking the foregoing down to the investing level, we're not making any significant changes currently. Given the long term upward trend of the market and the impossibility of consistently timing major changes, we know it doesn't make sense to sell stocks every time we're nervous about the outlook. We believe that our clients are invested consistent with their respective tolerances for market declines. And we're hopeful that the actively managed investments that complement the passive/indexed investments held by most clients will serve to at least modestly buffer any significant downturn.