

LORING  WARD

# Investment Committee Briefing

## Markets in Perspective

So far this year, one of the big stories in global markets was the surprise Brexit vote in the third week of June. Conventional wisdom was that this event was a harbinger of future economic weakness and lower markets. Markets fell a bit on the news; however, as so often happens with conventional wisdom, it was quickly cast aside. By the start of Q3, the S&P 500 had almost recovered to its 2016 high levels. In the weeks that followed, the S&P 500 and several other major stock indexes crept higher... until August 15 when they broke through to an all-time record high level.

### Market Commentary

U.S. stock markets pulled back a bit at the beginning of September, with markets concerned that signs of a steepening yield curve could give the Fed the political cover it might be seeking to raise rates. By the end of the third quarter, however, these fears seemed less of a concern and the markets resumed their march higher. Overall for the third quarter, the broad U.S. stock market, as measured by the Russell 3000, was up 4.40%.

There was speculation earlier in Q3 that the U.S. Federal Reserve might finally raise interest rates, but that speculation was squashed at the Fed's September meeting. Continuing weak growth in the U.S. GDP was likely the main reason, coupled with the fact that the Fed generally does not like to change policy in close proximity to U.S. presidential elections.

Q3 of 2016 was also notable for a change in the U.S. bond markets. After showing a general downward trend that began all the way back in June 2015, 10-year Treasury yields appeared to turn the corner. After hitting an individual

record all-time low of 1.37% in the first week of July, 10-year U.S. Treasury yields crept higher for the rest of the quarter to 1.60%. The start of a similar trend also occurred in the shorter end of the yield curve; two-year U.S. Treasury yields were at a low of 0.56% in the first week of July, rising to close out the quarter at 0.77%.

As for other stock markets, both U.S. small cap and U.S. value stocks did relatively well in Q3 of 2016 — small caps rose 4.40% during the quarter and value stocks rose 3.48%. These moves were mirrored in overseas markets — international small caps rose 8.00% and international value stocks rose 7.69%. Emerging market value stocks were up strongly at 8.16%. The domestic REIT market did not do well this quarter — REITs fell -1.24% in Q3, although they remain up year-to-date at 9.45%.

### Do All-Time Highs Mean Overvalued Markets?

On August 15, the Dow Jones Industrial Average, the S&P 500 and the Russell 3000 all closed at record highs, welcome news for the average stock investor who has patiently invested for the long-term.

But many ask, “Does the fact that a stock market index breaks through to an all-time high suggest that the market is at a precarious level?” It can be tempting to compare a stock market at its all-time high to standing on top of a tall mountain — it’s a lofty height with nowhere to go but down. But is this an accurate analogy?

A monthly survey of professional investment managers taken on September 2, just after the markets breached their record highs, suggests that this analogy might be a common belief in the industry. Fifty-four percent of the 208 money managers surveyed believed the stock markets were overvalued — the highest reading in that monthly survey since mid-2000. These managers held these beliefs despite reporting a view that global economic growth expectations are improving and a strong view that interest rates may continue to be held low by global central banks.

Now, one might say that this is just a coincidence; there are things going on right now that might make managers nervous about stocks. The September survey said managers cited some concerns, such as “vulnerability to a bond shock” and even “a Republican win in the White House in November.”

To check whether managers thought the same way the last time the market breached an all-time high, we took a look at the same monthly survey from April 2015, just a couple

of weeks before the stock markets breached their then all-time high (in May 2015), and we saw that the same survey had almost the same message. Indeed, the survey drew the exact same conclusion then that they did in this most recent survey — stock managers who seemed to be finding stock markets to be overvalued were again at the highest plurality in their survey since 2000.

Clearly, this may not be a simple coincidence, and this investment reaction is common in both investors and professionals. When markets break through to levels never seen before, folks get nervous that the market rally may not last.

So, we asked, “Is this truly the case?” We started our investigation by picking a stock market index with the longest track record of daily closes, namely the Dow Jones Industrial Average. We identified every time the Dow crossed into record territory on a daily basis, looking all the way back to 1896. We took care not to identify “spurious” records, such as when the market again breaks to a record high any time within one month of having just reached a record high.

Our analysis showed that there have been 105 times in the 120-year history of the Dow when the market reached a new record high. So how does the index perform in periods after reaching a record high, as compared to how the index performs on any other normal day (record-high days removed)?

**Stock Market Performance in the Periods Following All-Time Record Highs**

Following:	Index Level Change (Annualized) After:					
	1 Month	2 Months	3 Months	6 Months	1 Year	2 Years
Record Highs	7.10%	7.12%	7.23%	7.23%	7.39%	7.18%
All Other Days	6.82%	9.78%	9.54%	8.29%	7.64%	5.88%

As we can see in the table above:

- In the first few months, the performance of the market is a bit weaker after it has reached a record high than it is normally under non-peak conditions, although that “weakness” is small on an annualized basis
- One year after reaching a record high, however, the market index is roughly the same percentage higher (7.4%) following a record high as it would have been one year later after any typical day (7.6%)

**The Bottom Line**

We believe this data shows us four things:

1. Markets are relatively rational. A record high is only a record relative to where

the market has previously been, not a predictor of where the market is headed.

2. In competitive markets, all that matters to the rational investor is what is to come. Markets are, simply put, always forward-looking.
3. Overall, there should be no lasting effect resulting from reaching an all-time-high. There is no “over-valuation.”
4. Managers who pull back, increase cash, and look to time the market may, in the long run, miss out on the opportunities and growth that markets can provide.

This is why we don't advocate panicking or trying to time markets, but instead focus on the potential power of markets to reward patient, long-term investors.