Shake Off A Spooky October

What is it about the month of October? The stock market crash of 1929 ushered in the Great Depression.

Black Monday 1987, also in October, was driven by computer trading and portfolio insurance, though an economic calamity did not ensue.

During October 2008, the S&P 500 Index lost nearly 17%, the biggest monthly decline of the financial crisis.

As if those weren't enough, there is also the lesser-known Panic of 1907, which shaved 15% off the Dow Jones Industrials during . . . yes, October.

Despite its ghoulish reputation, if we look back as far as 1970, the broad-based index of 500 major U.S. stocks has averaged a gain in October. October ranks number three in performance when using the median return.

In case you're wondering, September has been the weakest month, on average. And, it may come as a surprise that the fourth calendar quarter has historically been the strongest of the year, by far. Go figure!

Between 2009 and 2017, we've experienced three declines in October, each losing a bit less than 2%. In the six periods that saw a gain, the S&P 500 averaged an impressive 5.3% advance.

This year was different. The Dow lost 5.1%, and the S&P 500 Index gave up 6.9%.

Why?

There isn't a specific catalyst. When investors place sell orders, there isn't a "reason to sell" on the ticket. But, we can reflect on the various themes that cast a shadow on shares.

1. Interest rates and a policy mistake

October started on a soft footing after Fed Chief Jerome Powell said the fed funds rate is ". . . a long way from neutral at this point (where rates neither stimulate nor restrict growth), probably".

It's a curious remark. The Fed has hiked rates eight times in almost three years and stocks performed admirably, because the rate increases were in response to a firmer economy. Besides, we are only three rate hikes away from neutral, using the Fed's own estimate.

Still, Powell's remark suggested a more aggressive posture might be brewing inside the Fed. So far, he has not clarified the thinking behind that statement.

The fear? If rates rise too quickly and the Fed risks throwing the economy into a recession, it would amount to a policy mistake.

If raise rates too slowly, there is a risk of overheating. In other words, an economic boom ensues, which may lead to inflation and eventually a bust.

The Fed's gradual approach is designed to thread the needle. Although the direction of rates may matter, the level still remains low.

2. **Slowing global growth and trade tensions**

   China is slowing and growth in Europe has softened. For firms doing a significant share of business overseas, the profit outlook has dimmed.

   But, as investors look ahead to 2019, they are again fretting about the impact of U.S. trade policy on earnings. Q3 profits have been quite strong–up 26.2% through November 1st. Yet, commentary regarding tariffs injected a cautious tone into sentiment. It's especially acute for companies relying on China's market.

   Simply put, bubbling to the surface are concerns that benefits from deregulation and the tax cuts might be offset by a trade war.

3. **The so-called October effect**

   Let's revisit the initial question: What is it about the month of October?

   On September 21th, Jason Zweig wrote in *The Wall Street Journal*, "Investors' fear of September and October is based less on evidence and more on what psychologists call 'availability'—the human tendency to judge how likely an event is by how easily we can recall vivid examples of it."

   In other words, dramatic sell-offs are seared into our memories. But, we don't recall the S&P 500's 8% advance in October 2015.

   Zweig adds, "Average returns on U.S. Treasuries appear to be higher in fall than in spring, suggesting that investors seek safety in the darker months. Stock analysts' earnings forecasts are less optimistic in fall and winter than in spring and summer."

   These may or may not be reasonable explanations for the so-called October effect. Such explanations aren't rooted in economic fundamentals but in the behavioral aspects of investors.

   It's why I have repeatedly emphasized the importance of adhering to the investment plan. It is a long-term roadmap that takes unexpected sell-offs into account. It places a barrier in front of an emotional response.

Final tally and perspective

With all the angst we've seen in the financial press, the S&P 500's latest pullback ended up as 9.9% from closing peak to trough, just short of an official correction, which would be a loss of 10%.

Although I understand that the speed of the drop may have been disquieting, a sell-off of 5%-10% is modest by historical standards.

Since 1980, the average intra-year peak-to-trough dip has been 14%. Yet, stocks are much higher today than when Ronald Reagan became President. Why? Stocks have a long-term upward bias. The average annual gain, including dividends, has been 12.6% since 1980.

We've experienced several notable sell-offs in recent years. Blame Brexit, the European debt crisis, China worries, the Ebola scare, the Japan earthquake/tsunami/nuclear disaster, U.S. debt downgrade, and much more.

When the risks that jolted short-term traders failed to materially alter the economic outlook, stocks recovered.

We've had growth scares before, and they occurred when activity was not as robust as today. Early 2016 comes to mind, when oil prices had collapsed, turmoil appeared in credit markets, and recession fears surfaced.

Today, credit markets are functioning normally, the outlook for the U.S. economy is favorable, and odds of a near-term recession remain low.

Bottom line: Scares come and go, but the market's long-term trend is higher.