TAIBERKOSMALA

FUSION CAPITAL MANAGEMENT

Flash Memorandum

To: Advisors
Date: February 9, 2018
Re: Early 2018 Volatility

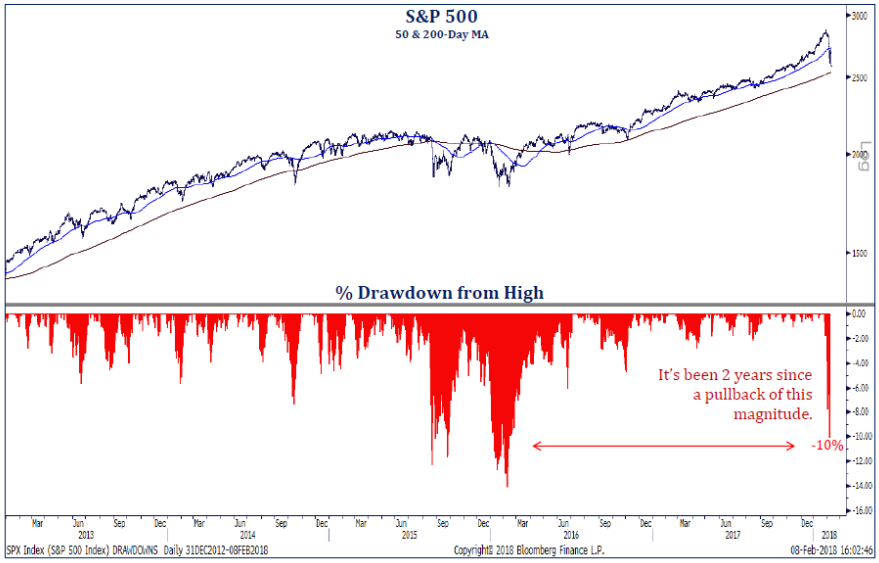
Following 2017 as the least volatile year on record for the U.S. stock market, 2018 was off to the races with the S&P 500 gaining 7.45% to an all-time high on January 26, 2018. The surge, fueled by the tax reform bill and solid global economic growth, broadly attracted investors from the sidelines who finally succumbed to the fear of missing out on the rally. Despite improving fundamentals globally, sentiment shifted and by the closing bell on February 8, the S&P 500 had plummeted 10.2%, leaving investors wondering if the sky was falling.

Mark Twain once said, "History doesn't repeat itself, but it often rhymes." Let's put this equity market correction in historical context. On average, equities have experienced:

- 3% declines 7 times per year,
- 5% declines 3.3 times per year, and
- 10% declines every 18 months.

We went well over 450 trading days without even a 3% correction, an all-time record. To put that phenomenon in perspective, there have only been eight times since 1926 when we've gone 200 days without a 3% correction! This historic run also resulted in the second longest rally without a 5% correction, falling only 10 days short of an all-time record. Further, 2017 was the first year in history that the S&P 500 posted a positive total return in every month of the year. Through January, the S&P 500 had posted 15 consecutive months of positive total returns for a cumulative gain of 36%! Although a correction was overdue, the rapid 10% decline in just 9 trading days is a relatively rare occurrence.

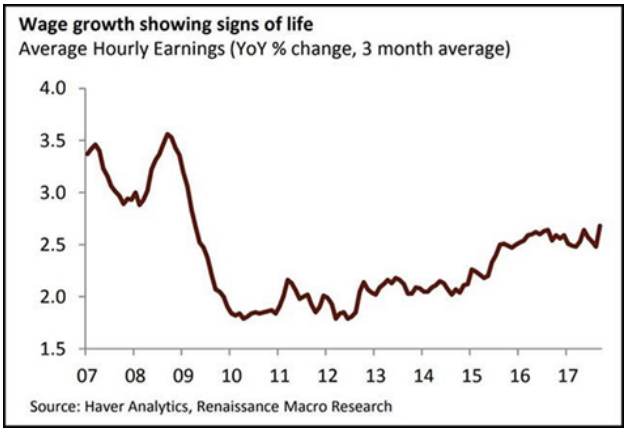
FIRST -10% CORRECTION IN TWO YEARS



Source: Strategas Research

The news causing the selloff was strong economic growth and a 40-basis point (0.40%) move up in interest rates over the course of a month. This combination of market forces is rarely the culprit for a market selloff of this nature which is more typically associated with collapsing economic data or impending recession. The most recent example of a rate move causing a sell off was the 2013 "Taper Tantrum" when the Fed announced a reduction in its QE Program. 10-year Treasury yields surged by 1.4% over a four-month period and the S&P declined less than 4%. Rates also jumped by 1.4% after the 2003 tax bill and the S&P fell 4.5%. In contrast, rates rose by over 1% after Brexit and the U.S. Presidential election and the equity market moved higher in tandem.

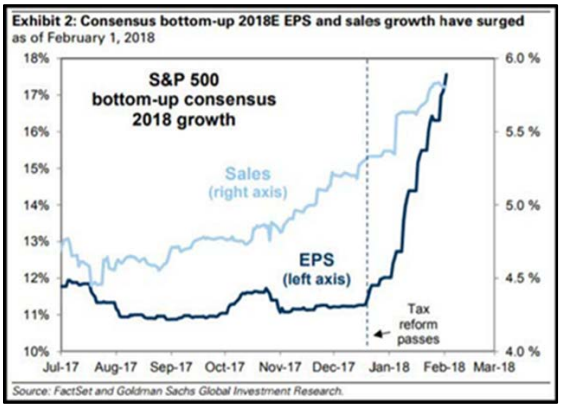
The average hourly earnings number, released on Friday February 2, seemed to have lit the fuse for the equity market sell off with reported wages growing at 2.9% (modestly ahead of the 2.6% expected by economists). The chart below shows that neither the 2.9% reading nor the overall trend was abnormal.



So why the correction?

Simply put, we were overdue for some type of pullback and the downdraft was accelerated by the unusual sense of complacency we've been highlighting. The market was dramatically overbought for months on nearly every metric we track, including: put call ratios, bullish investor survey data, commitment of traders long US equity futures (in the 95th % of all observations!), and the length of time without a meaningful correction. Although we were overdue, this draw down appears to have been exaggerated by volatility traders covering inverse/short VIX trades and trend following strategies reversing positions or covering long bets in futures markets. This dynamic is not in the category of panic stock selling, but rather more like a mini-1987 type unwind of futures and volatility derivatives which induced downward pressure on equities.

Overall, economic conditions and fundamentals are the strongest globally in over a decade. This 10% correction erased an abnormally strong start to the year. The downdraft in stock prices coupled with the simultaneous increase in earnings estimates has resulted in the S&P 500 trading at 16.7 times 2018 earnings estimates, down from over 20x earlier this year. Contrasted to an average 19.4 times over the past 30 years, one could argue that valuations are fair given the low (albeit gradually increasing) levels of inflation and interest rates.



In addition, this correction has not been accompanied by typical risk aversion metrics such as widening credit spreads, gold rally, yen/franc rally, flattening yield curve, declining corporate earnings, or global economic instability. Rather, credit spreads and lending conditions remain highly favorable, earnings are strong globally, all 45 OECD countries are expanding simultaneously for only the third time in 50 years, and real rates remain negative around the globe (meaning it is still punitive to hold cash). As evidenced in the following table, other years that had strong starts followed by periods of volatility ended up with solid returns.

JANUARY MOMENTUM CAN LEAD TO CONTINUED GAINS

A Big January Is A Great Sign For More Strength

Year	S&P 500	January Return	Rest of Year	Full Year	Intrayear Pullback
1951	21.66	6.0%	9.7%	16.3%	-8.1%
1954	26.08	5.1%	38.0%	45.0%	-4.4%
1961	61.78	6.3%	15.8%	23.1%	-4.4%
1967	86.61	7.8%	11.4%	20.1%	-6.6%
1975	76.98	12.3%	17.2%	31.5%	-14.1%
1976	100.86	11.8%	6.5%	19.1%	-8.4%
1980	115.12	6.7%	17.9%	25.8%	-17.1%
1985	179.63	7.4%	17.6%	26.3%	-7.7%
1987	274.08	13.2%	-9.9%	2.0%	-33.5%
1989	297.47	7.1%	18.8%	27.3%	-7.6%
1997	786.16	6.1%	23.4%	31.0%	-10.8%
2013	1498.11	5.0%	23.4%	29.6%	-5.8%
2018	2822.43	5.6%	?	?	?
	Average		15.8%	24.8%	-10.7%
	Median		17.4%	26.1%	-7.9%
	% Higher		91.7%	100.0%	

Source: LPL Research, FactSet 1/30/18

In summary, if felt we were on the precipice of a recession, this market correction would be troubling; however, the strong economic backdrop indicates that this is a technical pause, not the end of an elongated economic expansion.