Learning to Embrace Volatility

One of the reasons that Bernie Madoff was so successful at raising money for his fund was that he was able to show investors steady gains with low volatility year after year. One of the reasons that some people suspected that Madoff was a fraud was that he was able to show investors steady gains with low volatility year after year.

The volatility in the stock market has become unbearable for many people. The latest correction that began in earnest the day after the election took a month to smack about 9% off the S&P 500, placing the index back to where it was trading on February 3. In just 21 trading days, most of the good returns for the year had vanished.

I can sympathize with the people who hit the panic button toward the lows. This economic recovery has not felt much like a recovery and we have to be getting close to the point where the market will no longer lend money at low rates to developed economies. On top of those worries, it was impossible to turn the T.V. on without hearing the zombie pundits mindlessly chanting "Fiscal Cliff" over and over. I would personally love to see the U.S. government cut about $1.5 trillion dollars in spending and then start working on paying off the debt.

The market will always move in a direction that hurts the maximum amount of people. While everyone was stuffing their bellies with Turkey and waiting in Black Friday lines, the markets staged a brilliant turnaround that began on November 16. As I write, the S&P 500 is back up to where it was the day before the election and down less than 4% from its September 14 high. The way the market rallied (most of the gains happened on three days) made it very uncomfortable for investors to buy back and I doubt many did.

The main point of this month's letter is that **stocks will likely continue to be volatile, but with bond yields this low, they may be the only way to make reasonable returns.** A ten-year U.S. treasury bond is currently yielding about 1.6%. If an investor wanted to live only off the principal, $1 million in 10-year treasuries would only produce about $1,333 per month income. If you are in the 28% tax bracket, you are now getting $960 per month for your million dollar portfolio and there is no way you will be keeping up with inflation.

In no way am I saying that investors should put all of their money in stocks. I do think everyone should consider owning some as one of the only ways to preserve future purchasing power. Because there is so much volatility, I prefer to own stocks as part of an active mutual fund or through a disciplined trading strategy built on a model that has protective measures in place.

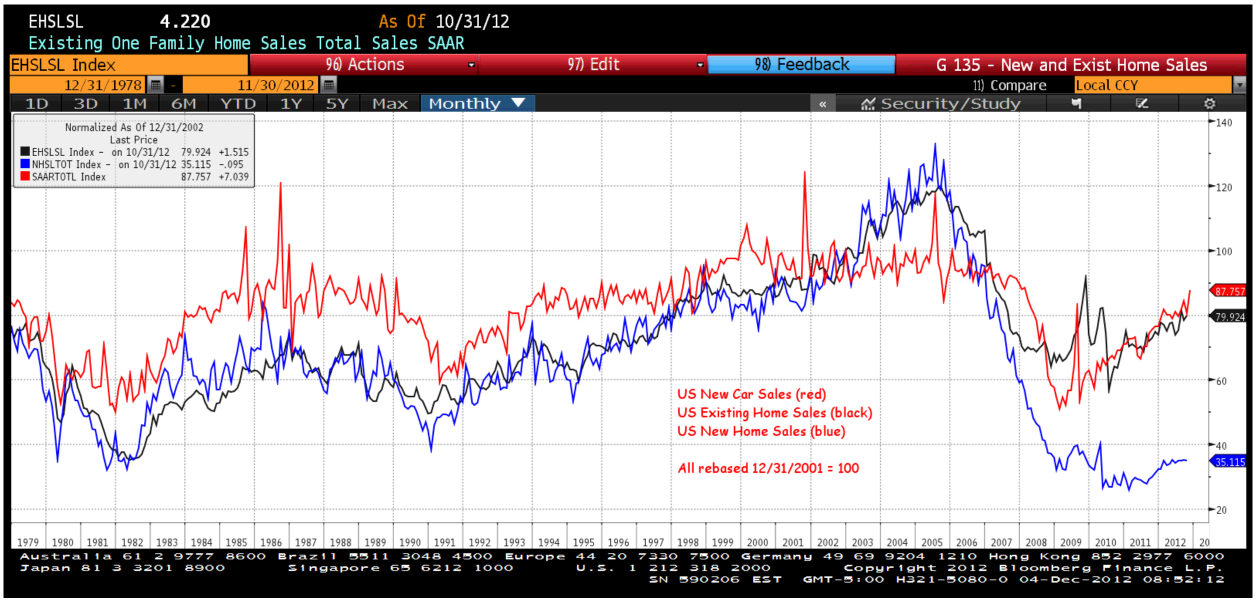
Below is a chart showing the six scariest corrections that the S&P 500 has had since the lows were put in place in March of 2009. As you can see, corrections are very normal in a bull market and it is impossible to time the length and deepness of each and every one of them. We all remember the stock market crash of 2008 and each time we see a 5% drop, we naturally wonder if the next 50% drop is right around the corner.

Since the 2009 low, there have been several scary corrections for the S&P 500. Source: thinkorswim

Now the chart of the Chinese or Greek stock market doesn't look anything like the S&P 500. I am showing you what a good stock market has looked like to help you see that even when stocks are rising, it is very natural to have these terrifying corrections. One of the best things to do is to try and determine which markets are in a bull market and focus on those. Gold and U.S. stocks would be examples.

At some point the S&P 500 will be at a major top and I hope the active managers and trading strategies that I have in place will minimize losses when we see the next recession, but until then I think it is very important to give the bull market the benefit of the doubt. It is very possible that the investors that can control their emotions and find a way to cope with the volatility will succeed in the future.

The current U.S. expansion is now 42 months old and is very likely to peak in the next few years, but I think it is still premature to call the bull market dead. One of the sectors that could be a surprise on the upside is real estate. As you can see on the chart below, new car sales, existing home sales, and new home sales tracked each other pretty closely for awhile. New car and existing home sales began to rebound in 2009 and new home sales have been flat at best since 2009. Building a bunch of new homes where there is actual demand for them is very stimulative to the economy.



New home sales (blue) have diverged from existing home (black) and new car sales (blue). Source: Marketfield

In addition to the potential for new home sales, we have a post recession peak for consumer confidence, a six year peak for NAHB home builder confidence, and extremely low interest rates. But what about the FISCAL CLIFF? Legendary technical analyst, Ralph Acampora, tweeted the following on Monday, December 3:

> If we fall over the "fiscal cliff", it will be a major buying opportunity because the politicians will be forced to compromise. If we don't fall over the "fiscal cliff", the market will rally smartly, celebrating the fact that the politicians have compromised. Either way, buy now regardless of the commentary coming out of Wash. D.C. - the NYSE internals and foreign markets are already moving up.[1]

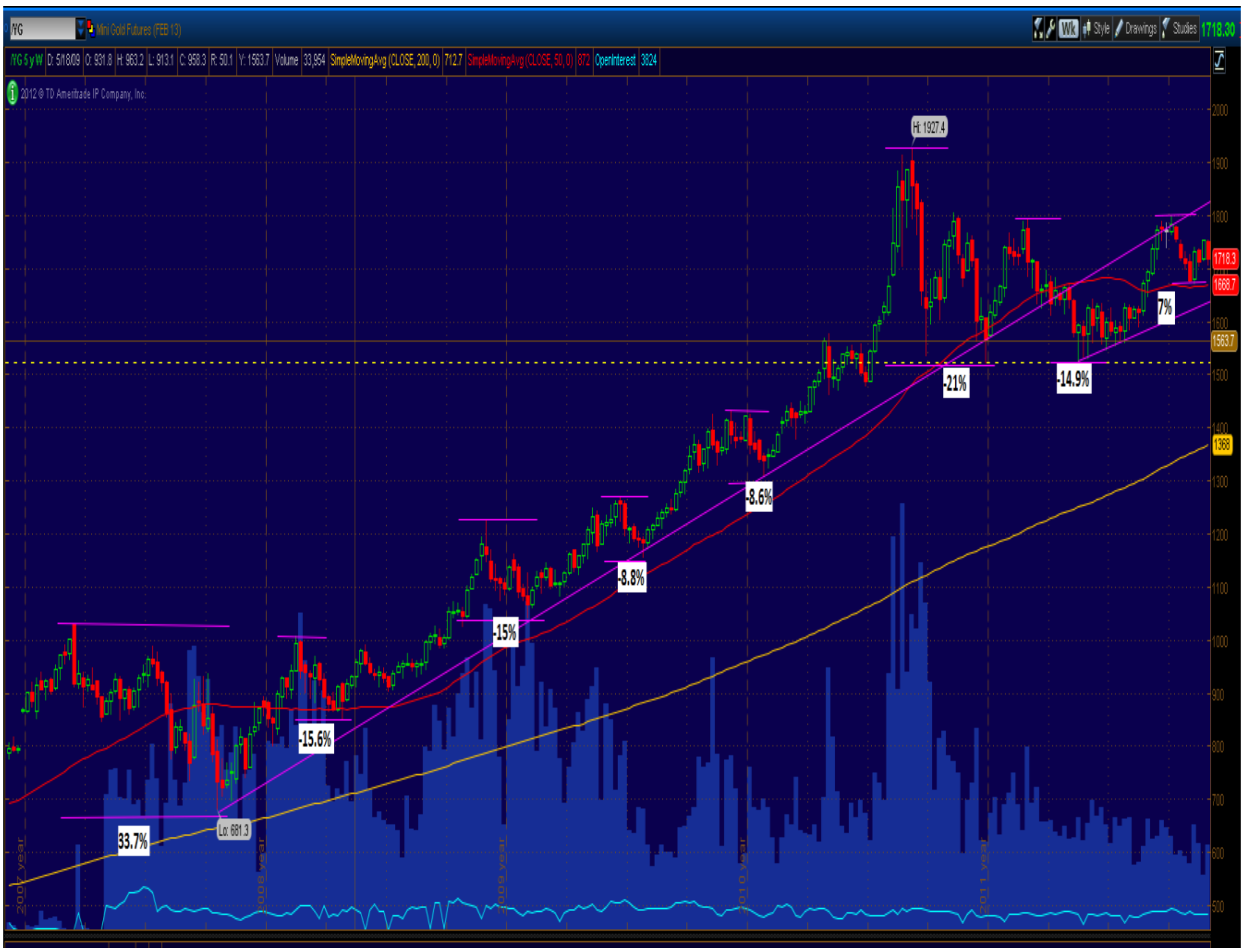
I am not worried about the overly hyped Fiscal Cliff. You rarely need to worry about what everyone in the media is talking about. It is the thing that nobody is talking about that you should be looking

[1] https://twitter.com/Ralph_Acampora

out for. In a recent research piece, Michael Aronstein of Marketfield Asset Management recently stated:

> Market participants, driven by the pre-adolescent attention spans of financial media, have a strong tendency to over-emphasize the importance of immediate, unknowable events (where the probabilities of nearly all potential outcomes are reasonably well incorporated into prices) at the expense of long-term, highly probable resolutions that only seem to get attention and market response when they finally arrive on the front pages. This is a form of market inefficiency that we believe to be exploitable.

In addition to stock market volatility, we have had some serious volatility in gold. Below are the corrections that gold has had over the last five years. As you can see these corrections are just as unpredictable in their depth and duration.



The gold bull market has not been easy to ride for the last five years. Source: thinkorswim

During this time gold has had a huge move from $700 to $1700 (143%), but it has not been easy to hold. When gold peaked last September and had its 21% correction, I was doing some serious searching to make sure I continued to believe that it was still in a bull trend. I then thought of Obama, Geithner, and Bernanke and came back to my senses.

Richard Russell of *Dow Theory Letters* said it well when he explained that bears are scary animals and dropping markets are appropriately called bear markets. Investors fail to consider that bulls are also dangerous animals and you don't want to be locked in a small room with one of them either. He still believes that gold is in a bull market and the bull is going to do everything it can to buck off as many people as possible so that very few people will have had the courage to stay along for the entire ride from around $250 per ounce to wherever it ends.

Speaking of the gold bull market, I am often asked by clients when I will sell my gold bullion. I recently came across the following inflation adjusted price of gold chart from www.speculative-investor.com. We all know that gold went from $35 per ounce in 1971 to about $850 per ounce in early 1980. At that time we had the Hunts cornering the silver market and manic speculation into anything that couldn't be printed. Gold became terrifically overvalued and was a terrible place to keep your money for the next 21 years (the secular bear market).

Steve Saville, of the Speculative Investor, recently noted that in today's dollars the 1980 peak for gold was around $3,000. The 1980 price will continue to rise in today's dollars if we keep seeing inflation. Saville points out: 1) you usually get a parabolic spike to end long term bull markets that we haven't had yet and 2) somewhere before we get to the inflation adjusted 1980 gold price, it will be a good time to start taking profits as it is unlikely that we rise above that price.

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