Baird Market and Investment Strategy

Breaking News: Stock Market Update

December 27, 2018

Please refer to Appendix – Important Disclosures.

Stock Market Update – Thursday, December 27, 2018

Following the Christmas Eve debacle, yesterday's upside explosion with the Dow gaining more than 1000 points is certainly welcome. At the close the TRIN finished at 21 which is a very bullish number rarely seen, suggesting the selling has become exhausted. Additionally, upside volume overwhelmed downside volume by a ratio of 25-to-1, also rare and bullish, although we are looking for two sessions to confirm that the downside momentum has been broken. Given that more than 80% of trading volume is now done with algorithms and other computer generated strategies, it is difficult to feel secure with a scenario using one day's performance particularly with a limited audience (same with the Christmas Eve session). We do think the decline on December 24 caused pessimism to soar, which is one of the requirements we are looking for to identify the start of the bottoming process. We anticipated the VIX jumping to 35 and that was fulfilled on Monday but historically all serious declines have the VIX stretched much higher. As a result, additional data is necessary for confirmation that the lows could be in place but we remain skeptical.

Although the decline from October was severe it was also very orderly with no sign of investor panic or capitulation that usually marks the end of a cyclical bear. Bear markets often produce the most spectacular rallies and almost always retest the lows at some point which will be important to monitor. Additionally, seasonal patterns at play with the market were severely oversold as the December rally often begins on Christmas Eve and goes into early January. From a seasonal perspective, this week is in line. Over the past 20 years bonds have outperformed stocks in January. Also, corporations will step aside in January and delay buybacks during reporting season which weakens the supply/demand equation, which raises concerns about January if the decline restarts. Therefore, we are reluctant to take too much from the post-Christmas surge or the break on December 24.

Bottom Line: **We remain cautious, awaiting further evidence that the fourth-quarter plunge in stock prices has run its course. The good news is that we feel confident that the U.S. economy will NOT fall into recession. This is important because a cyclical bear market historically produces a decline of 25% from top to bottom on average. A recession would likely cause significantly more damage.**

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