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Investment Commentary

January 16, 2019

4th Quarter Recap

In December the stock market experienced a sudden and sharp move down. From the high point in October the overall stock market was down as much as 20%. It has since bounced back up and at this juncture the overall market is down about 11% from the high point. The yield on the 10 year US Treasury Note has moved down from a high of 3.25% to the current yield of 2.75% even after the Federal Reserve raised short term rates .25% on December 19th.

The Current Economic and Investment Environment

We are in the late stages of the economic cycle and are getting closer to the next bear market/recession. There has been a lot of discussion about a recession starting in 2020, but ultimately it is impossible to predict. Bear markets tend to be drawn out, often starting from a point of optimism about stock market performance.

But at this juncture I believe it is important to listen to what the stock and bond markets are telling us. Something isn't quite right and the best course of action may be move portfolios to a more conservative posture sooner rather than later. Hopefully, the stock market will provide an opportunity to reduce the allocation to stocks.

In times of uncertainty it is always a good idea to look at the possibilities before making decisions. Here is what we know at this time that could have an effect on the stock and bond markets:

The Good News

- The economy is currently performing well.
- We are in a state of full employment.
- Corporations continue to show profitability.
- Interest rates are still low.
- Consumer spending is very favorable as evidenced by holiday sales.

- Stock valuations are very reasonable after the sell-off.

The Bad News

- Home sales are slowing, possibly due to higher mortgage rates.
- Corporations have curtailed capital spending (which is a big driver of economic growth)
- Overall global economic growth appears to be slowing
- Longer term interest rates have moved down which indicates the bond market believes growth is slowing
- At this juncture there is little the Federal government can do to minimize the effects of a recession. Tax rates are already low, government spending is already at a high point and interest rates are still very low.

"Known" Unknowns

- How long will the government be shut down and will it have an effect on the economy?
- What are the consequences of a divided Congress and the potential for "gridlock"?
- The Mueller investigation will come to an end at some point and the effects on market psychology are unknown.
- Will the Federal Reserve raise rates 2 more times as they indicated in December or will it be one time or not at all?
- Will there be a resolution of trade issues with China?
- China is the 2nd largest economy in the world and it is bearing the brunt of tariffs and trade issues. If the Chinese economy slows it will have an impact on the overall global economy.
- Italy is dangerously close to defaulting on their debt. Italy is the 3rd largest economy in Europe and default will be much worse that the Greek credit crisis.
- At this time it is unknown how Brexit will be resolved and what the implications are.

“Unknown” Unknowns

There are any number of sudden, unexpected events that could have an effect on the financial markets. Geopolitical events, an economic crisis or currency meltdown in another part of the world can happen at any time. Here are some of the possibilities:

- Putin has been flexing his muscles and has made statements indicating Russia has weapons the U.S. cannot defend against.
- China had ordered the military to “prepare for war” referring to a potential invasion of Taiwan.
- An executive of the Chinese company Huawei (a global technology and communications firm) was arrested in Canada last year at the request of the U.S. government. Recently an employee of the same company was arrested in Poland for “espionage”. China has taken very strong retaliatory measures by arresting Canadian citizens and has sentenced one of them to the death penalty. And U.S. prosecutors are probing Huawei over suspicions of trade theft. This is ongoing and tensions will likely increase.

Bear Markets

It typically takes 2 or 3 events occurring at the about the same time to trigger a bear market in stocks. In most cases an increase in interest rates resulting in an economic downturn/recession and reduced corporate profits along with another unexpected event will lead to a bear market. There are certainly plenty of possible events that could be a catalyst of the next bear market/recession.

Review of Asset Classes

Domestic Stocks

Domestic stocks could perform well in 2019 although with increased volatility and a modest upside. And they are likely to perform better than international stocks.

Growth stocks have continued to outperform value style stocks and that is likely to continue this year. The “acronym” stocks (Apple, Amazon, Facebook, Netflix, Alphabet, etc.) have been propping up the overall market in recent years but have

experienced some downside in the last few months. They are not likely to dominate going forward.

International Stocks
International stock markets underperformed the U.S. stock market in 2018. They remain undervalued but a rising U.S. dollar and trade tensions will continue to exert downward pressure on those markets over coming months.

Rising interest rates, the value of the U.S. dollar and trade tensions are likely to prevent much upside for emerging markets in the near term.

Investment Grade Bonds
Intermediate and long term interest rates have been in a trading range for several months. The overall return for conventional investment grade bond funds could be plus or minus 2% or so. But the current environment is very uncertain and it is difficult to know if rates will move up or down.

There may not be much difference in the investment returns of intermediate term bond funds, short term bond funds or even money market funds over the next several months.

Non-Conventional Bonds
Returns for non-conventional bond funds including floating rate funds have been flat over the past year. But the returns are higher than conventional investment grade bond funds. They will continue to outperform conventional investment grade bond funds in the near term.

However, I will likely recommend a reduction in the allocation to non-conventional bond funds in coming months. These funds do not perform well in a slowing economy or credit crisis type of environment.

REITs
Currently I am not recommending an allocation to REITs. This asset class has slightly underperformed the overall stock market in recent years. Also, certain sectors of the real estate market will underperform due to a significant downsizing of the retail industry.

Energy Sector
Several months ago the prospects for the energy sector looked promising. The investment performance of this sector had been dismal from the previous 3 years

and events on the horizon seemed to indicate the price of oil would move up. It did for a time but some of the geopolitical issues affecting the price of oil did not turn out as expected. Along with the concerns about future economic growth, the price of oil dropped dramatically in December. Oil prices are again moving up but later on this year I will likely exit this sector as we will likely see a slowdown in the economy.

Going Forward

This year the financial markets will be volatile and uncertain. And there is likely to be a lot of "headline risk" adding even more uncertainly. We are getting closer to a bear market in stocks so it is important to re-evaluate your tolerance for risk.