Quarterly Insights January 2019

A great deal has changed since investors' overenthusiasm, stemming from synchronized global economic growth, drove stocks in most major financial markets up 20% to 30% in 2017. The U.S. stock market went up every month during the calendar year, the first perfect monthly record in history. By contrast, in 2018 stocks rose nine months and fell three months, resulting in negative returns overall. The good news is high quality bonds held their value, offering valuable portfolio diversification. Optimism has now faded, causing heightened stock market volatility.

Investors grab at any piece of evidence in trying to ascertain whether recent global weakness will persist. This uncertainty stems from three major concerns: 1) whether the rest of the world will drag down a healthy U.S. economy, 2) the potential negative investment implications from a prolonged trade war, and 3) how the U.S. Federal Reserve Bank will react. The answers to these questions largely determine the direction of all asset classes in the short and medium-term. However, over the long-term, financial market performance is largely tied to the expansion in the world's population and innovation. These two dynamics lead to greater global demand and access to goods and services, which positively impact asset prices more than the uncertainty associated with market cycles and geopolitics.

Given these concerns, are financial markets correctly anticipating an economic slowdown? Continued economic stability is called into question when longer-term interest rates fall (and bonds rally) in the face of a declining stock market while the Fed raises short-term interest rates. The Fed has been accused of potentially causing the next recession if it continues with its stated policy. It intended to set at least three interest rate hikes on autopilot in 2019, together with selling a predetermined amount of bonds from its balance sheet, regardless of any weakness in future economic data. Investors believe this could result in sizable risks to the economy and financial markets. However, apprehension regarding a Fed mistake may no longer be reason for immediate concern, as shown by the Dow Jones Index's 747-point gain on January 4th. Why? Fed Chairman Jerome Powell declared the Fed will be prepared to adjust policy quickly and flexibly. That's music to the ears of all investors. But his reassuring commentary did not stop there. He also stated that the Fed will use all tools as appropriate in a future crisis. This change in communication is critical because investors want reassurance that they have a backstop if financial market conditions erode again as in late 2007 through early 2009.

Sentiment is beginning to shift positively, but will one less area of concern be sufficient to alter the balance of buyers over sellers to form a new bull market just yet? While nobody can time market swings, what we do know is that missing the occasional big up days in the market, especially during market turmoil, is the difference between making money or not. According to the *Wall Street Journal*, over the past 15 years, missing just the 10 best days would have cut annualized returns in half, sitting out the best 20 days would have erased all positive returns. The only clear message from history is that to successfully navigate market upheaval, "investors have to stick to their plan rather than react to wild gyrations and scary headlines."

There are many things that investors should take notice of if they strive to maintain an unbiased outlook and draw better informed conclusions. Most obvious, there is now a much slimmer chance of the Fed raising interest rates at the pace originally indicated unless clear and compelling reasons support a sustainably strong economy. Some feel the U.S. is in the later stage of an economic cycle given the current 10-year recovery, and therefore prone to recession in the next year or so. Another less evident view relies on other indicators. Historically, economic cycles tend not to peak when interest rates and inflation are low and when corporate profits have just begun to peak. From this perspective, the next recession may be 3 to 4 years away. So our economy may have a lot of life remaining and recent market action may prove to be one of the many false positives throughout history. That is why economists have been heavily criticized for predicting far more recessions than have actually occurred.

There is always plenty to worry about even without a Fed misstep, a prolonged Trump Trade War, or a contentious resolution to the federal government debt ceiling debates resuming later in February. But financial markets are known to climb a “wall of worry,” rising despite drama from current events. Such events can be expected to lead to continued market volatility. Thus, our firm’s attention is especially focused on how to use market volatility as an opportunity for our clients. We look forward to the New Year, with its opportunities and challenges, and wish you the very best in 2019!

Sincerely,

Randy

Randy Garcia
Chief Executive Officer