At Last, the Grand Market Cycle Restarts!

(And no, it hasn't been 8.5 years since the last market correction)

2018 Economic Outlook and Market Commentary – Gustin D. Fox-Smith AIF®, ChFC®

<u>Part 1 – What Wolf?</u>

First, I want to dispel the myth that the media has been repeating for over a year in order to increase their audience with fear. On the subject of a near term correction in the market, I've become frustrated with the news media continuing to repeat the mantra *"It's been almost nine years since we had a correction, we're way overdue."* That is simply untrue. We are not overdue for a correction and according to the data we aren't seeing any likelihood of a correction in the near term.

We did have a correction in the summer of 2015. It has been 2 years, not 8 ½. *(See Chart 1)*

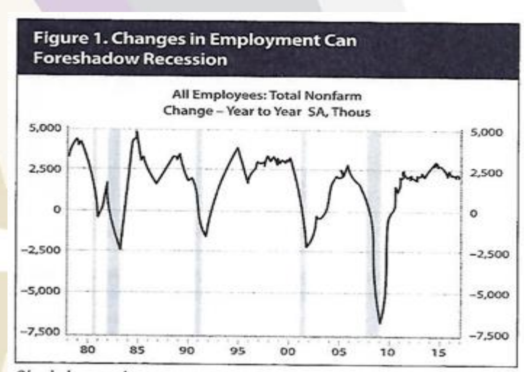
By definition, a correction is when the S&P 500 Index drops over 10% from peak to trough. During the summer of 2015, we saw a 12.35% decline as of August 25th and the index confirmed that level and then some three more times in the coming months with the largest decline reaching over 14%. This leaves me wondering if the media thinks we are idiots and that we don't have internet access to get the data that tells the real story.

***Chart 1** – Source: Yahoo Finance S&P500 Chart 4/1/15 – 3/31/16*

Truthfully, it has been eight years since we had a recession, defined as two consecutive quarters where GDP decreases. We could be a little overdue for a minor recession, but market corrections are typically signaled by certain data that nearly always precedes the move down. Here is a quick look at the data points that typically signal a correction and where they sit today:

1. Job growth: Five out of five recessions and market corrections were signaled by year over year job growth that drops below zero, i.e. lost jobs. You can see from chart 2 showing employment, we show no sign of a decline in jobs.

2. Business confidence is also an almost perfect indicator. Five for five recessions were preceded by business confidence below 45 with a reading of 50 being an even outlook. Business confidence is approaching 60 and climbing, not even close to signaling market stress in the short term. (see Chart 3)



Shaded areas denote recessions.
Source: U.S. Bureau of Labor Statistics, Haver Analytics

Chart 2

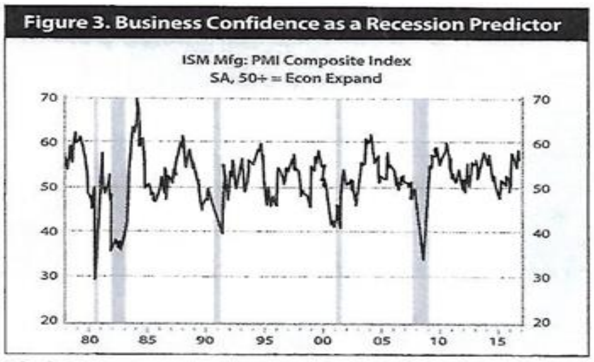


Figure 3. Business Confidence as a Recession Predictor

Shaded areas denote recessions.
Source: Institute for Supply Management, Haver Analytics

Chart 3

Figure 2. Declining Consumer Confidence Often a Recession Signal

Shaded areas denote recessions.
Source: The Conference Board, Haver Analytics

Chart 4

3. Consumer confidence: Consumer confidence declines typically by more than 20% over a year to signal five out of the five past recessions. Chart 4 shows that consumer confidence is climbing. This indicator is not signaling a recession.

4. Interest rates: The rate curve will often invert prior to a correction, meaning short-term rates climb higher than long-term rates. If you look at Chart 5, the yield spread is beginning to decline but there still is a 1% gap. This indicator is the only one that seems to be approaching a signal point, but still hasn't crossed

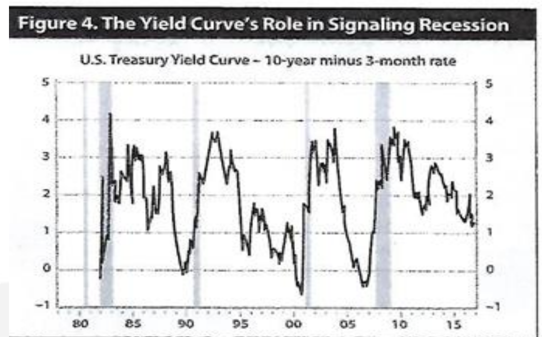


Figure 4. The Yield Curve's Role in Signaling Recession

Shaded areas denote recessions.
Source: Haver Analytics

Chart 5

We can see that none of our indicators is even close to a trouble zone. From an economic standpoint, risk of a recession and pullback of the stock market remains very low. Risks to the stock market would include rising oil prices, oil has been recovering from a multi-year low and it has been slow and methodical. Current prices for oil do not show immediate risk. Interest rates are predictive, typically when a yield difference drops to a zero, the stock market drops soon thereafter. Although the spread is well outside the risk zone, we are beginning to see it close a little bit. It is not an immediate risk but could become one, so we will watch it closely.

Stock valuations are also an important indicator to watch. It is true that right now valuations are very high and still rising. (Chart 6) Risks are high, but also do not seem to be imminent in the short term. While this measure currently is probably the closest thing to a signal that something may be awry with stocks, a market correction isn't the only way to cure high valuations. We forget that rapidly increasing earnings bring the P/E numbers down just as quickly as declining prices. With the recent spike in corporate earnings, those PE numbers are beginning to move along with stocks rather than ahead of them.

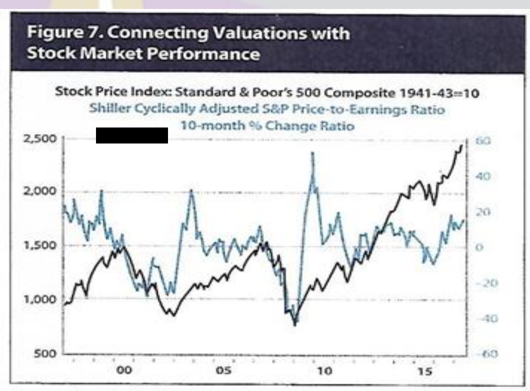


Figure 7. Connecting Valuations with Stock Market Performance

Source: Standard & Poor's, Robert Shiller, Haver Analytics

Chart 6

With economic and market conditions generally supportive, and with immediate risk levels low, even as absolute risk levels seem high, the big picture shows the market will likely keep moving higher, especially with climbing earnings. Add to that the boost of canceling the repatriation tax and lowering corporate and individual tax rates that were just passed by congress, plus what is going on demographically with the millennials, and I believe we're in for a much easier decade or so ahead. Mix in two to three down years along the way, but the trend will be much stronger. 2018 will most likely be a very solid year, similar in magnitude to 2017.

Part 2: Bring on the Bull!

After 17 long, challenging years for the global markets, all signals seem to be saying that we have launched into a new cycle at last! It couldn't have happened soon enough. We have been in a secular bear market long enough that the last time we experienced the tailwind of a long term secular bull cycle, the teenagers getting their driver's licenses this year hadn't even been born.

As we have met in the last 2 years, we've discussed our view of the Grand Market Cycle due to mounting data showing that we were getting close to a reset. But for those of you that aren't aware, I will give a brief summary.

It is common knowledge that the stock market has delivered an average return over the last 100+ years of roughly 9%. However, that average is attained through a Grand Market Cycle, lasting 35 years on average, that has repeated itself over and over as far back as we can look. So far, we have been able to identify 9 of these cycles in historical data and they all look almost identical. See chart 7 for data from the last 3 cycles.

The 35 year cycle is made up of two very distinct and opposite seasons. The first phase of the cycle lasts for an average of 15 to 17 years and the market produces returns far greater than the 9% long term average. This is not to say there are no down years in this part of the cycle. The last cycle's growth phase gave us an average return of over 15% per year while still experiencing 3 negative years, one included the 1987 Black Monday crash. But even with the rough years, the market climate created a tailwind that helps markets recover from pain in very short order. The 1987 event saw the market drop over 50% in 2 days and all of the loss was recovered within 6 months. In contrast, 2008 delivered a similar loss of just over 50%, but with no wind in our sails the market indices did not recover for over 5 years.

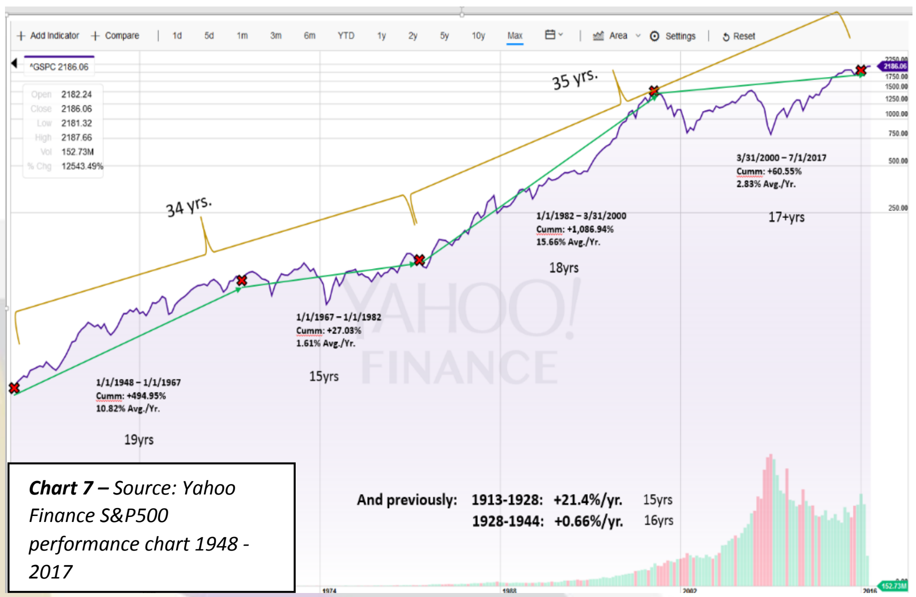


***Chart 7** – Source: Yahoo Finance S&P500 performance chart 1948 - 2017*

The second phase of the cycle begins when a market event occurs that scares people into protective action. The reaction causes households and corporations in our nation to clamp down on their pocketbooks, slowing down spending and expanding. As a result, we begin the long, dry, bear market stretch. This season also lasts 15-17 years on average, during which the market produces just over 0%. Once the flat phase ends, we get to repeat the cycle again.

The cycle we have just completed began in 1982 when we started a 17 year secular bull market that took us to March of 2000 when the Tech stock bubble popped. That event began the bear phase, which lasted until July of 2017. The full cycle lasted 35 years with very close to half of the time spent in gains and half in pain. While the bear season has played out, the S&P 500 has produced an average return of just 2.8%. During the growth phase, the S&P delivered an average return of 15.66%. We are pleased to see signs that a new growth phase has begun and life gets easier for a stretch here.

This repeating cycle affects everything in our economy, not just the stock market. During the bear season, we see wages remain roughly level. Housing also tends to end the cycle around the same price as the beginning of the flat period. Commodities also fall into the same zero growth environment

The great thing about this cycle is that it has nothing to do with statistics or math, because those can be fallacious. Every time you find a formula that seems to predict the market and try to apply it, the next time the pattern begins, you're wrong. This cycle is based entirely upon human behavior and we know human beings do not always act rationally when it comes to their money and are tremendously predictable in large groups.

The reason this cycle continues to repeat is that it is based upon predictable human behavior and the fact that people do not truly learn from what did not affect them personally. The people that grow up in their jobs during the growth cycle learn by observation that the only risk that exists is missing out on a profit opportunity. Losses are always short term during the growth phase and people begin to believe they cannot lose (Housing always goes up." remember?). Think about who will be in control of government and major corporations in 15 years and you realize they are the people who have just left college for their first job. Continue this line of thinking and you ascertain that their age means the last time a real risk event occurred, the 2008 crisis, they were in middle school. You do not inherently gain wisdom from an event like that unless you are independent and bearing the pain yourself. As young teens, it was an event that happened around them, not too them. As these people begin to take control of positions of power after 15 years of unwavering growth, they run their personal and business lives as if real risk does not exist. They take on too much debt in their organizations, too much leverage, buy bigger houses and cars than anyone needs, and generally pile on risk everywhere. Then, inevitably, the market hands them a real loss event, and they learn their lesson. In the last cycle, everyone was caught up in irrational exuberance, the Internet stock boom, and the "New Economy". Then the tech bubble imploded. And 2000 - 2002 was tremendously painful. Anyone that was over levered or had too much risk exposure was taught the lesson that risk exists and losses do happen.

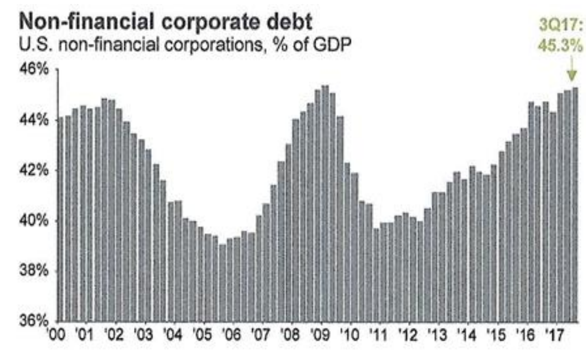


Chart 8 *Source: JP Morgan 2017 4th Qtr. Data Book*

When the market teaches us the lesson of financial prudence, we always take it too far out of fear. Families and companies don't just slow their spending, they choke it off completely by closing their wallets and avoiding any unnecessary spending. The resulting lack of economic activity causes a recession and slows everything in the economy to a crawl which just keeps things even.

Typically, as the bear season grinds on for 7, 8, 9 years, we see another phenomenon that repeats itself with nearly every cycle. During the no growth phase of the cycle people are generally uncomfortable. Many are stuck in jobs they do not like because no other jobs are available. We watch prices of everything climb while our homes, investments, and incomes are stagnant. Our Government reacts the same way each time. Knowing people are uneasy and desiring to remain in power, our representatives increase spending on everything from welfare to bridges and roads during the flat years of the cycle, hoping to be seen as the candidate that helped during the rough years. Unfortunately, while Government benefit programs all automatically increase payments at the inflation rate and new spending is added to keep voters happy, the things the Government taxes for its revenue remain flat for nearly 2 decades.

This leads us into the economic environment of the final 2-5 years of each cycle. Governments are going broke trying to meet the spending promises they have made while their revenues haven't increased at all. They begin doing very irresponsible things trying to manage the situation like manipulating the bond market to try to control interest rates, printing money at an alarming rate, FED Open Market Operations and Quantitative Easing, etc. This mismanagement of the money supply and economy rightly terrifies the families and organizations in our nation and makes many believe the whole system may crash down at any moment. It may be counterintuitive, but this mismanagement MUST occur in order to build the engine for the next cycle. The reason this is required is we, as private citizens and private companies in the United States, always react the same way when we watch our government acting irresponsibly. We begin to do the right things. In fact, the bigger and scarier the federal action in the economy, the larger the engine that is built by the rest of us and the stronger the growth cycle that follows.

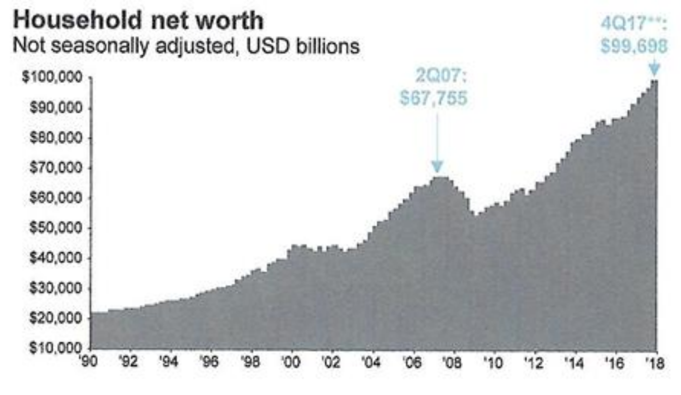


Chart 9 *Source:JP Morgan 2017 4th Qtr. Data Book*

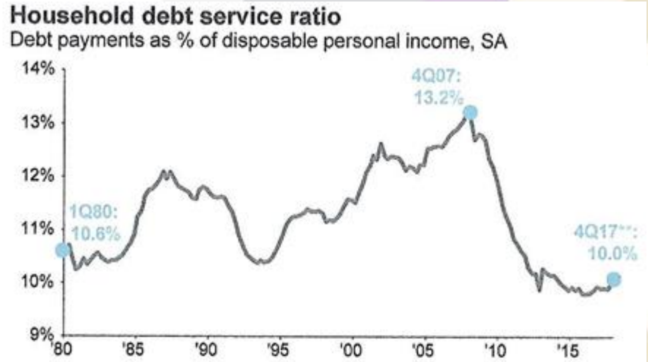


Chart 10 *Source:JP Morgan 2017 4th Qtr.*

Since 2008, as we've watched our government do amazingly unwise things with the money supply, we have watched our corporations slow their spending and expansion, save their money and we're now at the point where they have triple the funds that they had back in 1982, the last time we kicked off one of these growth spurts. And that's on an inflation-adjusted basis. Households and families do the same. We've seen people making more wise purchase decisions like buying more reasonable cars and reasonable houses, paying down their debts. The market for homes above $1M has nearly collapsed and I haven't seen a Hummer or a Lincoln Navigator hit the street in several years. Alongside paying down our debts, we've been putting money in the bank and investing a little bit more. The end result is that after eight years, there's a capital pool so big in the hands of the private citizens and private companies in our economy, that inevitably as soon as people feel things are headed in the right direction, it begins to flow into the market in the form of spending and expansion. And when your home value is climbing every month, your retirement accounts are growing, your job is secure and wages are going up, it is nearly impossible to feel that things aren't going in the right direction and that it is perhaps safe to enjoy some of the resources that 8 years of frugality have built. (See Charts 8 – 11)

Chart 11

Following the June jobs report that showed the first labor shortages in our market since 1999, we have seen everything in the market confirm that we have launched into the next cycle and I am so very happy to see it come.

We have seen really encouraging trading activity since July, the market is moving in small, responsible moves, there is broad participation from most industry groups and quality companies. Alongside that, the market has been growing at the same slope as earnings and consumer sentiment, which is not indicative of a bubble. As long as earnings are coming up at the same rate as the market and that gap isn't growing, it is a sustainable climb.

Chart 10

We just closed almost 17 years with a return of 2.8%, flat wages, home prices that have boomed, crashed and recovered but are close to where they started. And a stock market that just this year has finally begun to set new highs. And this time we are better off than we were in 1982 on several measures: our corporations have more money; our households have more money; and our households' debt service payments are much lower due to a more friendly interest rate environment.

In closing, may the new year bring you all you hope for and deserve and may the markets behave the way I am expecting because if I am right, we all get a lot more comfortable going forward. With that I will leave you with a bit of humorous analysis via a story that may be told through nothing more than a single chart. We all know we are over connected and addicted to our phones and tablets. And it is also common knowledge that Americans are the most productive workers on earth. It appears the two may be joining to an interesting result. (See chart 12)

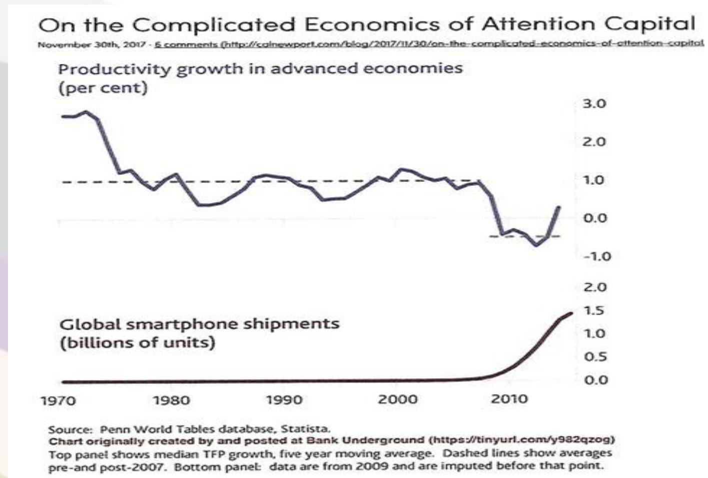


Chart 12

Be well and focus on what is most important, always.

Gus Fox-Smith, AIF®, ChFC®
President and Chief Financial Advisor
Regional Director