April 27, 2018

Dear client,

It was in spring of 2009 when stocks had bottomed from the “Great Recession of 2008”. Business sentiment was poor, the global financial system was in a panic, unemployment was high, and stocks were cheap. The turning point came late that summer when it became apparent to me that it was time to start to rebuild the stock portfolio.

In 2008, I had drastically reduced the percentage of stocks versus bonds to levels where I deemed the risk to be acceptable. This had the effect of keeping any losses within what I would consider to be an acceptable amount. I believe that this action was critical to the management of the portfolios.

Today is different and is the mirror image of 2009. The Great Recession is long forgotten, the economic expansion is well advanced, the Federal Reserve Bank is tightening its monetary policy, stocks and bonds are expensive, and the gambling casino mentality is taking over once again.

Although we have had a good dose of volatility so far this year, my base case for the rest of the year is to see decent equity returns. However, the risk/reward balance has become less favorable. Since early February, I have thought it to be prudent to focus on capital preservation and to trim the stock exposure.

Although it looks like the perceived risk of a trade war has diminished, a number of other concerns is attracting my attention. In conjunction with our economic research partners, BCA Research, we have developed an exit checklist for stocks. Currently, five of the nine are giving us a “sell” signal which, in the very least, points to a correction. Of all the concerns that I have, the one that keeps me up the most at night is interest rates. In past newsletters, I have mentioned that the market would have some trouble if the interest rates on the 10-year U.S. Treasury approached 3.25%. This week, the 10-year crossed the 3% threshold and closed on Thursday at 3.02%. If inflation starts to heat up due to wage pressures and lower than expected unemployment, the Fed will be forced to raise interest rates to fight inflation. This is a real possibility. What is important to the markets is not the level of interest rates but the rate of change in those rates.

We have developed two alternative scenarios to our base case and have calculated estimates how different asset classes may perform if any scenario were to happen. In addition, I assigned probabilities to each of the scenarios:

Table 1: Case scenarios for treasury and stock returns (2018-2019)

S&P 500 Return Scenarios		
Base Case	2018	2019
Stock Market Return	8.6	7.2
10 Year Yield	3.30%	3.50%
Dividend Yield	2.00%	2.00%
Probability	50%	30.00%
Optimistic Case		
Stock Market Return	16.10%	9.30%
10 year Yield	3.50%	3.75%
Dividend yield	2%	2%
Probability	20%	10%
Recession Case		
Stock market Return	-13%	-19%
10 year yield	2.45%	1.90%
Dividend Yield	2%	3%
Probability	30%	50%

In my base case, I think an 8.6% return is possible for 2018. However, the probability of this happening is only 50% although I don't think the stock market will have a negative return this year. On the other hand, in my optimistic scenario, I think a stock market return of 16% is highly unlikely. The recession case scenario of a negative (-13%) is also a low probability event.

All of these projections and returns are only meant to be suggestive because many variables and assumptions go into the calculations. Nonetheless, what the projections do for me is to get me to think about different possibilities and what probable actions I should take in the management of the portfolios. At this moment, I still have confidence in my base case scenario. Interestingly enough, my reasoning for having a bond component holds true especially in the recession case. In the recession case, the 10-year Treasury yield would decline lifting bond prices which in turn, would help offset declines in equity prices. This is one reason why I have always advocated a balanced portfolio that includes bonds, stocks, and at times, gold.

In conclusion, my base case is unchanged even though I have reduced the stock allocations in the portfolio. There is a good chance that the equity markets could deliver a high single digit return in 2018 and a lower one in 2019. However, I must separate investment strategy from forecasting at this point because unemployment is very low, inflation is rising, and geopolitical conflicts are flaring. The advanced nature of the cycle and our bias towards capital preservation leads me to heed the warnings from our indicators and checklist. We continue to favor Eurozone stocks over U.S., and small caps versus large caps. We have begun to buy bonds once again, but we are keeping the average maturities of those bonds shorter than we usually would.

Best regards,

Steven L. Yamshon
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