NATIONAL FINANCIAL NETWORK

July 11, 2019

Quarterly Newsletter…. by Dr. Robert Votruba

Let's play a guessing game. Don't worry, it will be easy because the format will be multiple choice with some decisive clues that will be given in advance.

After coming off the worst December for the stock market since the Great Depression, more bad news dominated the headlines in the first half of 2019. The United States is on the brink of an all-out trade war with China. Treasury yields now form the dreaded "inverted yield curve" perhaps the strongest predictor that a recession lies ahead. Gold prices are at a six-year high, indicating that fear is in the air. Global growth is slowing, negative interest rates persist throughout Europe, and Britain's failure to lay out a Brexit deal three years after voting to leave the European Union resulted in the Prime Minister's resignation. At home some are calling for impeachment of the President, accusing him of accepting assistance from Russia during the 2016 election.

Given these facts, would you guess that the stock market was…

A. Higher than where it started the year
B. Lower than where it started the year
C. The same

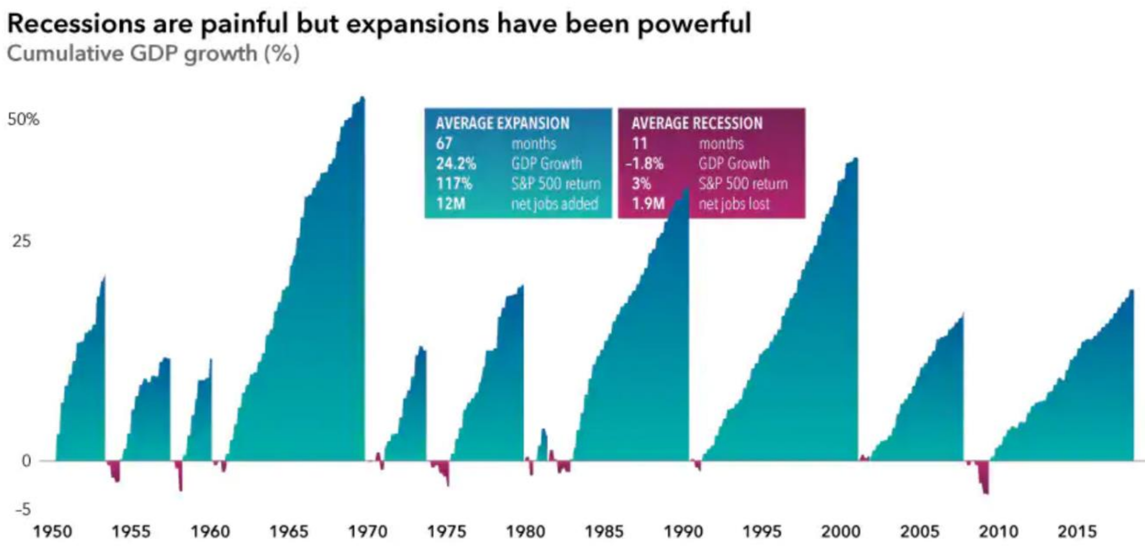
If we didn't know that the market now hovers near all-time highs, option B would seem a compelling choice. However, despite these headlines, the S&P 500, Dow Jones Industrial and NASDAQ all recently reached new highs. Perhaps the bad news was no match for the strongest job market in 50 years combined with a Federal Reserve Board (the Fed) that seems eager to sustain the economic expansion. Either way, as we learned from Yogi Berra, "It's tough to make predictions, especially about the future."

To be sure, the ongoing trade battle with China is cause for concern as is the inverted yield curve. An inverted yield curve is a seemingly unnatural state where short-term interest rates are higher than long term rates. Under most circumstances, someone would demand a higher interest rate if they were loaning their money out for 10 years than if they were loaning it for 3 months because they won't have use of their money for a longer time frame, and the longer the money remains in someone else's hand, the more risk there is. Today, long-term rates are lower than short-term rates. This is generally caused by fear and the expectation that the Fed will lower short-term rates in the near future. Discussions about the inverted yield have become mainstream as of late because it has been arguably the best indicator of recessions over the past 50 years - recessions typically result in bear markets (declines of 20% or more). Keep in mind that anticipating recessions has proven difficult in the past. In fact, since 1988 the International Monetary Fund (IMF) has never predicted a recession in a developed nation with a lead of anything more than a few months.

In addition to the inverted yield curve, markets have also been driven by ongoing trade negotiations with China. Most economists agree that if 25% tariffs (a figure the President has proposed) were levied on all bilateral trade between the U.S. and China, both economies would suffer, though China would be hurt more. Tariffs are taxes that are imposed on imports. Though the U.S. exported \$2.5 trillion of goods and services in 2018 (the largest in history and up 36% in the past 10 years), we imported \$3.1 trillion of goods and services (also the largest in history and up 22% over the past 10 years), thus we consume more than we produce. According to George W. Bush, since "the vast majority of our imports come from outside the country" the shortfall between what we consume and what we produce must come from other countries like China. While the impact of the trade deficit on markets is ambiguous, tariffs generally increase prices for consumers. So, Chinese citizens might consume less U.S. soybeans and we in turn might purchase less home appliances made in China. Though the means to address our relationship is up for debate, it is hardly debatable that

China does not offer the same free market access to us as we do to them, not to mention the challenges with intellectual property theft.

Of course, the market always has obstacles, both political and economic. On one hand we face an inverted yield curve and trade war with China, yet the U.S. continues to exhibit signs of economic strength. Take the job market for example. The unemployment rate remains near a 50-year low, as the economy has added jobs for 105 straight months – a record. Since over two-thirds of our economy is driven by consumer spending, a healthy job market helps to sustain growth. Thanks to higher asset prices, U.S. household net worth is at an all-time high. The U.S. is currently the largest producer of oil and gas in the world (we produce more oil than Saudi Arabia) which helps to hold inflation in check and is still the world's leader for innovation and technology breakthroughs. At the end of July our current economic expansion will become the longest on record, yet at its current pace still may have more room to run. Despite these signs of strength (which are mostly backward looking) the Federal Reserve has signaled that they will likely lower interest rates as soon as later this month to ensure that the expansion continues. Though we cannot know for sure if we are headed for a recession, we do know that while common, when compared with expansions, most recessions don't last very long.



Sources: Capital Group, National Bureau of Economic Research, Thomson Reuters. As of 9/30/18. Month-end values used for S&P 500 returns. Nearest quarter-end values used for GDP growth rates. GDP growth shown on a logarithmic scale.

While the current bull market is the longest on record – the market hasn't experienced a 20% decline in over 3,750 days – it has been labeled as "unloved." It has been called unloved because looking at dollars going into funds (mutual funds and ETFs) for the past 5 years, investors have taken more out of stocks than they have put in, yet at the same time, money has been pouring into bond funds even though rates remain near all-time lows. Of course, investors losing out by trying to "time the market" is nothing new. According to DALBAR, investors have trailed the market's returns over both the long and short term by trying to outwit it. A look at the last 10 years gives some insight as to how tough market timing is. Consider: if all the trading days (2,517) that occurred from the 10-year bull market for the S&P 500 (through March 8, 2019) were ranked from "best" to "worst," the bottom 2,464 trading days (98% of all days) produced a zero-total return while the top 53 trading days (just 2% of all days) create a 400% total return. Yes, bull markets don't last forever, but they last longer than bear markets by a wide margin.

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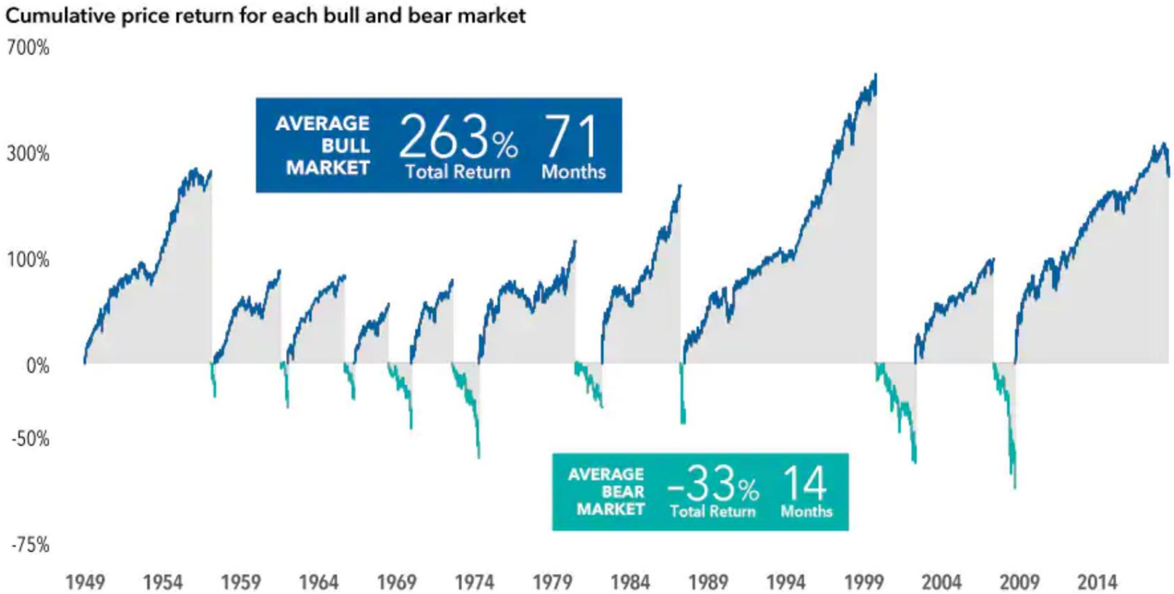

Sources: Capital Group, RIMES, Standard & Poor's. As of 12/31/18. Bear markets are peak-to-trough price declines of 20% or more in the S&P 500. Bull markets are all other periods. Returns shown on a logarithmic scale.

While the near-term focus will likely remain on tariffs and The Fed, expect increased attention on the 2020 presidential election later in the year. The market has risen approximately 50% since Donald Trump was elected in 2016 and if history is any guide, the third year of a president's term is often the best. Though scant evidence exists that the White House has a meaningful influence over stock prices over the long-term, the market likely perceives the current administration to be more business friendly than most potential challengers.

Though bull markets do not die of old age, if Yogi Berra were an economist he might have said something like: we know for sure that it's later in the cycle that it used to be. Stocks have had an unprecedented run over the past decade. Though there have been two setbacks where the market has pulled back almost 20% over the past 10 years, it has been mostly smooth sailing for investors. The waters have been calm for bonds investors as well for nearly 40 years, even though pundits have been calling for bond prices to fall (and interest rates to rise) for the past five years. Certainly, the past 10 years have taught us as much as this year that trying to time the market is as futile as trying to separate a teenager from their cell phone for more than half an hour. It just doesn't work. So, the next time the waters get choppy, and they surely will, just remember that the best way to not get seasick is to look at the horizon.

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Data Source: FactSet
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2019-82465 Exp 7/2021