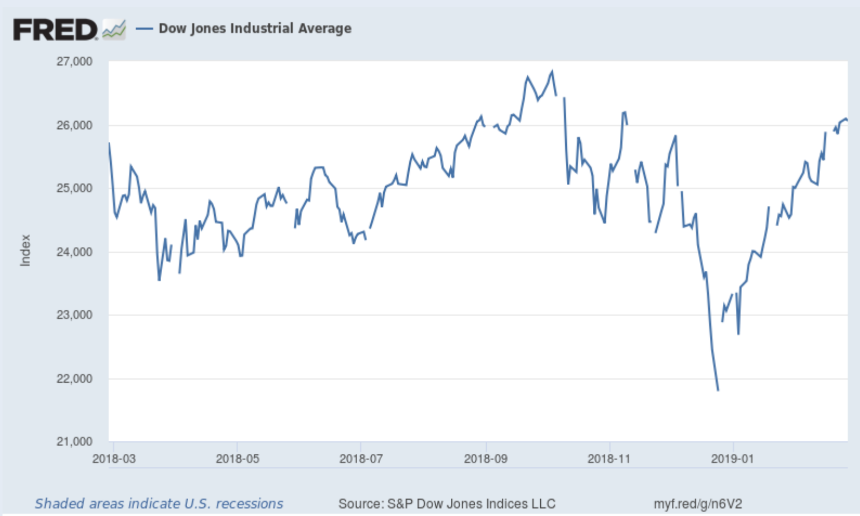
Magellan Planning Group, Inc.

Preparing for the Correction—Part IV

-J. Kevin Meaders, J.D., CFP®, ChFC, CLU*

VERNAL EQUINOX 2019—ATLANTA My last letter of December 19, *The Time to Panic is Not Yet*, was not a pre-planned letter, and went out because of the severe market volatility which you may remember. Since then, stocks have recovered nicely.

The all-time high was on October 3rd, when the Dow hit 26,828. The bottom was on Christmas Eve when we finally bounced off a low of 21,792, a drop of over 5,000 points, or about 19%.



Oct 3 – Dec 24

A 19% drop.

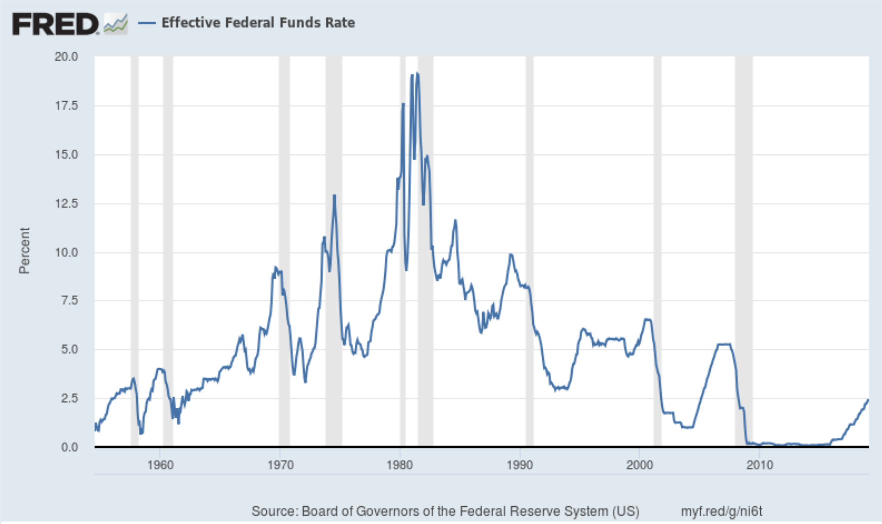
Are you ready for one twice this magnitude?

As I stated in that letter, "we believe the current market volatility is—from a fundamental perspective at least—unfounded." It didn't take long to be proven right. Two full months later we had just about completely recovered and are now about 800 points away from our all time high. Obviously, this is just the Dow Jones Industrial Average, but other indices look similar.

Nonetheless, if you have been reading my letters over the last few years, you know that we expect additional rate hikes from the Fed and a further reduction of their balance sheet—meaning that money, as it was created electronically, is being destroyed electronically.

As an expansion of the money supply occurs, so thus the economy expands. This is called 'stimulus', or 'buying treasuries,' or 'expanding the balance sheet,' or 'quantitative easing,' or any of those terms other than 'printing money'. That's the one term everyone *does* understand, so better not use it.

But just as expansion of the money supply causes expansion of the economy (and inflation), the opposite is also true: a continuing reduction of the money supply usually causes a slowdown in the economy.



Unfortunately, no one knows how much the perfect amount of reduction is and history has proven that it seldom ends well. Which is why interest rates go up, plateau shortly, and then sharply reverse, as you can see in the chart here. This is not natural, but Fed-made.

Our warning track, if you remember, is 2.5%. Well, as you can see from the chart above, we are there. And though the Fed indicated recently that it will pause for the rest of this year, they have also indicated that they are likely to raise some in 2020, and the reduction of the balance sheet continues at least until September. Of course, if the numbers change later this year, the Fed could change their position just as easily as they have reversed their attitude since September 2018.

“Growth of economic activity has slowed from its solid rate in the fourth quarter,” the Fed said in a policy statement that kept its benchmark overnight lending rate, or federal funds rate, in a range of 2.25 percent to 2.50 percent.

“Recent indicators point to slower growth of household spending and business fixed investment in the first quarter ... overall inflation has declined.”[1]

So, the immediate threat of rate hikes has somewhat abated. But we have other concerns.

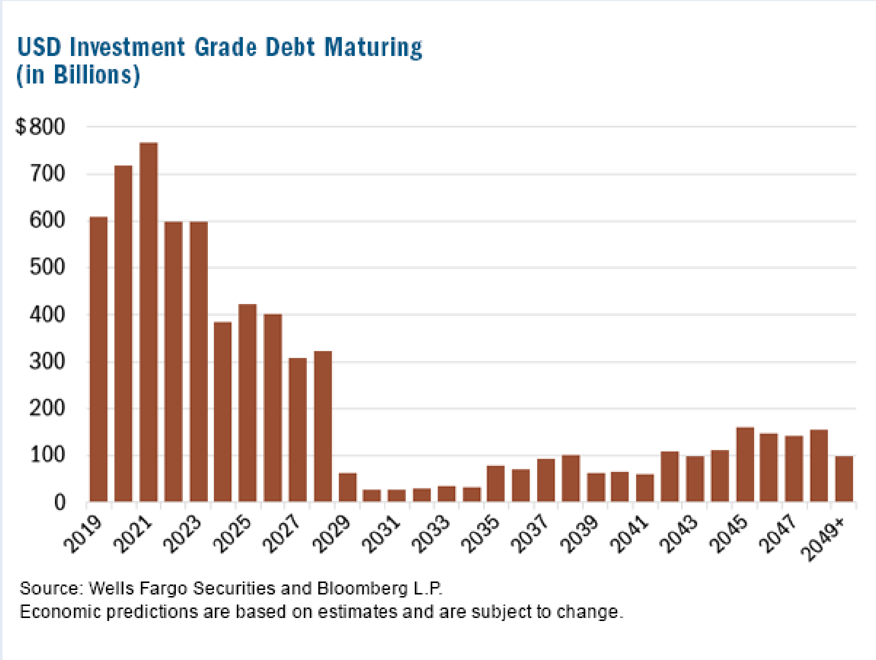
A tangential factor that we believe could be the instigator this time—as the dot.com's were in 2000 and sub-prime mortgages were in 2008—is U.S. corporate debt.

Citigroup Inc. recently issued a warning about the U.S. corporate bond market: "High-grade non-financial companies have seen their total debt burdens rise 10% year-on-year since 2010— double the 5% growth rate of their earnings. The backdrop for Corporate America’s debt now looks 'foreboding' as foreign investors beat a retreat."[2]

According to our research, of the 500 companies on the S&P 500, a surprising 180 of them—36%—are rated one notch above junk, BBB. Still considered investment grade at that rating, one downgrade puts them in the "junk" or "high-yield" rating category, which is BB and below. [3]

[1] https://www.reuters.com/article/us-usa-fed/fed-holds-rates-steady-to-slow-balance-sheet-reduction-
[2] https://www.bloomberg.com/news/articles/2018-12-10/u-s-credit-faces-a-warning-sign-with-ominous-debt-rating-trend
[3] https://www.businessinsider.com/risks-are-quietly-piling-up-in-the-us-bond-market-2018-6

As you can see from the chart below, about $3.3 trillion — or 48% of all current outstanding commercial debt — comes due by 2023. The timing could be quite problematic.



According to an article in MarketWatch, "The sheer volume would be challenging for the market to digest in the best of scenarios, let alone this late in an economic expansion. Adding to our sense of caution are early signs that lending standards have begun to tighten for commercial and industrial borrowers."[4]

In laymen's terms, here's what's been going on:

1. Interest rates have been at all-time lows for some time.
2. Corporations have been borrowing tons of money at these historically low rates.
3. They've taken this money and used it (mostly) to buy back company stock. This reduces the number of shares in the market (the supply) and thus helps to boost earnings per share, which helps to boost stock prices. This is good for the executives (surprise!) who get stock bonuses and stock options.
4. As you can see from the chart above, much of that debt is maturing soon. Meaning they will have to pay it back or re-borrow, re-finance.
5. The problem is, rates have gone up, and they won't be able to refinance at the same low rates. This puts pressure on the company's financials.

Everything works fine until it doesn't. Let's put all these facts together and we can almost see events unfolding. We think it may go something like this:

The market continues to hit all-time highs as a China trade deal is reached. The Fed takes this as license to continue to raise rates. Many of these BBB bonds mature and are renewed at higher rates putting pressure on their financials.

Some of these are downgraded to BB. Those that are downgraded lose value as they are sold (often by mandate) from investment grade bond funds, ETFs, pension plans, insurance companies, charitable foundations, university endowments, and banks.

[4] https://www.marketwatch.com/story/a-3-trillion-tsunami-is-about-to-wash-over-the-stock-market-warns-fund-manager-2019-02-20

This contagion spreads to other highly leveraged companies and the situation spirals. The stock market reacts negatively, and this contagion spreads to Europe, with the PIIGS leading the way as international investors seek safety. Or perhaps the problem starts there and transfers here; the result is the same: market losses.

Where will global investors run? According to history as recent as last December, they will run to treasuries, and we will say "welcome, what took you so long?"

Take a look at the following chart comparing equities and treasuries before and during the Great Recession.[5]

Index	2007	2008	2009	2010
S&P 500	3.53%	-38.90%	23.45%	12.78%
DJIA (Dow)	6.43%	-33.84%	18.82%	11.02%
NASDAQ	9.81%	-40.54%	43.89%	16.91%
1-3 Yr Treasury	7.30%	4.71%	0.54%	1.77%
3-7 Yr Treasury	9.01%	12.16%	-0.60%	9.09%
7-10 Yr Treasury	10.18%	28.81%	-16.11%	10.14%

Obviously, the year to pay attention to is 2008. While everything else was down 33% or more, you can see that the treasuries paid handsomely. And while the 7-10 year gave 16% back in 2009, the 1-3 year and 3-7 year were both pretty flat. This is where we plan to harbor during the storm. We are actively looking for an entry point for these treasuries, since they have not entirely sold back off since the December scare.

If you are managing your own 401k plan or other retirement plan, you may not have these options. In this case, you may want to look to see if you have a stable value fund, or a government securities fund of some sort. These may not provide as much upside during a downturn, but they will at least help to preserve your principal.

Our goal at Magellan is to have 70% of our portfolios OUT of the stock market and IN to treasuries by the time the Fed hits 3%—which we expect to be sometime in the latter part of this year—even though today they announced no more rate hikes for this year. We'll see.
Our approach today is a little more conservative than the approach we set out with a year ago, but the corporate debt signs are ominous. It reminds me of the mortgage resets that we could see coming in 2006 and 2007. We all know how *that* ended.

We believe the next 18 months or so will be trying, and we are clearly working with a heightened level of awareness behind the scenes. If you feel you could use a little help, please do not hesitate to drop us a line.

We look forward to conquering the coming storm together.

[5] www.macrotrends.net

About J. Kevin Meaders

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Kevin Meaders graduated from Oglethorpe University in Atlanta with a double B.A. in Philosophy and Political Science, and then obtained a law degree from Georgia State University College of Law, focusing on estate planning and trust law. He has earned the designations of Certified Financial Planner (CFP®), Chartered Financial Consultant (ChFC) and Chartered Life Underwriter (CLU). He holds a General Securities Principal and Registered Representative registration and Investment Advisor Representative registration through Voya Financial Advisors (member SIPC).

About Magellan Planning Group

www.magellanplanning.com

Magellan Planning Group was established in 2000 to provide a service uniquely tailored to the needs of our affluent Atlanta community. We concentrate on *personalized* retirement planning through tri-disciplinary coordination:

- Financial planning with our Certified Financial Planner™ to prepare a retirement plan that takes into account your needs and expectations. We are a fee only asset management firm.
- Estate planning with our in-house Attorney-at-Law to determine and prepare the documents needed to minimize family liability and maximize privacy. (www.magellanlegal.com)
- Tax planning through a relationship with our in-house CPA to manage tax obligations throughout the year and prepare a tax return that takes into account current tax laws. (www.magellantax.com)

Our relationship doesn't begin and end with the preparation of a plan and the appropriate documents. We establish close personal relationships with our clients and their families and maintain those relationships through regular 'check-ups', market commentaries and educational Lunch & Learns.

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