—New Albany—
Investment Management

August 9, 2018

Market Insight: Turn Down the News Volume, Listen to the Market

If you just listened to the news headlines, it would be hard to find reasons to like this market. "*Trade Wars*"; *Tariff Threats*"; "*Danger Signs are on the Horizon, Be Prepared to Take Profits*" These are just a small sampling of the daily deluge of fear fanning headlines that have contributed to the erratic price movement of the markets and have given many investors a reason to turn cautious. It has now been 130 trading days (January 26th) since the S&P 500 last closed at an all-time high, making this period performance the third longest drought without a new high since the bull market began in March 2009. Many investors and market gurus are saying the current 'pause' is a sign that the market has topped or stalled and are questioning the viability of significant further gains. Perhaps we have become a bit spoiled? Now that the path ahead is 'uncertain', investors and economist are becoming more defensive.

Breaking News: The path ahead is ALWAYS uncertain! It is just that sometimes we fool ourselves into thinking we know what is going to happen. When applying this truth to the markets, it gives us a lenses to understand what is happening today. When there is a consensus, confidence is high, and the market typically trends strongly in one direction- could be up or down. In 2017, the market trended strongly up on the consensus that the tax cuts would fuel growth. In 2008 the market trended strongly down on the consensus that the fall in real estate prices would pull the whole market down. Today there is no consensus, but confusion and worry about what is going to be the next source for future growth. And with confusion, the 'wall of worry' tends to build. So, is it time to run for the exit or is the market just in a big consolidation phase, re-energizing for the next leg higher?

Listen to the Market, not the talking heads: One of the biggest influences of stock and bond prices is the expectation about future financial conditions. Prices reflect a perceived future value which means the market can be a very good leading indicator about future financial conditions. So in periods like today, were the news is a mixed bag of good and bad, the best way to assess what lies ahead is to listen to what the market is saying by looking at several key indicators in both the stock and bond market.

In the pages to follow are some of the key charts I watch closely to provide a peek into the future. Some are more short term indicators, and others are very long term.

1) **Level of Interest Rates:** The level of interest rates tell us a lot about the health of the economy, credit conditions, future growth and inflation. Over the past year, both short and long term rates have risen as economic growth has accelerated. This is good. According to the Federal Reserve, as long as short term rates remain below GDP, credit conditions are considered accommodating. Today the Fed Funds rate is at 2% and annualized GDP is around 2.5% - 3.0%. The Fed has conveyed their plans to raise the short term rate to 3% by 2020, a level considered neutral. But for now, credit conditions are still accommodating and therefore are supportive of stock prices.

2) **Changes in the Slope of the Yield Curve: Flattening**. When speaking of rising interest rates, it is important to understand where on the maturity spectrum rates are rising. Remember, the Fed only controls the level of short term rates. Long term rates are a function of supply and demand forces, and expectations of future growth and inflation. So watching the relative change in the slope of the yield curve gives us a good indicator of the consensus of future growth. A steepening curve means investors are expecting growth and/or inflation will pick up in the future. Likewise a flattening curve means growth is expected to slow; and when the yield curve gets very flat or inverted, a recession has always occurred.

Today, the spread between short term and long term rates has narrowed to 32 bps which is quite flat and has raised concerns about a recession. Many news stories saying a potential recession is just around the corner. I find this logic a bit humorous because in my mind a potential recession is always possible. So a better way to view this is not to consider 'if' but 'when' is a recession likely. Let's look at a few charts that address both the timing and impact on the market.

Flattening Yield Curve: The chart below, from Charles Schwab, shows the yield spread between 10yr and 2yr Treasury note over the pass forty years with the gray vertical bars showing periods of recession. Notice once the spread differential breaks through the yellow dotted line (50 bps) a recession has eventually ensued. The good news is that the average time between when the yield spread breaches the yellow line and a recession ensues is **33 months (almost 3yrs).** From a big picture standpoint, this means we are probably in the 4th quarter of the economic cycle, but not yet near the end. The not so good news is that the equity bear markets tend to begin in advance of the recession. But again, the question is not 'if' but 'when'?

Stock Performance when the Yield Curve Flattens and then Inverts: The table below refers to the prior chart and looks at the stock market's performance after the yield curve flattens below 50 basis points. Notice how the stock market had positive returns in every case. This shows that **yield curves tend to lead bear markets but often with a significant time lag.**

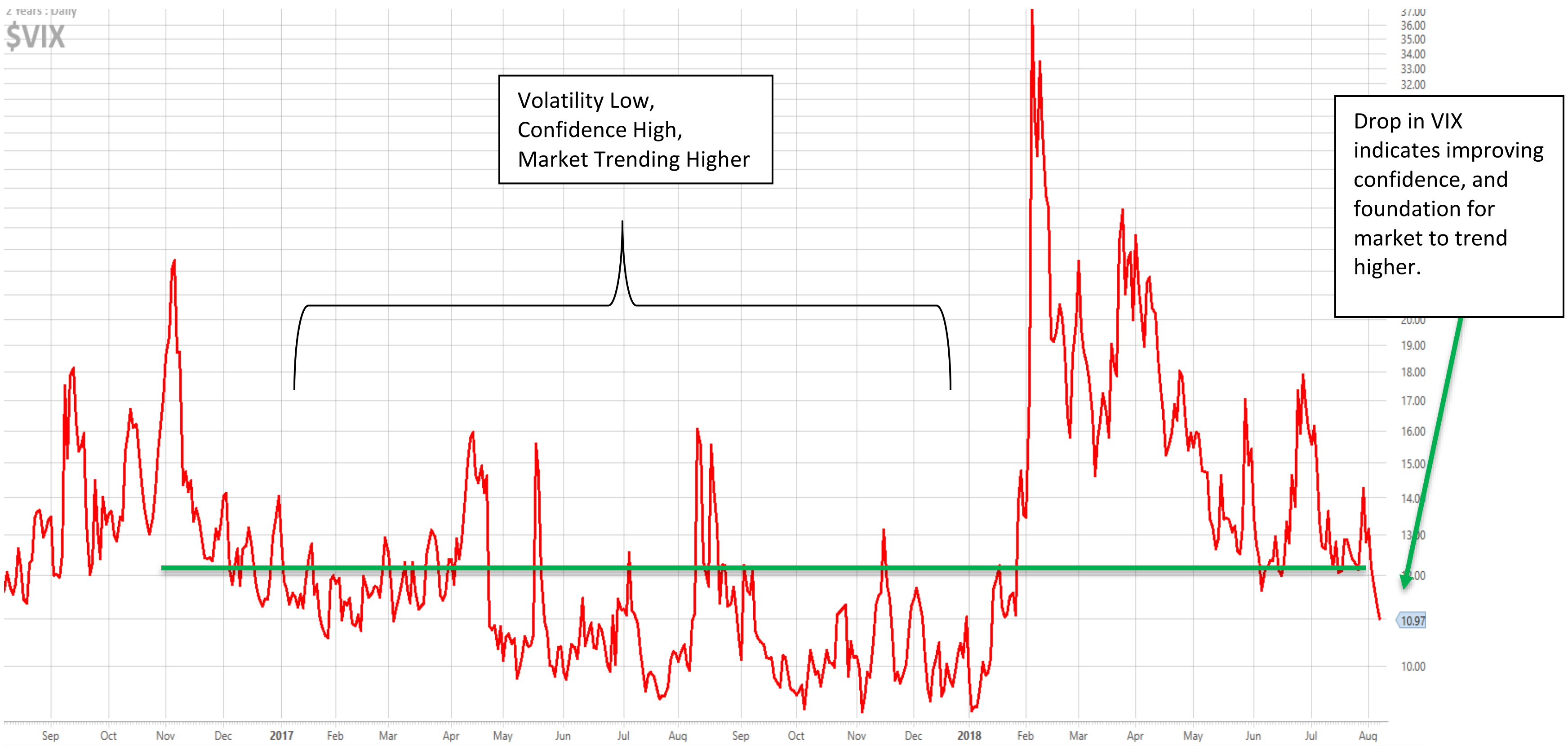
			S&P 500 price performance	
Yield curve broke below 50bps (green circles)	Date of inversion (crosses solid line)	Date of trough (red cirlces)	From 50bps to inversion	From 50bps to trough
Oct. 1977	Aug. 1978	Mar. 1980	12%	11%
Aug. 1980	Sep. 1980	Dec. 1980	3%	11%
Sep. 1988	Jan. 1989	Mar. 1989	9%	8%
Dec. 1994	Jun. 1998	Apr. 2000	147%	216%
May 2005	Jan. 2006	Nov. 2006	7%	18%

Source: Charles Schwab, Bloomberg, FactSet, as of April 20, 2018. Bps=basis points.

In sum, it is important to watch the yield curve but it is a very long term indicator and does not directly impact the near term direction of stocks.

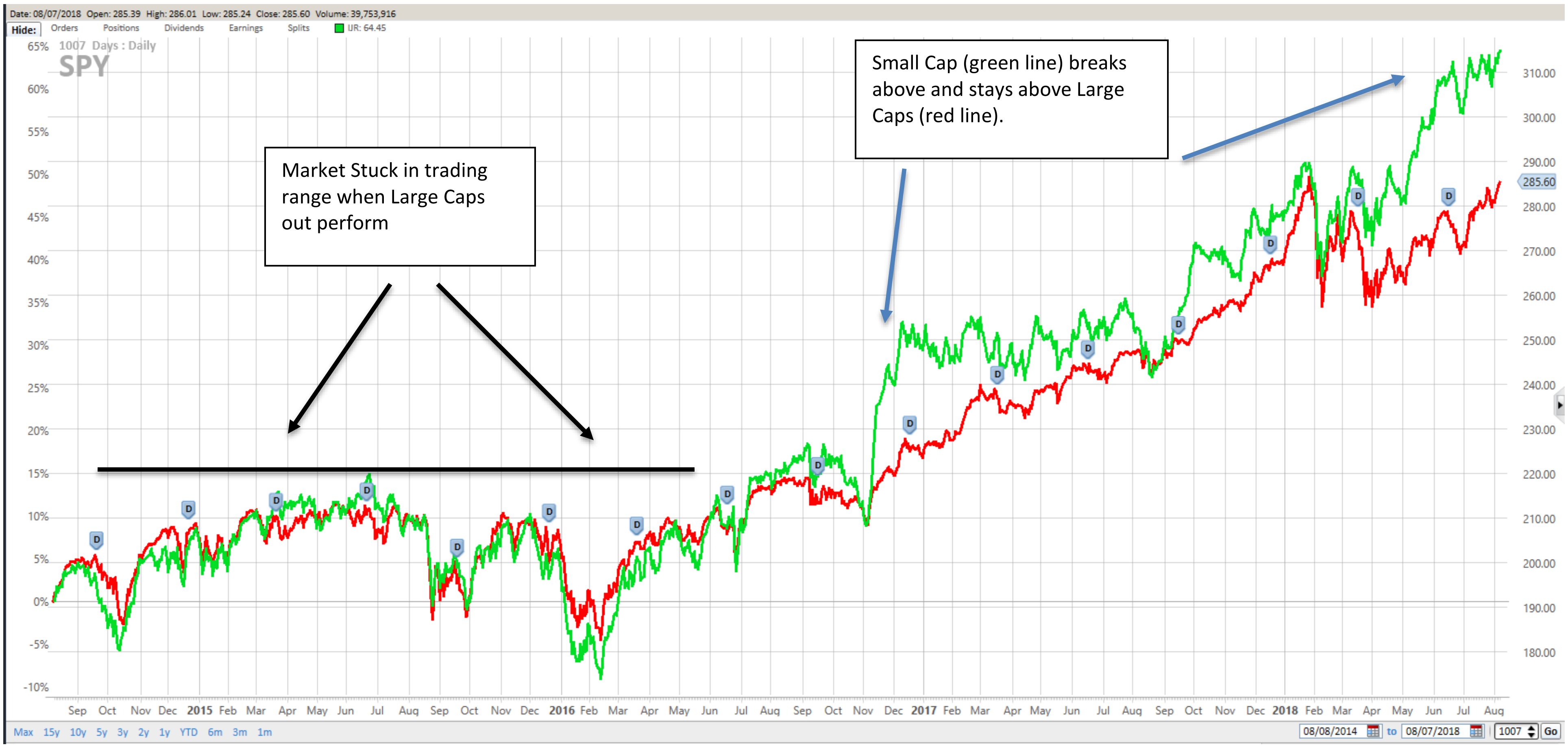
3) **Volatility Index (VIX):** The VIX index measures the expectation of stock market volatility over the next 30 days implied by S&P 500 index options. Although this is a short term measure, where the actual level sits gives us a good picture of underlying investor sentiment and health of the market.

   The chart below shows the VIX over the last 2yrs. At first glance it may look quite erratic, but instead **just focus on the time periods of when the VIX is above and below green line.** When the VIX was above the Green line, the market is in unsure footing, and the market bounces around in a large trading range. When the VIX falls below the Green line, the market regains its footing, and resumes an upward trend. For most of 2018, the VIX remained above the Green line, and no surprise, as the market has been directionless. But just recently it dropped below the Green line, indicating market fears are starting to abate and may well be ready to start trending higher again. So despite all the negative news, the market is quietly regaining confidence.



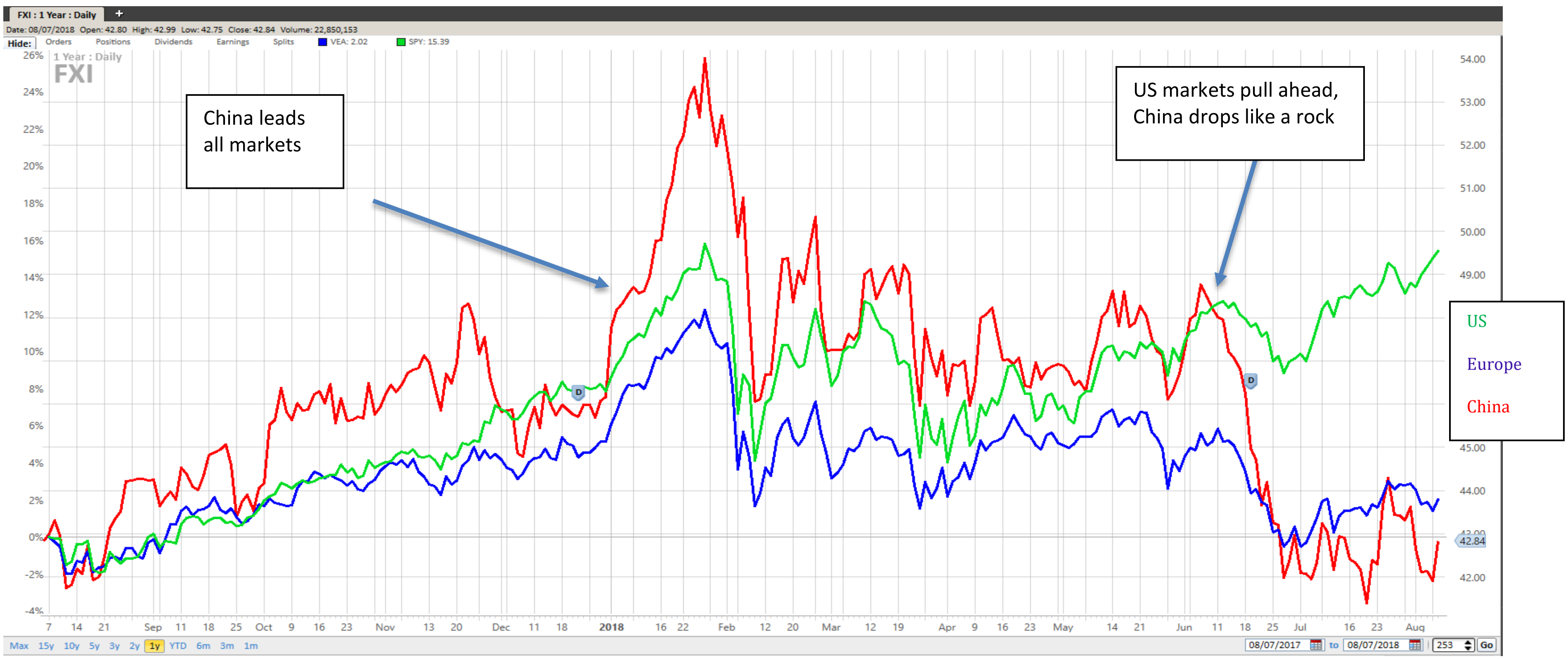
4) **Small Cap Stocks Leading the Charge:** Another good indicator to determine the health of the market and economy is to <u>watch the relative performance of Small Cap stocks verses Large Cap stocks</u>. By definition, Small Cap stocks are more domestically based, have higher debt, and thus are more sensitive to change in the health of the US economy. When Small Cap stocks are underperforming, the economy is struggling or declining. And when Small Caps are outperforming it is a good sign the economy is solid and improving. A good way to view this is to look at the relative performance of two indexes: The US Small Cap Index (IJR) and the S&P 500 (which is the largest of US stocks).

The Chart below compares the performance of the S&P (red line) to the Small Cap Index (green line) since September of 2014. Notice how the for the most part the S&P (red line) was above the Small Cap (green line) from September 2014 through July 2016 (almost 2yrs) and during that time the market was stuck in a trading range, unable to make new highs. Then in July of 2016, the Small Cap index regained the lead, then catapulted ahead by December 2017 and has lead the charge ever since. This is quite remarkable and indicates the health of the economy is not only good but probably improving! You haven't seen that in the headlines.



5) Threat of Trade Wars and Tariffs have sent Global Markets their separate ways: The headlines would lead one to believe all markets are struggling under the threat of trade wars and tariffs. Yes, some are indeed struggling, but not all.

The chart below shows the 1yr performance of the three major markets: US represented by S&P (Green), China (Red) , and Europe (Blue). In 2017 all stock markets rose, but China was the leader, up over +32%, followed by Europe up + 20%, and the US lagging. Then in early 2018, when the tariffs began to be enforced, all markets fell and for a while China continued to outperform. However, starting in mid June, the tables turned and the <u>US market has not only outperformed but is the only market positive for the year.</u> What changed? <u>Despite the headlines saying trade wars and tariffs are bad for the US economy, the market is saying otherwise. In fact, the interpretation from this chart shows says it is only China who is the big looser</u>. China stands to lose far more than the US in this trade spat.



So What Lies Ahead? Well, no one knows for sure. But, I can tell you what the market is saying. <u>Despite all the negative news headlines, the state of the economy is pretty good. Interest rates are still accommodative, credit is still cheap and easily available, and the economy is strengthening but at some point it will slow</u>.

Economic Numbers Confirm What the Market is Saying: It is also important to size up the charts against the data. Here is what the numbers are telling us:

- 2nd Qtr GDP jumped to 4.1%, up from 0.5% 1st Qtr.
- Capital Spending +7.3% (reflecting benefits from tax cuts, and reflecting strength in energy and Technology sectors)
- Productivity accelerates by +1.5% which contribute to widening profit margins, bodes well for future earnings and offset potential negative effects of tariffs.
- 2nd Qtr Earnings +24%, following a +27% gain in the 1st Qtr.
- Valuations remain constant, with the P/E at 16.5, and near its 5yr average of 16.2

In Sum, the charts and the data make a strong case to stay the course. The six month pause in the market has been a good time for the fundamentals catch up with the market and likely provide fuel for the next leg higher. So turn the volume down on the talking heads, and watch the market.

Active verses Passive Portfolio Management: Changing market conditions emphasize the need for active portfolio management rather than a static buy and hold strategy. Yes, positive returns are harder to earn now but with careful attention to how much and where the risk is allocated, the opportunity for returns is still possible. Understanding specific stock style and sector risk, bond credit and duration risk, and how these assets to fit together, is essential in managing the total portfolio during this challenging investment climate.

Investment Strategy: No changes have been made over the last month. We are maintaining a pro-growth/risk tilt in the portfolios and remain slightly above the midpoint of risk bands. On the bond side, the strategy goal is income and capital preservation. Bond duration continues to remain quite short to avoid rising rates and average credit quality is at investment grade. We are pleased to see this combined strategy is working.

These are my own thoughts. Please contact me with any questions or concerns.
I hope you are savoring the essence of this summer!

Kind Regards,

Barbara

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