—New Albany—
Investment Management

October 23, 2018

Market Insight: Re-calibrating to Neutral; 'All Weather Gear' Recommended

Anyone who has spent time in Ohio knows how quickly the weather pattern can change from hot and humid one day to cold and rainy the next. This October has been particularly dramatic, as near record highs and freezing temperatures were seen over the course of just eight days, reminding us it is that time of year when we need to have our 'all-weather gear' handy.

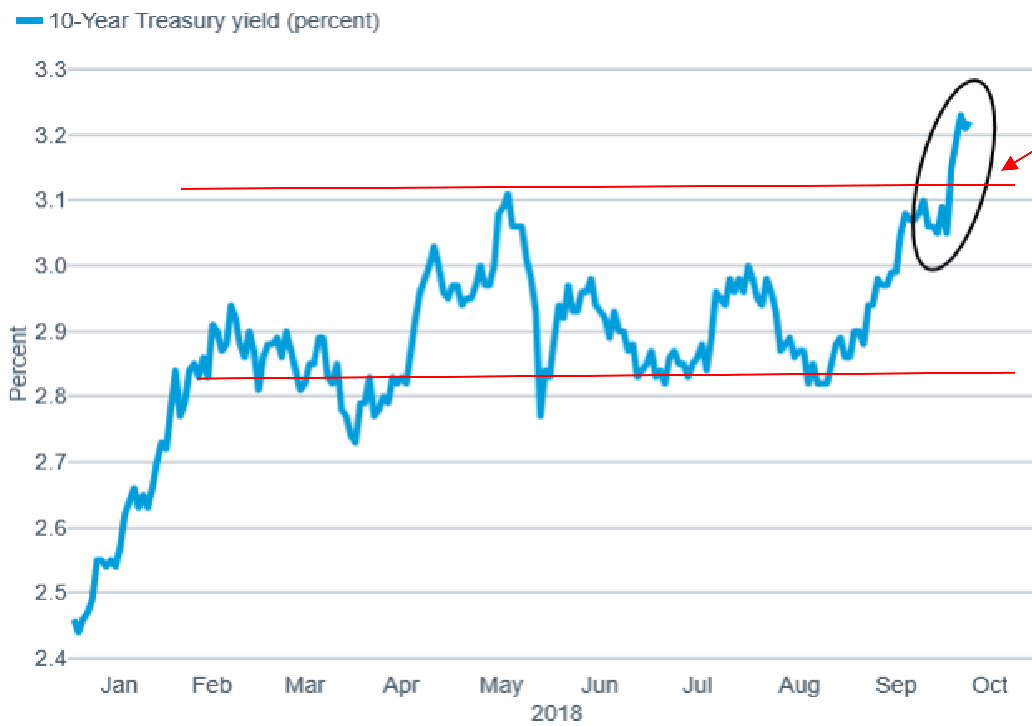
Perhaps the market has been taking its que from the weather lately. After a very strong 3rd quarter performance where many US market indices made new highs, October blew in a nasty sell-off. Investors are a bit shell shocked, wondering if the economic cycle is ending and if stocks have started a prolonged decline. **Is this 10yr old Bull market coming to an end?** Probably not yet. **Is a recession near?** No. **Is it time to change investment strategy?** Maybe.

Aging Bull Market: By any measure, this bull market is old. In fact, in August the stock market made history by logging the longest bull market ever in the US, 3453 days, 9.9yrs. During the first 7 years of this Bull market, the main fuel for rising stock prices was extremely low interest rates and a flood of liquidity by the Federal Reserve. Economic growth average only 1.5%, and corporate earnings grew modestly. By contrast, the later stages of this bull market has been fueled by the new tax code and pro-business climate which has fostered high expectations of faster economic and earnings growth. These high expectations were realized this year as GDP has more than doubled to over 3% and companies are reporting record double digit earnings growth. Everything seemed to be on track as September came to a close.

It's all about expectations: But just as the weather suddenly changed in October, so have expectations about future growth and the aging bull market. Suddenly, the same data and news which has been broadcast and debated for months has jolted the markets. The main factors cited are as follows: Historic low unemployment will be a constraint to future growth. The 'sugar high' from the tax cuts will wane by 2019. Higher interest are now seen as an inhibitor of future growth. The trade spat with China is seen as a threat to future earnings. While each of these are legitimate concerns, none of them are new. But it must be recognized the winds have changed, the investment climate is now more volatile and more risky. With that, abrupt market moves are nearly impossible to predict and are a painful reminder to always be prepared.

The two charts on the next page show how quickly the markets changed course. The first chart shows US 10yr Treasury yields breaking above a seven month trading range to new highs, pushing rates up 12bpts to 3.24%. The second chart shows the reaction of the S&P 500, dropping over -7.0% from its high.

Yields breaking out to new highs…



Source: Charles Schwab, Macrobond, Federal Reserve as of 10/12/2018

US 10yr Treasury broke out of trading range.

Stocks drop in reaction to rise in interest rates.

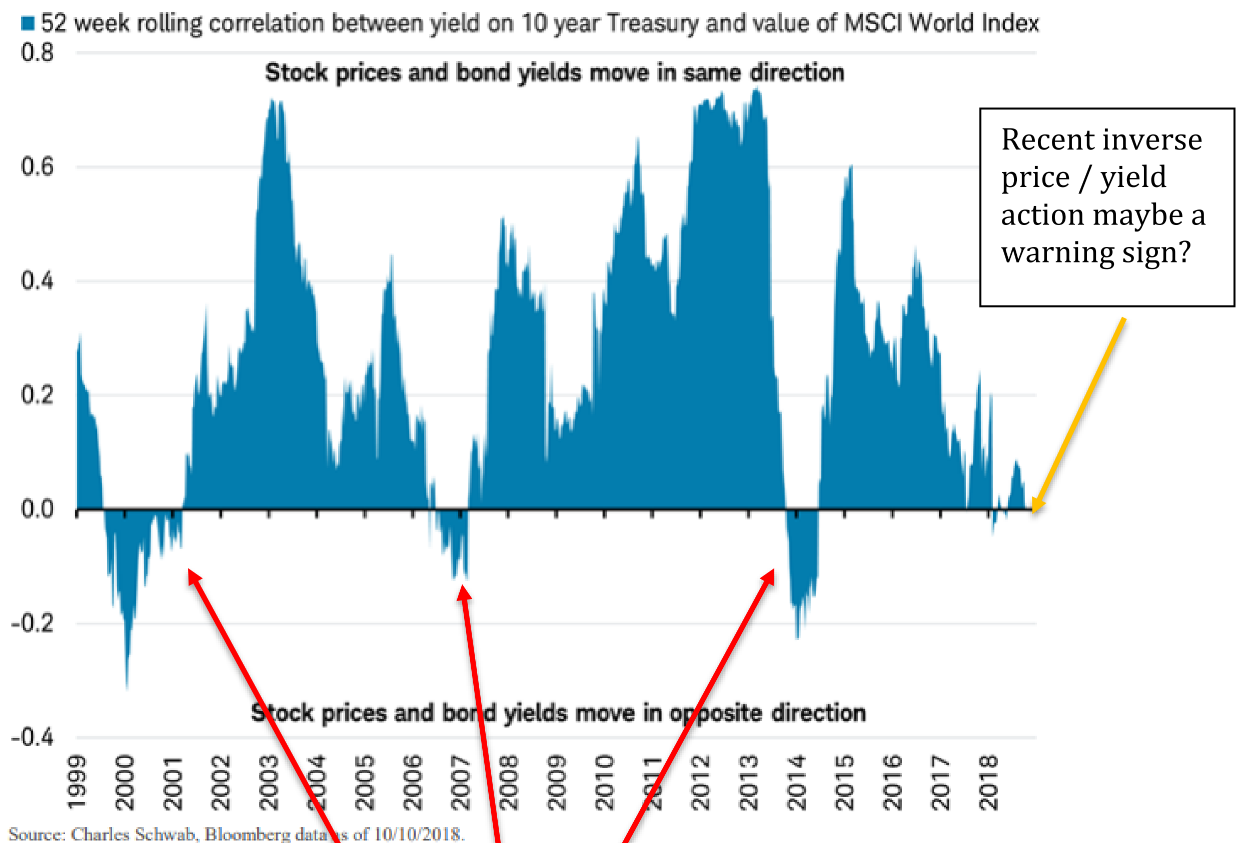
…pressuring U.S. equities

Source: Charles Schwab, Macrobond, Standard & Poor's Dow Jones as of 10/12/2018
Past performance is not indicative of future results.

Conflicting messages: The stock market is trading down on fears that rising rates will slow the economy. Meanwhile the Fed has stated it expects the economy will remain strong for 'quite some time' and because of this strength, they are going to continue to raise rates. Conflicting messages indeed. What is an investor supposed to do? For the first time during this bull market, the Fed's expectations and the Market expectations are no longer lining up. Hmmm. This is a sea change indeed and perhaps a warning sign that a change is coming.

Warning: Conditions are Changing. Over the past 20 years, bond yields and stock prices have often moved in the same direction. During deflationary periods—like the period since the financial crisis—bond yields and stock prices have tended to be positively correlated. But just recently, that has all changed. Today, measures of inflation have crept higher, (CPI +2.2%), and so have expectations about future inflation. With this change, the correlation of stock prices and bond yields has shifted to an inverse relationship. In the past, when stock prices and bond yields move inversely, it has been a warning sign of trouble ahead.

The chart below shows the correlation between bond yields and stock prices over the past 20 years. During this time, the correlation has been mostly positive, meaning stock prices and bond yields have moved in the same direction. There have been only three times where the correlation was inverse, '99-'00, '06-'07, and '13-'14, and each of those periods preceded global stock market declines of -18% in 2001, -42% in 2008, and -3% in 2015, measured by the MSCI World Index. (Source Charles Schwab)



Periods of inverse correlation of stock prices and bond yields have proceeded a market decline.

Another Warning sign- The GAP is narrowing: The gap or spread between the unemployment rate and the inflation rate is another barometer that has been a good forecaster of future recessions. History has shown when it is narrowing the economy is nearing its peak, the risk of a recession is rising, and there is a prolonged period of weak stock price performance. Today the US unemployment rate is at 3.7%, and inflation, as measured by CPI, is 2.3% which puts the GAP at 1.4%. The chart below shows the GAP or spread between the Unemployment rate and inflation has been falling. <u>But notice each time the GAP first approached the near zero level, there was **at least 2 years before a recession hit**.</u> So it very well could be quite some time before the economy actually peaks.

Inflation measured by Consumer Price Index year-over-year % change.
Source: Charles Schwab. Bloomberg data as of 10/14/2018.

Investment Climate Changing: Though we may well still be years away from a recession, the investment climate is changing. According to Charles Schwab: *'The threat of storms in the global economy and markets seem to be starting to move from "Advisory" to "Watch" where conditions are favorable to a recession.'* But we are not yet in the '*Warning*' stage where a recessions is imminent.

In sum, only time will tell for sure if the recent market sell off is just another correction in an aging bull market or the beginning of a new downward trend. But given the strong momentum of the US economy, at least two more quarters of double digit earnings growth, and the still small stimulus effect of low rates, **the old bull market is likely to keep on kicking.** At the same time, given the later stages of this economic cycle where the Fed is determined to move policy to neutral, the risks are rising. Volatility is back and will likely increase even further. So it is indeed prudent to **make ready with an 'all-weather' type investment strategy. Risk exposure will be gradually moving to neutral.**

These are my thoughts. Please contact me with any questions or concerns.

I hope you are enjoying the Autumn colors! Best Regards,

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