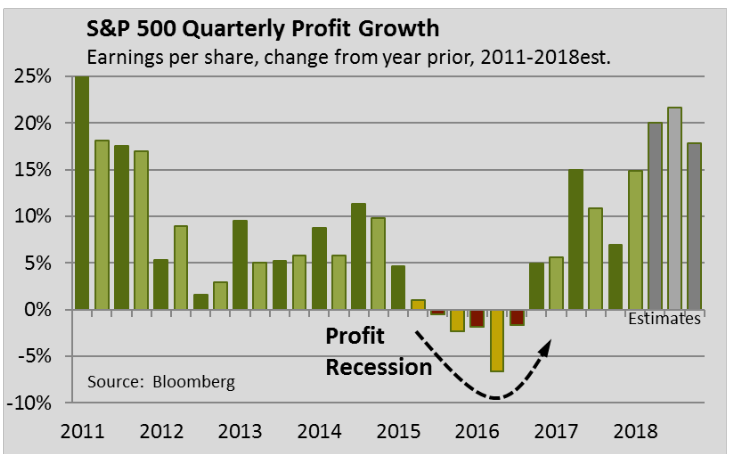
Only a Matter of Time

June 2018

Summary

After a year of abnormal stability, a more normal (and volatile) stock market has resumed. 2017 was the most stable year in the history of the U.S. stock market. During the year, only 4 days saw stocks drop by 1% or more, and the biggest total drawdown throughout the entire year was 2.8%. It was only a matter of time before the "normal" bumps returned to equity markets. So far in 2018, the market has fallen by 1% over 16 times, and has realized drops of 10% and 7%. It is only June, and the late summer doldrums are still ahead. In concert with bigger swings in the market, U.S. equities are up a meager 2% for the year and international equities are slightly negative at -3%. Interest rates rose substantially over the past 6 months, generating losses in bond returns as well. If such a trend continues, it will mark only the fourth year since 1980 where core bonds realize a calendar year loss.

One of the challenges of strong prior year returns is that expectations are reset much higher. Positive outlooks on economic growth, corporate earnings, and inflation can set the stage for disappointment. Corporate earnings growth has been steady, but a big portion of earnings growth is driven by the lower corporate tax legislation (not increased company performance). Expectations for profit growth are the highest since the recovery from the financial crisis (2008-2009).



The U.S. economy seems relatively strong and growth should remain solid for the remainder of the year; however, a convergence of factors points to increased instability in the intermediate term:

- **The current economic cycle is "well-aged,"** and a fair amount of good news is already baked into stock prices. Moving forward, negative surprises are more likely than positive ones.
- **The Fed has a steady plan for interest rate increases.** However, with such low unemployment, wage pressures may force the Fed to act more aggressively in tightening monetary policy. Policy in the Eurozone is friendlier but moving toward tightening despite the surrounding high unemployment, etc.
- **Protectionism and tariffs may escalate trade tensions.** China and NAFTA are specific concerns. Typically, politics do not have a lasting impact on financial markets, but there are not many winners in a trade war.
- **The mid-term year in the presidential election cycle is tricky**. The median equity return in a mid-term year is only 4%, but the low of the year often sets the base for a strong pre-presidential year. The 10% correction from February does not eliminate the risk of weakness in the late summer or fall.

Allocation Changes

It has been nine years since the financial crisis ended, and the subsequent economic expansion has lasted 108 months, the second longest period of growth in history. The longest period was during the 1990s when companies like Dell, Microsoft and Intel created the technology revolution. There is no timer set for the next recession, but it is important to lean towards capital preservation at times when economic growth is "well-aged."

Equity allocations in client portfolios were recently moved from maximum equity to neutral levels. Stocks may be positive by year end, but more modest equity allocations will help absorb potential bumps later in the year. High expectations, rising rates, weak mid-term years, and trade worries provide ample support for lower equity allocations.

BCA Research summed up the wisdom of reducing equity allocations at this juncture, "given the advanced stage of the economic cycle and the fact that a lot of good news is discounted in risk assets, we believe that it is better to be early and leave some money on the table than to be late."

Investment Returns

After strong returns in 2017, it is not surprising that financial markets have slowed this year. After some big swings, large cap U.S. stocks (S&P 500) are slightly positive for the year at 1.9%. International and emerging market returns were the strongest sectors a year ago but have both posted negative returns so far this year (the strong dollar has been a drag on international returns as well).

Investment Returns

As of June 15, 2018

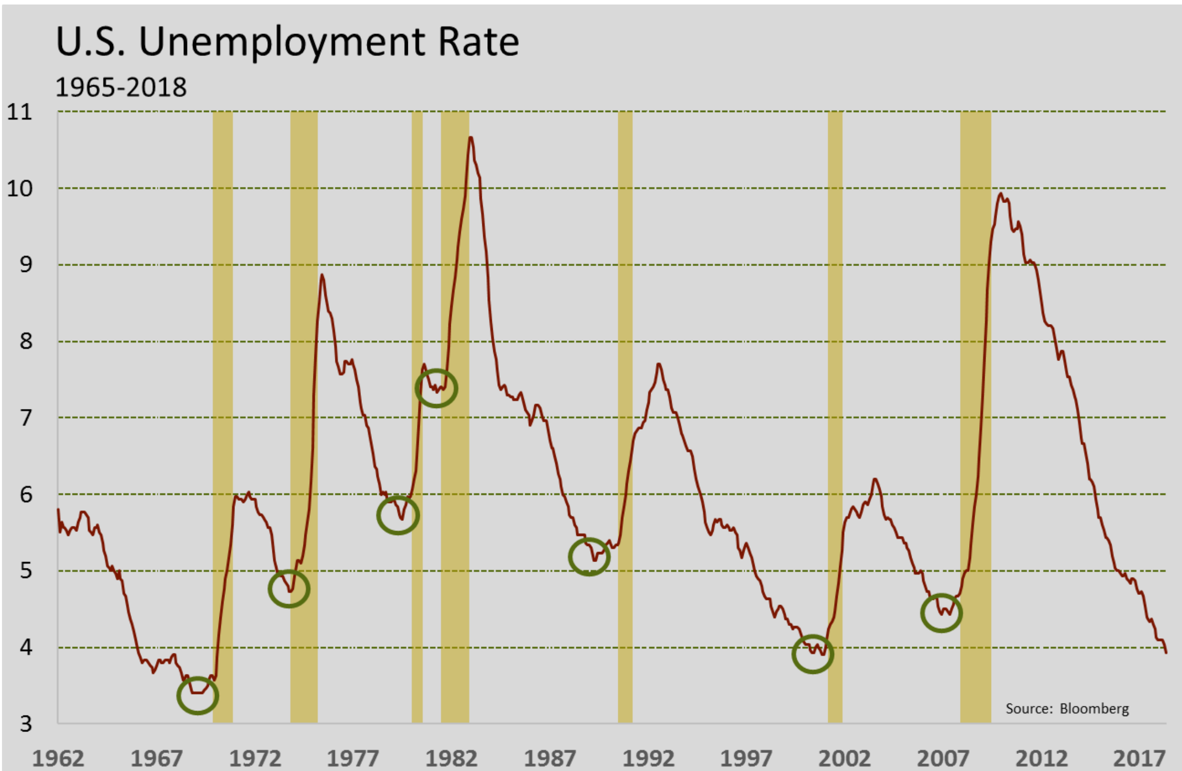
	YTD 2018	2017
All Country World Stocks	-0.9%	24.6%
S&P 500	1.9%	21.8%
Dow Jones Industrial Average	-1.4%	28.1%
Small Caps	7.4%	14.6%
International	-2.9%	25.7%
Emerging Markets	-8.1%	37.7%
Bonds (Barclays Aggregate)	-1.6%	3.5%
U.S. Treasury Bonds	-1.8%	2.6%
Commodities	8.9%	5.8%

Source: Bloomberg

As interest rates increased sharply over the past six months, core bond returns have been negative. Higher interest rates are bad for bond prices since existing bonds with lower rates are not worth as much. The past six months saw the worst returns for bonds in five years (losses in 2013 were driven by rising interest rates as the Fed began tapering its bond purchases).

Why is Low Unemployment a Concern?

Unemployment fell to 3.8% in May, a 48-year low. Such a statistic demonstrates the health of the economy over the past few years. Generally, low and/or falling unemployment is a positive. However, in the current environment, an extremely low unemployment reading may become a negative for financial markets.

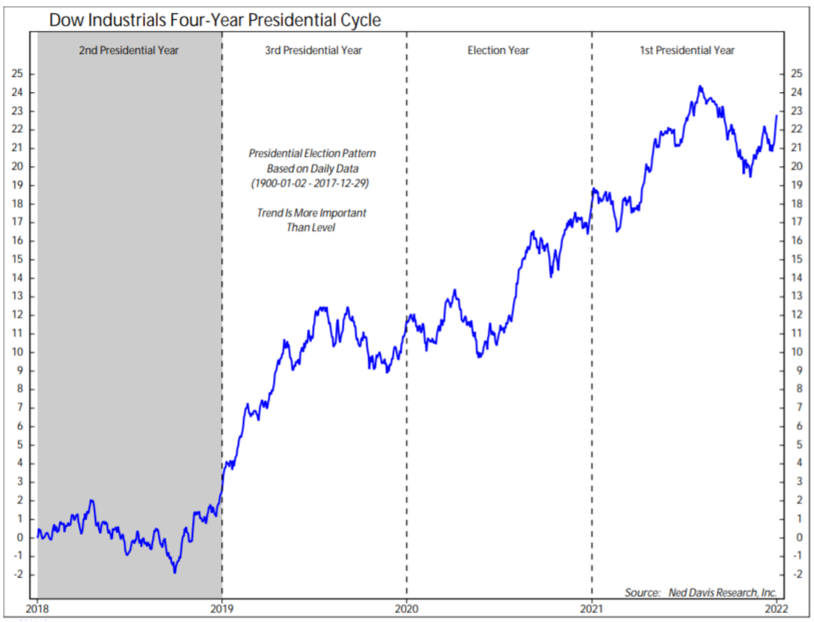


Very low unemployment also means a tight labor market where workers have plenty of options for employment. This puts pressure on employers to increase wages to keep and attract employees. Since wage growth is strongly correlated with inflation, the Federal Reserve will need to continue to raise interest rates to keep inflation under control. Interest rates have been rising for a few years now, and at some point, the higher borrowing cost will have a negative impact on the ability of businesses and individuals to take on debt (finance new projects, buy a home, etc.). It is difficult to tell when rising rates will begin to hurt the economy, but at some point, they will become a drag.

Low unemployment → wage pressures → inflation →
higher interest rates → economic slowdown

A Tough Year in the Presidential Election Cycle

Typically, the mid-term election year is one of the most challenging in the four-year presidential cycle. The median return is only 4.1% since 1900, which is less than half of the historical annual return. Elections always create jitters for the stock market, and the mid-term year is no exception. Regardless of party, the euphoria of a new president (the hope of change driven by new policies and approaches) creates some positive momentum for financial markets. This trend often holds for the first 12-18 months of a new president's term. Partway through the mid-term year, markets often falter. There are a few causes: a) it is always easier to campaign than to govern, and disappointment over lack of accomplishments is common; b) a president prefers to "take their lumps" well ahead of the next full election cycle, so controversial actions (e.g. trade tariffs, North Korea agreement, etc.) can be negative influences; and c) monetary (Fed policy over interest rates) and fiscal (tax and spending policy) policy stimulus tend to be relatively weak.



The mid-term weakness is evidenced in returns from the Dow. The median return in the mid-term year is the lowest of the four-year cycle, and corrections tend to be elongated. According to Ned Davis Research,

> *"One of the reasons mid-term years have been weak is that the government has tended to remove stimulus during mid-term years… The pattern has been that stimulus is removed after the presidential election, through the post presidential election year, and into the first half of the mid-term year. Stimulus is pumped back into the economy starting late in the mid-term year, throughout the pre-election year…"*

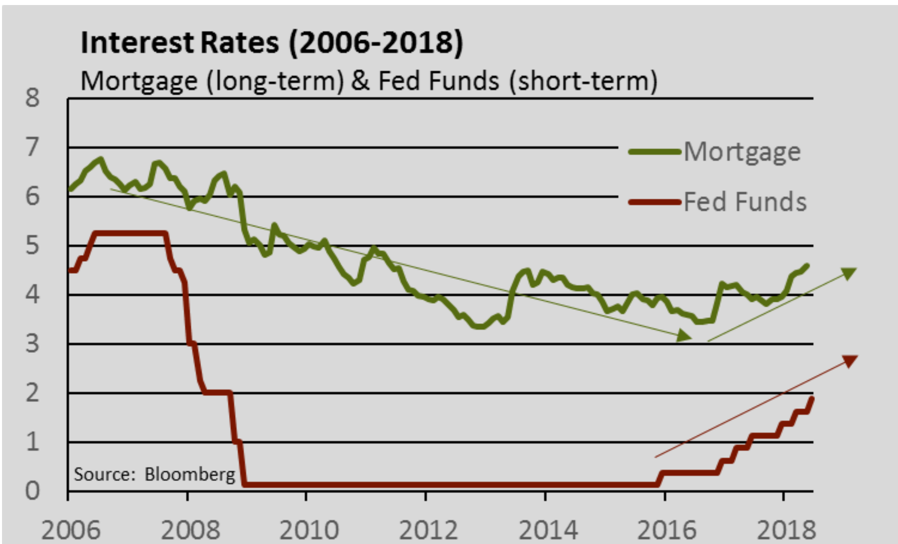
There are a few factors to consider in this cycle. First, the Fed continues to raise interest rates; this is consistent with the historical mid-term removal of monetary stimulus. The Fed only controls short-term interest rates, but the impact is apparent in longer-term loans as well. The average conventional mortgage rate in May was 4.6%, the highest rate since 2011. Second, the tax reform passed in January is a positive fiscal stimulus (contrary to the typical mid-term pattern). The new tax code for individuals may be a small factor since lower brackets are somewhat offset by loss of deductions, etc. However, lower corporate taxes have provided a meaningful boost to corporate earnings. It is unclear if the Fed will tighten rates enough to offset the tax stimulus. If inflation concerns continue to rise, the Fed may be forced to act more aggressively and increase the odds of market weakness later in the year.

The Impact of Rising Interest Rates

Interest rates impact the economy and investors in many ways. Short-term rates reflect what an individual might earn in a bank checking or savings account. Intermediate-term rates might reflect a typical borrowing rate for a company. Long-term rates could be a mortgage or government bond.

The Federal Reserve has been raising rates for over two years, but their direct influence is only on short-term rates. The Fed has also been reducing its balance sheet (or holdings of debt securities). There is some concern that the Fed has fueled a lot of the market advance through its quantitative easing (QE) program. By purchasing bond securities, the Fed pushed bond prices higher, making bonds less attractive due to high prices and low yields. The alternative for many investors was to take on more risk by buying stocks. As the Fed unwinds its QE program, bond prices may fall and interest rates may rise. If Fed policy provided a boost to risk assets over the past nine years, then what happens to those assets when Fed policy is removed?

In some ways, rising rates are good for investors. Low rates make it difficult to be conservative and generate a meaningful return. The interest paid on checking and savings accounts is higher now than for most of the past nine years when those rates were effectively zero. However, it is the influence on borrowers that can have a significant impact the economy. The borrowing environment is likely not punitive yet, but interest rates seem to have turned a corner and are moving higher.



Conventional 30-year mortgage rates have increased on average from 3.4% last summer to 4.6% in recent months. While rates are still low in a historical context, increased borrowing rates will at some point impact the economy. Using a $250,000 mortgage as an example, a 1% increase in interest rate is equivalent to $2,500 more per year in interest. The corresponding mortgage payment goes up by approximately 7%. If mortgage rates go up by another 1% by next year, mortgage payments could be 15% higher for the exact same property. There is no magic number where higher rates begin to have a negative impact, but as rates drift higher, the risks continue to grow.

Although each meeting is “data dependent,” the Fed has signaled the intent to raise rates by approximately 1% over the next year. If such a path is followed, it will be difficult for intermediate and long-term bonds not to follow suit. At some point, borrowers may notice a pinch in their pocketbooks.

A Bond Bear Market?

Most investors view bonds as the "safe" part of a portfolio. In general, that is a fair description since bond losses have been uncommon over the past 40 years. In most periods, an average quality bond (e.g. the Barclays Aggregate Bond Index) generates a positive return. However, in the first six months of 2018, average bond returns were negative. If that trend continues, 2018 may be only the fourth time that bonds post a negative calendar year return since 1980. There is obviously no guarantee that will occur, but the Barclays Aggregate Bond Index is roughly at a loss of -1.5% midway the year.

	1994	1999	2013	2018 YTD
Fed tightening short-term rates?	Yes – Rose from 3.0% to 5.5%	Yes – Rose from 4.75% to 5.5%	No – Unchanged	Yes – Rose from 1.38% to 1.63% with expectations of another 0.75% by year end
Average bond rate	Increased from 5.6% to 8.2%	Increased from 5.6% to 7.2%	Increased from 1.9% to 2.5%	Increased from 3.2% to 4.0% by mid-year
Average bond return	-2.9%	-0.8%	-2.0%	Down -1.5% at mid-year
Future economic growth	Slowed from 4.5% to 2.5% next year	Remained near 4% but slowed in 2001	Stayed low but flat at 1.5 to 2.5%	TBD
Economic recession follows?	No	Yes – in 2001	No	TBD
U.S. stock returns (current yr. / next yr.)	1.3% (1994) 37.6% (1995)	21.0% (1999) -9.1% (2000)	32.4% (2013) 13.7% (2014)	1.9% at mid-2018 TBD 2019

Source: Bloomberg

Although there are a limited number of prior cases, the past impacts are noteworthy:

- In 1994, average bond rates rose from 6% to 8% shortly after the Fed raised interest rates for the first time in five years. After stubbornly high inflation of the 1970s & 1980s, fear of inflation was the primary focus of central banks. Economic growth slowed in 1995-1996 but a recession was avoided.
- In 1999, average bond rates rose from 5.5% to 7.5% shortly after the Fed raised interest rates two meetings in a row for the first time since 1994. Economic growth remained solid above 4% through most of 2000, but a recession ensued in 2001.
- In 2013, the Fed began to taper its purchases of asset backed securities. This marked the first step towards normalizing monetary policy, but the Fed Funds rate was not changed. Worries over the transition sent rates rapidly higher, and this flurry was deemed the "taper tantrum." Economic growth remained low and flat for the next few years.

Although there are not many similar environments in recent history, a rising rate environment is typically destabilizing for the stock market. In two of the three cases, economic growth slowed meaningfully in subsequent years; however, only one of three cases resulted in a recession. In two of the three cases (both included Fed tightening), stocks were volatile posting flat or negative returns in the near term.

Rising rates do not necessarily bring a recession or stock market losses; however, financial markets become more volatile, and economic growth typically slows after a year or two.

Summary

A more normal and volatile market has resumed in 2018. After a period of strong stock market gains, it is common for markets to consolidate and pause before moving forward. Stocks may be positive by year end, but more modest equity allocations will help absorb potential bumps later in the year. Market weakness is common in late summer or early fall in mid-term years. In addition, high expectations, rising rates, and trade worries top the list of concerns for the near term. As a result, equity allocations in client portfolios were proactively reduced to neutral levels.

If you have questions on the investment environment or your portfolio, please call us at 734-769-7727. To find an electronic copy of this document and other recent commentaries, please visit our website at www.risadvisory.com.

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These data are for illustrative purposes only and is not indicative of any investment or strategy result. The S&P 500 is an index of 500 stocks representing major U.S. industry sectors. The Dow Jones Industrial Average is an index made up of 30 large U.S. company stocks. Small Cap is represented by Russell 2000 Index, which is an index of the 2000 smallest companies in the Russell 3000 Index of 3000 broad-based U.S. companies. Mid Cap is represented by S&P Mid-Cap 400 Index, which tracks medium-sized U.S. firms, which is broadly defined as a company with a market capitalization ranging from about $2 billion to $10 billion. Developed Int'l is represented by MSCI EAFE Index, which is an index of major international equity markets as represented by 21 major MSCI indexes from Europe, Australia and Southeast Asia. Emerging Markets is represented by MSCI Emerging Markets Index, which is an index that is designed to measure equity market performance in global emerging markets (over 20 countries including Brazil, Russia, India, and China). World stocks (the All Cap World index) are represented by the MSCI ACWI index and is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 45 country indices comprising 24 developed and 21 emerging market country indices. High-Yield is represented by the Barclays U.S Corporate High-Yield Index, which measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt. Investment grade and broad market bonds are represented by the Barclays Aggregate Bond Index includes most U.S. traded investment grade bonds, including Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S. Treasuries are represented by the Barclays Capital U.S. 7-10 Year Treasury index, which measures the performance of U.S. Treasury securities that have a remaining maturity of at least seven years and less than 10 years. TIPS are represented by the Barclays U.S. Government Inflation-linked Bond Index, which includes publicly issued, U.S. Treasury inflation protected securities that have at least 1 year remaining to maturity. Commodities are represented by the S&P GSCI is a world-production weighted index designed to track investable commodities representing the price movements of the world economy.