Retirement Income Solutions

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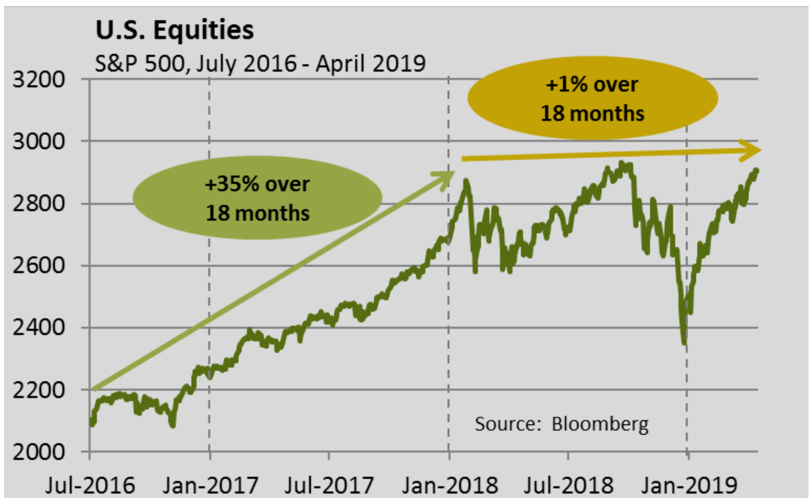
The Bear That Wasn't

April 2019

Summary

The fourth quarter of 2018 was filled with anxiety about a pending recession. The long-awaited bear market was about to arrive. U.S. stocks fell by -19% and ended the year with a loss for the first time since 2008. Most major asset classes were negative for 2018, so old-school diversification did not bolster portfolios. A few months later, markets have almost fully recovered. Despite the panic at the end of 2018, markets have calmed, and investor optimism has returned.



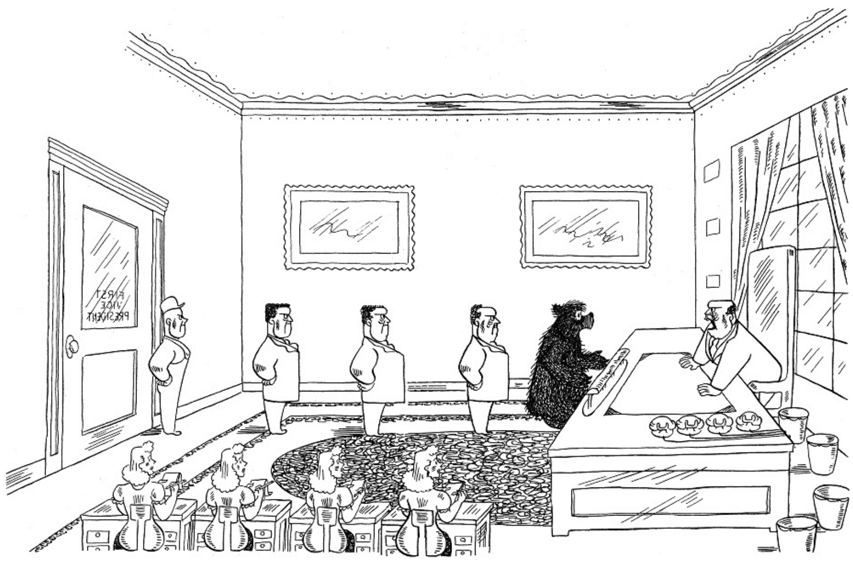
- **Fears of a recession were steadily unwound in early 2019.** The market fell rapidly (-19%) in late 2018 as economic worries grew. However, those fears appear to be unfounded as stock markets have almost fully recovered.
- **Longest & weakest…** The current economic expansion is 3 months from setting the record for the longest period in history without a recession. The 10-year expansion is also the weakest of the 11 recoveries since WWII.
- **The yield curve has inverted**, and such a signal has been a reliable recession indicator in the past. However, a more detailed look indicates that it is not as worrisome as some represent.
- **Pockets of volatility…** Since the expansion is well-aged and some indicators are concerning, the market may continue to oscillate between a pleasant calm and dramatic swings.
- **The Fed is on pause for now** and markets have stabilized. When the Fed revives its plan to raise rates, volatility is likely to increase.
- **The pre-presidential election year is the strongest in the four-year cycle.** Average drawdowns of -16% in the midterm year have led to average gains of +33% one year later.
- **Slowing corporate earnings typically lead to market losses**, but recessions are where the big negatives occur.

While most indicators show the economy is not close to a recession, the mature market cycle is hard to overlook. The solid recovery from the December lows is a relief. The U.S. economy seems to be avoiding weakness in the rest of the world. However, pockets of volatility are likely to continue to appear. Until a clearer buying opportunity presents itself, portfolios remain at Neutral equity levels.

The Bear That Wasn’t

“The Bear That Wasn't” was written in 1946 by Frank Tashlin. Despite its connections to the Looney Tunes franchise, the satirical children’s book about society, the economy, and corporate culture is not on many bookshelves today. However, there are some interesting takeaways from the book; one key tenet is that people can be easily influenced by others when repetitively hearing the same information. In the book, the bear is told repeatedly that he is not a bear and is a silly man that needs to shave. For a while, the bear starts to think he is a man.

This book can be used to explain investor psychology over the past few years. After the 2016 election, optimism about tax cuts and synchronized growth around the world created extremely stable financial markets. As a result, 2017 was the most stable year in the history of the stock market. No one felt comfortable, and there was a lot of anxiety about the political environment, but the news and economic pundits convinced everyone that the economy had a rock-solid foundation.



“You can’t be a bear.”

A year later, fears of a recession took hold, and the solid foundation was crumbling. The news outlets reported that corporate earnings were tanking, Brexit was an unsolvable mess, communist China’s growth rate was slowing, and the Federal Reserve had gone too far, planning to raise interest rates too quickly. As a result, in the fourth quarter of 2018, U.S. stocks fell by almost 20%. There was a period in October when stocks fell 15 out of 18 days. The recession had arrived, and investors should seek safety.

In reality, neither perspective was correct. The economy has been steadily plodding forward, but such news does not get your attention on TV or article clicks on the computer. From mid-2016 through 2017, the stock market advanced 35% over 18 months. In the subsequent 18 months, the stock market rose by 1%. On average, the tally is 12% appreciation per year; however, those returns were all front loaded.

The economy is still gradually advancing, but this cycle will not last forever. There was a short-term acceleration after the election due to the initial boost from tax cuts. At this later stage in the economic cycle, a slower growth period is to be expected. Markets are adjusting to that “new normal.” One of these days, the bear will be a bear… just not quite yet.

Longest & Weakest

Volatility in the fourth quarter of 2018 was driven primarily by fears of a recession. The U.S. economy has now gone 118 months without two consecutive quarters of negative GDP growth (the common definition of a recession). If the streak continues through the summer, it will become the longest expansion in history without a recession. This distinction is important since stock market downturns in such periods tend to be deeper and longer lasting than those that do not coincide with a recession.

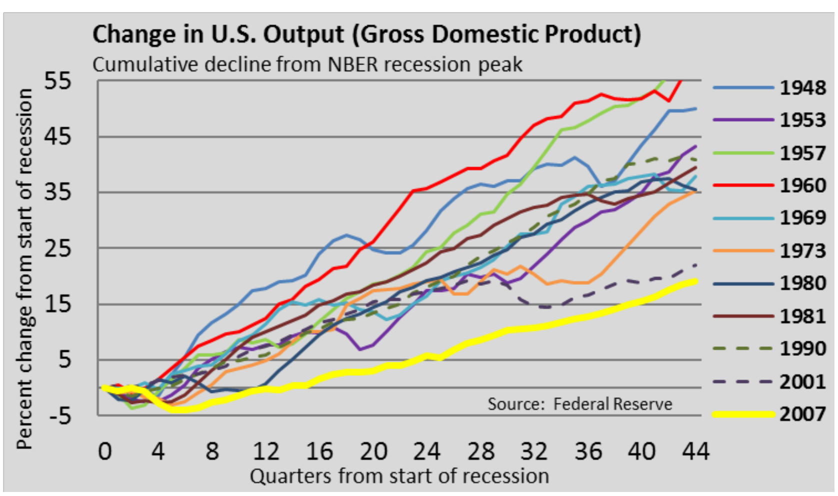
Economic Expansion Following Recession

1929-2019

Recession Date	Length of Subsequent Expansion (months)	Stock Returns During Expansion
AUG '29 – MAR '33	50	234%
MAY '37 – JUN '38	80	71%
FEB '45 – OCT '45	37	14%
NOV '48 – OCT '49	45	90%
JUL '53 – MAY '54	39	86%
AUG '57 – APR '58	24	36%
APR '60 – FEB '61	106	94%
DEC '69 – NOV '70	36	35%
NOV '73 – MAR '75	58	60%
JAN '80 – JUL '80	12	13%
JUL'81 – NOV '82	92	242%
JUL '90 – MAR '91	120	309%
MAR '01 – NOV '01	73	44%
DEC '07 – JUN '09	**118***	**274%**
AVERAGE	**59**	**112%**

Source: NBER, Ned Davis Research

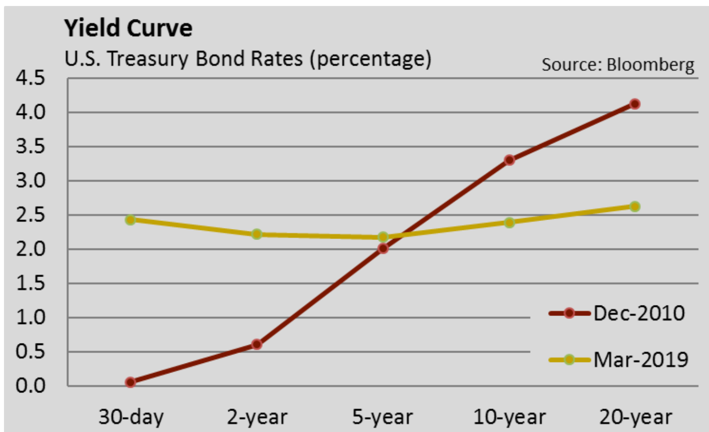
In terms of duration, the current expansion is quite mature. In terms of the magnitude of economic growth, the current environment is steady and lackluster. All 10 of the recessions since WWII were followed by stronger economic recoveries. The slow and steady economic advance has been consistent, but its lack of strength generates concerns over its ability to withstand negative shocks from around the world.



The Yield Curve Has Inverted, The Yield Curve Has Inverted!

Interest rates represent the cost of interest that borrowers pay on loans. One complex-sounding term describing interest rates is the yield curve. Yield is synonymous with interest rate, and the curve represents the image portrayed by various Treasury bond maturities (for example: 30-day, 2-year, 5-year, 10-year and 20-year) when they are plotted together. A "normal" yield curve is upward sloping. This intuitively makes sense because a lender takes more risk with a longer-term loan. A rational lender should require higher rates of interest for longer duration loans.

An "inverted" yield curve occurs when longer-term rates are lower than short-term rates. The inverted shape to the yield curve is an unnatural state since an investor gets paid less to take on more risk. More importantly, an inverted yield curve has historically been a warning sign that a recession is near, and the stock market may struggle. Such a state is caused by two factors that are somewhat in conflict with one another: first, the Fed is worried about an overheated economy and therefore raises short-term interest rates to prevent inflation; second, investors are worried about a recession and purchase intermediate Treasury bonds with no default risk. This "flight to safety" pushes the 10-year rate down since investors will accept less return just for the safety of government bonds.



An example of a more traditional, upward-sloping curve is the structure that occurred in December 2010 (see above). In March, the yield curve was much flatter, with most Treasury bonds yielding between 2.2% and 2.6%. Technically, part of the yield curve is currently "inverted" since a 30-day Treasury Bill is paying more than a 5-year Treasury Bond.

An inverted yield curve does have a good record of predicting recessions. All 7 recessions since 1966 have been preceded by an inverted yield curve. The current flat (even slightly inverted) yield curve is worth noting, but it is not necessarily the canary in the coal mine. There are a few reasons to not put too much weight on this indicator:

1) It is only one indicator, and most other early recession indicators have not yet triggered.
2) In some cases, there was a lag between the inversion and recession of over a year. The last inversion occurred in early 2006, which was almost two full years ahead of the recession and 18 months ahead of the stock market peak.
3) There are two cases since 1966 when the yield curve inverted but a recession did not occur.
4) The most important comparison (the 10-year versus the 2-year) is still technically not inverted.
5) Perhaps most importantly, interest rates for all other inverted curve cases were substantially higher. For the 7 recessions since 1966, the 2-year Treasury rate ranged between 4.6% and 16.8%, at least double the current rate of 2.2%. The shape of the curve is notable, but rates are still very low in historical terms.

The Whipsaw

The roller coaster that began in September continued during the first few months of 2019. Markets reversed course with strongly positive results, and the investor ride was much more pleasant. Just like at an adventure at Disneyland, the ride ended up right back where it started. U.S. stocks fell dramatically at the end of last year but rebounded strongly with a 15.9% increase through mid-April, ending up within 1% of where they started 7 months ago. International stocks followed a similar pattern. Emerging market stocks have been the most resilient in recent months, realizing a 4.8% gain over the past 7 months. Big swings in financial markets should be expected at this point of the economic cycle.

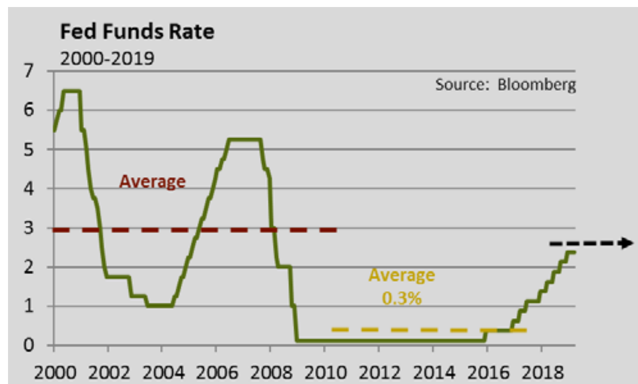
Ups & Downs

Region	9/20 to 12/31	12/31 to 4/15	9/20 to 4/15
U.S.	-14.5%	15.9%	-0.9%
International	-13.2%	11.8%	-3.0%
Emerging	-6.9%	12.5%	4.8%

Source: Bloomberg

The Fed on Pause

Less than a year ago, the Fed was signaling that monetary policy would continue to tighten. In September, Fed Chair Jay Powell said, “Looking ahead...projections show gradual interest rate increases continuing....” After some weakening economic data and the market revolt in the fall, the Fed communicated a very different stance. Interest rates are on hold for the foreseeable future. The stock market response to continued low rates was strongly positive, rallying by 16% since the beginning of the year. Although inflation has been non-existent for several years, if inflation concerns return, the Fed will have to restart the tightening process.



Big Bounces Off of Midterm Year Lows

Stock market returns in mid-term years (e.g. 2018) have been the weakest year of the four-year presidential cycle. By contrast, the pre-presidential election year (e.g. 2019) is the best year in the four-year presidential cycle. In fact, big bounces typically occur after the market has its intra-year pullback. On average (see chart, right), after a -16% drawdown, stocks rally by 33% one year later.

According to Ned Davis Research, “One of the reasons the stock market has performed well after midterms is that the government has tended to stimulate at that point in the cycle.”

Year	Intra-Year Pullback	Return 1-Year Later
1950	-14%	+31%
1954	-4%	+43%
1958	-4%	+36%
1962	-26%	+33%
1966	-22%	+33%
1970	-26%	+45%
1974	-38%	+35%
1978	-14%	+11%
1982	-17%	+58%

Source: LPL Research, FactSet

Year	Intra-Year Pullback	Return 1-Year Later
1986	-9%	+41%
1990	-20%	+29%
1994	-9%	+14%
1998	-19%	+38%
2002	-34%	+34%
2006	-8%	+25%
2010	-16%	+31%
2014	-7%	+9%
2018	**-19%**	**???**
Median	-16%	+33%

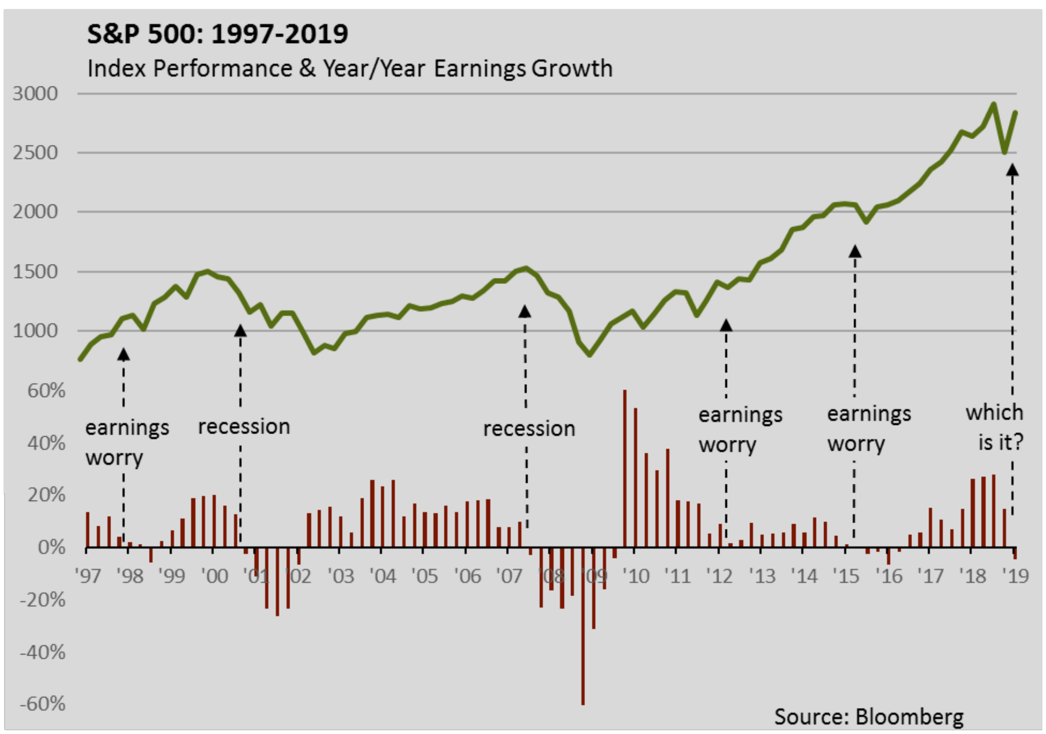
Earnings Worries Versus Recessions

The value of a company can come from many places; for most, value is derived from earnings (profits). Consequently, the broader stock market tends to do well when aggregate earnings are growing. Historically, any meaningful decline in earnings, both earnings slowdowns and full recessions, are negative for stocks. Over the last 20 years, there have been 6 major earnings declines (two of which were recessions) which explain most of the stock market drawdowns over that same period.

- Earnings worries not associated with a recession realized drawdowns of -19%, -19%, -12% and -13% in 1998, 2011, 2015 and 2016, respectively.

- Earnings slowdowns in the midst of recessionary periods realized drawdowns of -47% and -55% in 2002 and 2008.

The latest slowdown in earnings occurred over the last 6 months, generating a drawdown in stocks of -19% in late 2018. A lot of media discussion centered on the determination of a recession. That occurred since earnings slowdowns in the midst of a recession are significantly more damaging to stocks than earnings worries without a recession.



Summary

Over the past few years, the stock market has realized an oscillating pattern of calm and panic. Small changes in policy and economic data seem to have a magnified effect on stock market performance. Until a better buying opportunity arrives, client portfolios will remain at their Neutral equity levels. Consistent with that outlook, we recently made changes to client portfolios, maintaining a Neutral equity position while also adjusting allocations of international, emerging markets and various bond / non-equity sectors.

Economic slowdown in China, the dependence of international and emerging market stocks on China's economy, Brexit, and trade policy with China are all known risks. However, future problems which disrupt markets and economies are more likely to come from an "unknown" risk than any known risks that are already contemplated.

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.

Brock Griff Karen Larry Todd Pam John Evan

Brock E. Hastie Managing Partner	Karen Chapell Managing Partner	Todd Kephart Managing Partner	John Goff Managing Partner
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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.