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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

What is happening? How do the financial markets go from a model of strength to producing a highly volatile sell-off in the space of the three months since the last Outlook & Trends described the economy as very strong? Why do we continue to see such volatility when the economy is still very strong? In this edition of Outlook & Trends, we hope to provide a little more insight than can be gleaned from the news media's talk of tariffs, government shutdowns, Washington personalities, and 20% bear markets.

The Economy

By all measures, the economy remains strong but may be moderating. Leading economic indicators continue to rise, although the rate of progression has slowed a bit. Last quarter's GDP grew at an annual rate of 3.4%. The current estimate for this quarter is 2.7%. Purchasing managers suggest that business is still strong, reporting their index of economic activity to be 59.3, where any reading above 50 implies expansion. Unemployment, a lagging indicator, remains at a 49-year low of 3.7%. As we said in the last issue of Outlook & Trends, "It doesn't get much better than this." The problem is though, that if it does not get much better, then there is a good chance it will get worse sometime in the future. Presently, however, there is little that would imply an imminent recession or provide a short-term economic reason for market volatility. One can make the case, however, that there are plenty of reasons for intermediate-to-long-term weaknesses now built into the economy that could become visible at any point.

The Markets

Despite the economic strength, the stock market reversed during the last quarter. The S&P 500 average erased prior gains and closed 6.2% lower for the year. An even broader measure, including international stocks, the All Country World Index, was down 11.2%. Excessive volatility was a hallmark of the quarter's performance. Volatility may be accentuated by computerized high frequency trading coupled with short-term trading decisions made by machine-based algorithms, as well as investors crowding into index funds, but the fact of the matter is that there have always been short-term variations in stock prices. They are simply less noticeable when the trend is strong. In a strong uptrend, everyone applauds the large short-term up moves that occur, and buyers step in to limit declines. In a strong downtrend, there is so much concern with the declines that few notice the sharp recovery rallies. It is when the trend flattens out that the ups and downs are magnified, and volatility becomes very noticeable.

Teddy and Grizzly Bears

A flattening trend is always present during a period of horizontal consolidation and typically can be seen before the onset of an extended decline in prices. Years ago, when we first started studying the stock market, different periods were dubbed corrections, consolidations and bear markets. Corrections occurred when rising prices got ahead of themselves and were brought back to a more reasonable level within an ongoing upward trend. Consolidations happened when an intermediate term (i.e. about 9 months or shorter) cyclical counter-trend slowed a rising trend down, causing the overall direction to become horizontal. A bear market signified a long-term down trend, which was as much a state of mind as it was a market phenomenon. Sellers created falling prices which reduced the collateral value for margin loans. Less collateral forced more selling. Selling created more selling. Eventually the entire over-leveraged financial structure washed out, until there was no one left who wanted or had to sell.

The definition that calls a decline of 10% a correction and a 20% fall a bear market was invented by the media sometime during those years. They have come to be accepted definitions by commentators but are arbitrary and miss the point completely. Corrections, regardless of the percentage pullback, while perhaps scary over the short term, are necessary for the markets to retain their health, as they bring prices back to a more normal level from

which a renewed uptrend can occur. Journalists talk of stocks entering, leaving and re-entering corrections just because they pass the 10% mark in one direction or another. A correction, consolidation or bear market is not a point. It is a process, and, once it begins, as Yogi Berra said, "It ain't over 'till it's over".

Consolidations, or what we might call a Teddy Bear market, are periods when buyers and sellers have less conviction, regardless of whether there is a 20% drop at some point. Traders are competing to see whose vision of the future direction will eventually win out. Bear markets are a different story. These are times when selling feeds upon itself. Liquidity (the availability of new cash) dries up, and sellers find they must leave positions at any cost. We will call those bear markets the Grizzlies.

The Grizzly last made its appearance in 2008. It morphed from a consolidation that started in 2007 into a Grizzly in 2008 when failed mortgage loan derivatives sucked liquidity from the system and Lehman Brothers failed. The banking system came close to locking up. The government and Fed stepped in to provide additional cash into the banking system and economy. That, plus a change in accounting rules, eventually provided enough liquidity to re-grease the economic gears and allowed the stock market to bottom. In 2011, the Fed initiated a round of money printing (called Qualitative Easing), which kept a nascent consolidation Teddy Bear from growing that year. In 2015, after the Fed ended its QE policy, the absence of new liquidity caused a new Teddy Bear market consolidation. Further deterioration then was reversed by the European Central Bank initiating its own QE policy.

The Dow Theory, one of the oldest and most venerable set of stock market guidelines, was published in 1929 from the collected works of Charles Dow, editor of the Wall Street Journal. The theory posits that turning points in the stock market can be identified when Dow's average price of industrial stocks and his average of rail stocks (now more broadly transportation stocks) both turn up or down together, one confirming the direction of the other. There was no mention of 20%. Dow was concerned about the direction of the long-term trend. The Dow Theory has occasionally given false signals, and is usually somewhat late, but has withstood almost 100 years of testing. The bear confirmation occurred on December 19.

Since 2009, asset prices have been propped up by one or more international central banks, and market-supporting liquidity continued to grow. The ECB has announced that it intended to end QE policy at the end of 2018. Is it any wonder that the markets have embarked on a new Teddy Bear market in anticipation of the removal of a primary prop under asset prices, even if the U.S. economy measurements are in good shape? It is no longer about current company profits driving stock prices. It has become about the availability of cheap money. Whether this Teddy Bear market remains a volatile consolidation or turns into a Grizzly may depend on central bank policy decisions and whether any pent-up financial instability is exposed by the current interest rate and liquidity reduction policies.

LFM&P

As we mentioned in the last issue, we suspended our long tradition of simply trying to provide information and perspective in *Outlook and Trends* with a minimum of self-promotion. Last time, we included a description of our retirement planning. This letter includes a similar sheet describing our investment services. It is possible that we may again return to a comfortable financial environment. It is also possible that a new reality will emerge before us, an environment where planning and risk-management become more important than ever. Predictions will necessarily be faulty. We will never know how market and economic events turn out until after the fact. However with the excess global debt, demographic changes occurring with retiring baby boomers, over-valuation, and a shift in central bank policies occurring, to paraphrase Bob Dylan, the trends they are a-changin'.

If you are interested in finding a fee-only, fiduciary investment advisor to help you manage your investment risk or develop a financial plan, please send an e-mail or call.

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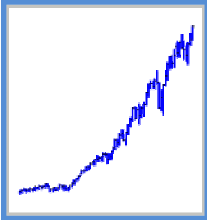
Investment Advice and Management



For many people, investment in stocks and bonds, mutual funds, and ETFs is an important strategy to augment income, build wealth, and reach their life goals. For many of those, learning to invest can be a life-long process with many challenges and setbacks encountered along the way. One of those challenges is simply learning how to overcome natural human emotions and ways of thinking that are counterproductive. Another set of lessons is learning how to appreciate and manage risk.

Often people are too busy with their daily lives to spend the time necessary to learn and manage investments. Others simply do not have an interest in spending time digging into the details of the investment process. As a result, they follow the conventional advice, buy a few mutual funds, and hold on in fear and disbelief when markets experience their occasional declines.

We recognize that the markets' results cannot be predicted with any more accuracy than any other outcomes that depend on human emotions and decisions. That does not mean though that there is no point in selecting strong investments or managing risk. We have developed and follow non-emotional, rules-based strategies, which seek to do both - recognize and manage strength and impending risk.

- We start with a client's investment goals plus their capacity and willingness to be exposed to risk. *LFM&P's* MarketAware℠ approach seeks to recognize market conditions and adjust portfolios to increase market exposure during low-risk times and reduce exposure during high risk periods.

- The biggest cause of investment error, emotion, is reduced by identifying purchase, sale, and risk level rules. During quiet times, we study how the markets have reacted in the past under multiple circumstances. During active, volatile times when decisions are necessary, the pre-defined rules can be implemented quickly and unemotionally.

- Each client's portfolio is different. We do not use generic "model" portfolios built for an average client, because we do not have any average clients.

- The well-being of our clients is too important to us to hand off to a disconnected third party. We maintain the management function ourselves. Our clients can always talk directly to their strategist, advisor and portfolio manager.

- People often own a large number of mutual funds, but achieve very little diversification if they all rise and fall together. We are careful to diversify, yet also target areas of current strength.

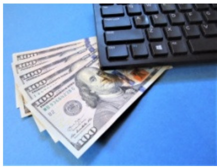
- Our portfolios are *"reallocated"* rather than "rebalanced". Rebalancing is periodically returning a portfolio to its initial allocation. Reallocating is periodically reviewing economic and market trends and adjusting to add strength and compensate for current market risk.

When clients work with *LFM&P*, they work directly with David and Barbara. David is a CFP® professional and a member of NAPFA. *LFM&P* has been a fee-only, fiduciary organization ever since its beginning 2002. If you wish to have help with your investment program, *LFM&P* can be either your investment advisor or manager, and provide you with the MarketAware℠ approach.

- If we are your advisor, you will receive our advice on how to best reallocate your portfolio periodically, generally every three to six months. The choice of following the recommendation or not is yours. You decide. If your broker allows advisors to complete transactions for you, we can do that after receiving your approval. If you have an account, like an employer retirement plan such as a 401(k), which does not allow advisors to represent you, you would likely have to relay the instructions to make the changes yourself.

- If we are your investment manager, we review your portfolio, search for opportunities and evaluate risk continuously, applying our rules-based MarketAware℠ strategy when conditions develop. To accommodate this relationship, you give us the authority to instruct a broker to buy and sell on your behalf without prior individual approval. This is called "discretionary authority". If you do not have a favorite broker who will accept discretion, we can suggest one. We do not ever hold your funds.

LFM&P's investment advice and management fee is the same for either arrangement and is based on the value of assets advised or managed.



Investment Advice or Management can be provided by itself or may be combined with a continuing financial planning relationship. We call the combination Wealth Advisor or Wealth Management.

Financial planning helps clients to resolve current financial issues, organize financial goals, suggests actions that should be taken to meet those goals, identifies when to act, and provides implementation assistance when necessary. From the perspective of investments, it is an important process to undertake to determine what your appropriate investment strategy is.

When constructing a financial plan, we get to know each client's financial situation and desired direction. We often ask many questions to clarify information that has been provided and to prompt clients to consider issues and details that they have not yet addressed. We use the information and answers provided to construct a model, which projects what the client's financial future may look like based on the ideas discussed as well as reasonable assumptions about the future. The projection includes expected income and expenses, cash flow, taxes and wealth, and is projected for every year for the duration of the planning period.

The model is created with several different variations in expense or income to see how sensitive the results are to changes in spending or income. The model uses investment returns based on today's market valuation – not generic averages – and is also "stress tested" to see how objectives are likely to fare in a poor investment environment. The client can use the results of the model and sensitivity analysis to adopt a mental framework to guide both long-term and day-to-day financial decisions.

The result of the planning process shows a financial path to achieve your desired results, and an understanding of what actions must be taken to bend a current course toward that outcome. It also helps to define what your asset allocation and investment strategy should be. It is an ongoing process. It needs to change as your life changes, so that you can make small changes to stay on course over time.

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