LFM&P

LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

There has been a partial recovery in the stock market from the losses incurred from October through December. Bonds are rising again after two years of losses. Preliminary evidence suggests the economy may be slowing and parts of Europe may be in recession. As we said in the January issue, "The trends, they are a changin' ".

The Economy

Leading economic indicators, which tend to precede the economy by 1-2 years, have flattened out as the stimulus effect of last year's tax cuts peters out. The economy continues to grow, but at a slower pace than before. The most recent reported growth rate was 2.2%. The current estimate is 1.7% for the first quarter of this year. The ISM Purchasing Managers Index suggests continued expansion, but it has been falling since a peak last August. Likewise, the National Association of Realtors reports the price of single family homes peaked in June.

The Markets

The stock market pullback at the end of 2018 has been ascribed to Federal Reserve policy. They raised short-term interest rates and reduced the size of bond positions that were acquired to support the economy and markets during the Quantitative Easing periods from 2008 to 2013. Although both operations were known long before October, it is possible that the markets were just beginning to feel the pinch. When Fed chair Powell reiterated the plans and said that they were on "auto-pilot", the market got spooked. The market's strong adverse reaction, plus lunch at the White House caused the Fed to soften its approach, saying that they could be "patient" with interest rate increases and would provide a schedule telling when the bond roll-off would end. That has further been interpreted to mean that the Fed is likely finished raising rates, and the Fed's balance sheet reduction will stop at a still inflated level of $3.8 trillion, up from $900 million before the QE program started. The hair-trigger market reaction and the low tolerance for rate increases and liquidity reduction suggests that the economy may not be as sound as it looks on the surface. It may also be that there are more than a normal amount of over-extended or under-capitalized investments, abetted by the decade of low interest rates, that could fail if credit tightens.

It's likely that, if the economy were to fall off dramatically, the Fed will step in with further support, or they will be invited to more White House lunches before the 2020 elections. For now, stocks have recovered much of their losses, but under the venerable Dow Theory, a bear market will still be in effect until proven otherwise by new highs in the Dow Industrials and Transports.

The Debt Cycle

Our current situation can be seen within the context of an economic cycle top. Ray Dalio, founder of the world's largest hedge fund, has published a treatise entitled "A Template for Understanding Big Debt Crises" that discusses the existence of short and long debt (and economic) cycles. The former last 7-10 years. The latter are 75-100 years. The short cycle causes typical economic recessions. The long cycle causes economic depressions when debt gets too far out of hand. Dalio also produced a short, animated version, which explains how the economy works. You can see it at https://www.youtube.com/watch?v=PHe0bXAIuk0. While Dalio does not specifically mention it, since short cycles are superimposed on top of the long cycle, it is understandable that there could be multiple bubble tops formed by the peaks of the short cycles near a long cycle top. We may be witnessing this as the long cycle rolls over, evidenced by the sequence of dot-coms, the housing bubble, and now the current central bank QE bubble.

Dalio offers seven characteristics that are useful for spotting bubbles. The following chart lists them along with our interpretation of the current condition.

Are prices high relative to traditional measures?	Yes. All long-term stock market measures are 70% to 90% above average, depending on the measurement.
Are prices discounting future rapid price appreciation?	Yes. Investors are willing to pay 22.3 times current earnings on average. The 140 year median is 14.7
Are purchases being financed by high leverage?	Yes. Margin debt hit an all time high of $668 billion in 2018. This compares to about $500 Billion in 2007.
Are buyers/companies making forward purchases?	Yes. Stock buy-backs are at an all time high of $806 billion. The prior high was set in 2007.
Have new participants entered the market?	Yes. Household stock allocation has grown to 56%, up from 35% in 2009 and is now similar to 2007, and 2000.
Is there broad bullish sentiment?	Yes. AAII reports that the current ratio of bulls to bears is 1.59 compared to historical average of 1.26. The high for this cycle was hit in January 2018, at 3.85!
Does tightening risk popping the bubble?	Yes. October to December action suggests that it does.

OK. So if there is a bubble, what does it mean, and when will it pop? Dalio suggests, "The more leverage that exists and the higher the prices, the less tightening it takes to prick the bubble and the bigger the bust that follows". One of the first indications that the trend is changing is changes in interest rates. When the Fed raises short-term rates, holding cash equivalents becomes more attractive relative to risky assets like stocks. As money flows toward greater safety, and investors see the potential peaking of the economy, more bonds are bought, causing their yields to decrease. Eventually, long-term rates can fall below short-term rates. Since long rates are usually significantly higher than short rates, this relatively unusual condition, called an "inverted yield curve", is an important marker for a recession on the horizon.

The yield curve inverted momentarily on 3/27. What does that mean? The good news is that there is usually some time before the deleveraging process starts and possibly still some investment gains remaining, especially if the inversion does not last long. The table shows a highly variable lag time from 0 to 36 months until a stock market correction, and 10 to 48 months before a recession. Often market falls do not start until after the inversion has righted itself. Not only might there be a long time until stocks are affected, there could also be substantial gains in the interim (from 0% to 42%). But, despite the variability, the signal should not be disregarded. The market's next bottom after the inversion was at best 4% higher (and 4 years later) and at worst 48% lower. A key takeaway, however, is that the valuation level, measured by Schiller's CAPE, is highly related to the performance after the inversion. The highly valued pink lines below suggest that this is not the time to bet the farm (or your retirement).

First Inversion Date	Market Correction Began	Schiller CAPE	Market Months Lag	Recession Date	Recession Months Lag	Gain to Market Peak	Loss to Market Bottom From Peak	Loss to Market Bottom From Inversion
12/27/1965*	2/1966	24	2	12/1969	48	+3%	-22%	-20%
	12/1968	22	36			+18%	-33%	-33%
1/16/1973*	1/1973	17	0	11/1973	10	0%	-47%	-47%
7/19/1978*	2/1980	9	19	1/1980	18	+42%	-26%	+4%
9/29/1980	11/1980	9	2	7/19/81	10	+13%	-26%	-17%
3/27/1989	7/1990	15	16	7/1990	16	+27%	-20%	+1%
9/10/1998	----			----				
4/7/2000	9/2000	43	5	3/2001	11	0%	-49%	-48%
1/17/2006	10/2007	26	21	12/2007	23	+22%	-56%	-46%
3/22/2019	????	29						

*These dates mark the inversion of the 10 year bond and the federal funds rate. Other dates are the inversion of the 3 month and 10 year Treasuries.

If you would like to work with 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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