YANKE FINANCIAL

5540 Centerview Dr, Ste 200 | Raleigh, NC 27606
919-306-5811 | Toll-Free: 800-513-2812 | Fax: 919-375-2303
patrick.yanke@yankefinancial.com
www.yankefinancial.com

YANKE FINANCIAL, LLC NEWSLETTER — WINTER 2019

Patrick H. Yanke, CFP®
Branch Manager

February 22, 2019

Slowing but not Shrinking

Market News and Current Trends

Last year saw volatility return to the markets… and it made for a wild ride. Investors who had gotten comfortable in the low-volatility environment of the previous nine years felt it most acutely. We experienced the single greatest point drop in history at the end of January, the fourth quarter was the third worst quarter since WWII, and December was the worst month since WWII. The good news is that the S&P 500 was only down 4.4% by the end of the year despite those milestones.

Volatility is the New Normal

What changed last year to bring volatility back to the markets? In large part, we can look to the Fed. Since the Fiscal Crisis, they have kept interest rates near zero and been the greatest buyer of government debt, fueling liquidity in the markets. This environment was purposeful to keep calm in the financial markets. The environment is different now.

Not only has the Fed raised their Fed Funds rate to nearly 3%, they have embarked on a strategy to reduce their balance sheet. Being the greatest buyer of government debt in the world ballooned their balance sheet from its traditional level of about $750 billion to nearly $5 trillion. Allowing these securities to mature will slowly reduce liquidity in the markets and their accommodation.

Markets don't tend to worry about absolute values. They react most aggressively to trends. A reduction in Fed accommodation is a trend which will drive market volatility for the foreseeable future.

Bear in mind, though, that the numbers are now bigger mostly because the markets are higher. That record-setting point drop in the Dow in January of last year didn't even crack the top 300 in terms of percentages. It's important to keep perspective in times of uncertainty.

Forecasting a Slowdown

As mentioned above, markets move based on trends, not absolutes. The trend leading into 2018 was for robust economic growth going forward. That changed as economic forecasts changed. While 2018 is expected to post an annual GDP growth number near 3%, 2019's GDP growth is forecast to be around 2.7%. Worse still, the forecast in future years is expected to return to levels below 2%/yr. Even though this isn't a recessionary reduction in GDP, the changing trend can drive markets. Peak to trough, the S&P 500 was down about 20% last year. Even though it hasn't officially been called a "bear market," by definition…it was.

Understanding Market Movement

As investors, it's important to understand what drives markets. In the short-term, they tend to react emotionally as investors think about "greed and fear." Greed drives short-term gains as investors try to take advantage of market growth and fear drives markets down as investors try to avoid losses. Another way to describe this is "momentum." Market volatility is a swinging pendulum where rising markets build fear of the next sell-off and falling markets build anticipation of the next rally. Trying to time these reversions has proven to not be consistently effective.

Over the long-term, markets tend to move based on the fundamentals of the economy. In a growing economy, you expect markets and values to also grow. There is a mathematical expression for this expectation:

Expected Return	=	Real Growth	+	Dividends	+	Inflation	+/-	Change in PE Ratios
6.9%	=	2.1%	+	2.7%	+	2.2%	+/-	0%

Given the economic forecasts for GDP growth, dividends, and inflation, investors should plan for single-digit asset growth in this environment. There are a couple of wild-cards in this equation, though. One of those is PE ratios. Note that this number in the equation isn't factored… there is no way to forecast changes in PE ratios. Expanding multiples will yield greater returns and the reverse will lower them.

The other wild-card in the equation comes from understanding what drives long-term economic forecasts… the labor force. From 1950-2015, the labor force grew by 1.5%/yr and productivity grew by 1.7%/yr. GDP grew by an average rate of 3.2%/yr during this timeframe. Looking forward, economists expect the labor force to grow by only 0.5%/yr and productivity to grow by 1.6%/yr to give a GDP growth rate of 2.1%/yr (in the equation above).

The wild-card in the labor force is the labor force participation rate. During the last decade, it fell to its current level of about 63% (which is about where it was in the mid-1970s). These "idle" workers reentering the workforce (or sensible immigration policies) could drive higher GDP growth than currently forecast. Already this year, we saw double the number of jobs added than expected and the

MY BUSINESS PHILOSOPHY

Do unto others as I'd have them do unto me. I don't like to pay people just to have a conversation with them. Let me do a confidential financial review for you. There is no obligation.

ONLINE RESOURCES

My webpage has a wealth of resources and calculators for the online investor. Go to www.yankefinancial.com. Clients can also access their accounts for statements and tax forms.

Continued from the front:

unemployment rate rose. Why did it rise? The growing economy attracted people back to the labor force. It is a real possibility and impossible to forecast accurately.

The Yield Curve

If I had to choose one signal investors are watching closely right now, it would be the yield curve. This curve shows the interest paid at different durations of debt. On the short end of the curve are instruments like money markets and CDs. On the long end are 10- to 30-year bonds.

When the yield curve is positive, bonds on the long end of the curve pay more interest than those on the short end. Investors should be rewarded for taking on greater risks. When short-term debts pay higher interest than long-term debts, this is an inverted yield curve.

A rising Fed Funds Rate has an influence on short-term debt instruments. Short-term bonds are constantly maturing and adjust rapidly to rising interest rates to be competitive. Primary market-makers issue debt at prevailing rates.

Long-term rates are largely driven by supply and demand in secondary markets (investment markets). When there is greater demand for bonds, values rise and interest rates fall. When there is less demand for bonds, values fall and interest rates rise. The Fed's balance sheet is also influencing the long-end of the yield curve in this environment.

While the Fed has been steadily increasing their short-term rates, the investment dynamics on the long end of the curve have kept long-term rates steady. This combination is pushing the market toward a negative yield curve.

Why are investors concerned about a negative yield curve? This indicator has been a fairly reliable predictor of recessions. Over the most recent 35 years, it preceded each of three recessions. Going back further than that, inversions preceded the past seven recessions with two false positives.

Recognize what normally happens when the yield curve inverts. The Fed tightens rates on the short-end to combat rising inflation in a heating economy. They intend to "cool" things off a bit. On the long end of the curve, investors shift portfolios more to bonds recognizing that market trends may be preparing to reverse. These are actions taken in anticipation of the next recession. It can be self-fulfilling.

What we have now is a fairly unique scenario. Although the Fed Funds Rate has risen and may rise more, it is nowhere near its usual "tight" level near the end of an economic expansion. Long-term rates remain at historic lows as fears lingering from the last recession haven't subsided. As the cycle continues, fears of the next recession grow.

Where are we in the economic cycle? If you believe, as I do, that the economy's recent decade of below-average growth is blossoming into more average, historical growth rates, you may see a current negative yield curve as a false positive. On the other hand, the predictive accuracy of this signal may be a self-fulfilling prophecy. If market participants believe this signal of impending recession, shifting investment dollars may prove them right. The surest way to recession is for capital to dry up. Only time will tell.

Greatest Risks

Right now, the greatest risks to the economy and the markets are the unknowns. The next crisis may be caused by political instability, bad actors, negative expectations, or acts of God. However, without those outside factors the current trend is one favorable to business, workers, and investors.

I am very wary of Europe. I have said for years that the EU is an artificial construct that can't survive for the long-term without true European unification. The economic stress levels are growing. Italian debt alone has the potential to sink the Euro. Contrarian investors who "buy on bad news" may see opportunity in these markets but I think it will get worse before it gets better.

Although the global economy is forecast to slow a bit, there is opportunity overseas for domestic investors. A dollar forecasted to soften this year should boost overseas returns. Trade tensions aren't likely to result in a domestic recession but there is some risk in China and Emerging Markets. Productive trade talks will help stabilize global growth.

Economic forecasts are assumed relevant looking one year ahead. Beyond that, there are too many assumed variables to claim accuracy. Be skeptical of long-range forecasts.

Do Something

Investors should still remain vigilant with their portfolios and review their holdings. I believe this environment is where the best managers will have an edge over "passive" managers seeking to match index performance. Sit down with your financial advisor and ensure your investments are prepared for the future and consistent with your objectives.

Summary and Call to Action

My investment outlook favors equities over bonds. This is an environment for strong investment managers and careful stock selection. Income-oriented investments may struggle in a low—and rising—interest rate environment. I think bonds have value as a diversifier for managing risk in a portfolio—as an asset class, though, I think rising rates could remove much of the reward for taking duration risk.

What to do now? **Take the long view with your investment assets** and dust off financial plans. When was the last time you reviewed your plans? Your estate plan should be reviewed at least bi-annually and updated with every change of life. Most importantly, make sure you have carefully delegated who will execute your documents for you. To review existing planning documents or build new plans, make a resolution to work with an advisor this year.