Keep Your Eye on the Prize

"A ship in harbor is safe, but that is not what a ship is made for."

~ John Shedd, author

The second quarter showed less volatility than the first, but I think choppy still best defines the type of market we're mired in. Unfortunately, I don't expect that to change this coming quarter, and volatility may even pick up a bit during the summer. However, this would be par for the course as during most mid-term election years, volatility is notably stronger throughout the year, particularly during the third quarter, as shown in the chart below. This seems to happen every four years, regardless which party is in power. Typically the party in control of Congress losses a decent amount of seats, but how many and which party will ultimately control the two houses remain largely up for grabs. If there's one thing the market truly hates, its uncertainty.

The silver lining of a few more months of choppiness is historically a very strong market following the election, regardless of the outcome. According to a recent study by Terry Marsh, an emeritus finance professor at UC Berkeley, the Dow Jones Industrial Average has produced annualized gain of just 1.4% in the six months before the mid-term elections and an astonishing 21.8% annualized return in the six months thereafter! This study went back all the way to 1890 when the Dow Jones Industrial Average was created, so a fairly long amount of time, certainly enough to get the amount of data points needed for an accurate reading. So while the next few months should see continued stock market volatility, it's important to remember that this too shall pass, and longer term gains lie ahead.

Source: CFRA, S&P Gobal. Past performance is no guarantee of future results. Data: 12/31/1944-6/22/2018

"A smart man learns from his mistakes, a wise man learns from the mistakes of others."
~Saying

Discretionary vs Staples

Over the past year, the four best performing sectors are technology, consumer discretionary, energy and financials. These are the aggressive areas of the market and what you would expect to see in a growing economy. Earnings tend to rise and fall much more quickly in these areas and, for that reason, money rotates into these sectors when a strengthening economy is expected in the months ahead. The four worst performers over the past year are utilities, consumer staples, healthcare and REIT's. These are the defensive areas of the market and again, what you would expect to see given the positive economic conditions, particularly when overlapping with rising interest rates.

A simplistic way to look at this would be the consumer sectors, namely discretionary and staples. Discretionary items are those purchases people choose to make, whether or not to buy a car, or go on a vacation for example. Staples are those items that you'll need to buy regardless, such as food and toothpaste. You can learn a lot just by looking at which one of those sectors are outperforming the other. On the top chart shown below, the consumer discretionary index has been handily outperforming the consumer staples index for the past two years, coinciding with a rising S&P 500. *Cont. on pg. 3*

Preceding the financial crisis, the consumer staples sector started outperforming the consumer discretionary sector in early 2007, as shown in the charts below. This was a good eight months before the top of the market. In hindsight, this was a major red flag that there was trouble beneath the surface. It is okay if consumer staples outperforms consumer discretionary for a few days or even weeks at a time, as that often happens during market selloffs. However, when that type of performance lasts for months at a time, particularly during a rising stock market, it could be viewed with significant concern that all is not well. Luckily, that is not where we are today.

Apples and Oranges

Although it's logical to correlate the economy and the stock market, it's a mistake to think of them as mirror reflections of each other. The stock market has been in a bull market for the past nine years, while the GDP (Gross Domestic Product) has struggled to grow more than 2%. There are a number of reasons for this difference, most notably foreign earnings, stock buybacks and equity valuation increases.

Additionally, GDP is a flawed measuring tool of economic activity. It tracks final sales, but that doesn't measure the total amount of economic activity (the total of all checks written between businesses and consumers) that was necessary to create the sale. For example, a new car might cost $30K to the consumer, but the total amount of economic activity that went into building and selling the car is significantly more than the final cost of the car.

The point of all this is that the GDP is an indicator, but one that shouldn't be relied upon nearly as much as it is. You can't buy shares of GDP. Investors buy shares of companies and the strong profits companies are producing are all the proof I need that the economy is strong and growing.

Down but not out

"Anyone who believes that exponential growth can go on forever in a finite world is either a madman or an economist" ~Kenneth Ewart Boulding, economist

Besides the tariff battle being raged on twitter, the biggest concern for investors seems to be the rise in interest rates we've seen so far this year and the potential for the yield curve to invert. The yield curve is the difference between short term and long term interest rates, and is typically referred to using the 2 year Treasury bond and the 10 year Treasury bond. While long term rates have risen, they haven't risen nearly as much as short term rates have, due to the Federal Reserve recent rate increases. With the Fed expected to raise rates a couple more times this year and potentially a few next year as well, if long term rates don't keep pace the yield curve will likely invert sometime in 2019, meaning short term rates will be higher than long term rates. This is important because every time the yield curve inverts, a recession has followed.

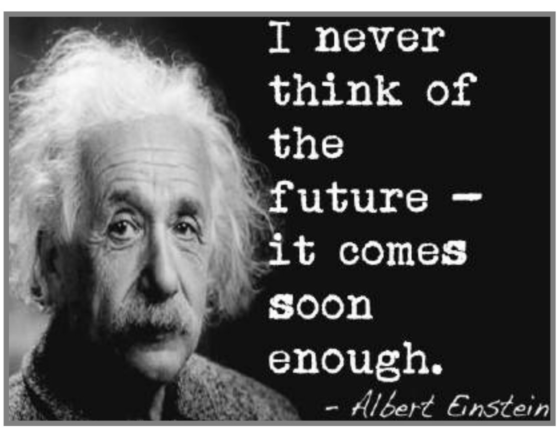
While that all sounds foreboding, it typically takes a year or so for a recession to come after the yield curve inverts. Additionally, the S&P 500 has rallied an average of 29% to the top of the market once the yield curve inverts, according to Federated Investors. So while an inverted yield curve would be cause for concern, it would not be something we would need to immediately act on.

Perhaps most importantly, the yield curve hasn't inverted yet, the difference between the two rates have merely gotten smaller, which is referred to as flattening. The yield curve can stay relatively flat for years without inverting and has often coincided with strong stock market returns. The arrows shown in the chart below indicate when the yield curve first became as flat as it is today. Those years were 1984, 1988, 1994 and 2005, all great times to own stocks and all years away from the next significant downturn.

"Imagine how hard physics would be if electrons had feelings!"
~Richard Feynman, physicist

Lunar Phases

While I'd like to think investors are generally rational beings basing their investment decisions on solid fundamental and technical data, I know that's not always true. Fear, greed and other emotions often drive investment decisions, and according to a recent study by the Leuthold Group, so does the moon. Since its inception in 1957, the S&P 500 has generated annualized returns of about 10%, according to a the report. However, during the days surrounding either a new or full moon, the average return jumps to 19%! Furthermore, the average return was just 5% during the rest of month. The effect was even greater for high-beta (volatility) stocks, which averaged over 33% during the best periods and negative 13% during the worst. Why that's so, I do not know, but with that type of performance, perhaps it's something to be incorporated into our investment decisions. In case you were wondering, the next new moon will be July 13th, which also happens to fall on a Friday, if you believe in such things.



Even though we are witnessing a very positive economic environment, with earnings well on their way to growing more than 20% this year, very low unemployment and stable inflation, the stock market can't seem to find its footing so far this year. There seems to be a misplaced (in my opinion) concern amongst investors that since the stock market has rallied for so long that there must be a bear market lurking around the corner. Or that since in a few months' time this economic expansion will be the longest on record, there must be a recession coming soon. While I will admit we may be late in the cycle ,to borrow a baseball reference, a whole lot can happen in the final few innings, including extra innings! In a long term secular bull market like we're in, extra innings are a common feature, as they tend to last far longer than most investors believe possible. Although I expect the next few months to have its ups and downs, the market is still set up to head higher long term. So go ahead and pass the peanuts!

Several financial deadlines are now behind you. Take a breath, and then take some time this summer to review your progress, set new goals and tie up loose ends. Tally up any recent life changes that may affect your estate plan – adjusting it as necessary – and evaluate your benefits and insurance.

SUMMER 2018 | MARKET CLOSURES

Wednesday, July 4: Independence Day

Monday, September 3: Labor Day

MARK YOUR CALENDAR

- ☐ **Thursday, August 2:** Celebrate Information Security Day – update your passwords for all online accounts to keep your personal information secure.

PLANNING TO-DO'S

- ☐ **Register with SSA.gov:** Check your earnings history for accuracy and review your expected benefits through this site. If you're close to retirement age, discuss with your advisor when and how you should file to maximize your benefits.
- ☐ **Enhance your estate plan:** Check the beneficiaries of your IRAs, insurance policies, trusts and any other accounts, and update information that is no longer relevant. Ensure your plan protects you and your family in the case of an unexpected event.
- ☐ **Review insurance needs:** Periodically review and update coverage to ensure proper protection.
- ☐ **Address life changes:** Speak with your advisor about major life changes you've experienced and how your financial plan could be affected. These changes include marriages, births, deaths, divorces, a sudden windfall and more.

Year-to Date Index Performance

INDEXES	12/31/2017	6/29/2018	% CHANGE
Dow Jones	24,719.22	24271.41	-1.81
S&P 500	2673.61	2718.37	1.67
Nasdaq	6903.39	7510.30	8.79
Wilshire 5000	27794.17	28394.13	2.16
Russell 2000	1535.51	1463.07	7.00
MSCI EAFE (Intl)	2050.85	19858.64	-4.50

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