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Reliable indicator or new scenario?

Market News and Current Trends

Since the Fiscal Crisis, growth in the economy and markets has been met with a certain amount of skepticism. Until 2013, investment dollars flowed to bonds over stocks by about a 4:1 margin even as the S&P500 increased nearly 150%. This is a measure of uncertainty in the minds of investors who were seeking the traditional stability of debt instruments over the volatility of equities. This situation still hasn't changed much in the last five years as rising equity valuations have raised expectations for the next market correction and investors continue buying bonds..

Are Stocks Still an Attractive Asset?

It wasn't that long ago, I was writing about the "new normal" of below average economic growth for the foreseeable future. We were told the days of 3%/yr GDP growth were behind us. Those were the expectations as recently as two years ago. Tax cuts, reduced regulation, and repatriation of overseas wealth have combined to improve consumer optimism and the economic outlook.

There has been a strong trend of rising GDP growth over the last year or so. The first quarter of 2018 measured 2.8% GDP growth over the prior year and current estimates for the second quarter are registering over 3% in year-over-year growth… that would be greater than 5% in actual growth! The foreseeable future now shows an improving economic outlook—potentially back to historical growth rates.

The Next Recession and Bear Market

When measuring the value lost in the equity markets during the most recent 12 recessions, more than 50% of the losses were in the most recent two downturns. The average loss was about 25%… just a bit more than the definition of a bear market. It's important to note that if the next recession is in line with historical "norms", it doesn't have to be as catastrophic as the last two. That doesn't mean we shouldn't prepare for the possibility and practice diversification to protect our wealth while it grows. It does mean that we shouldn't necessarily look to the most recent recessions as examples of what to expect in the next one.

As investors we tend to get a bit myopic and view the next recession through the lens of the prior recession. Investors should realize how severe the last recession was compared to others and not be afraid to invest in accordance with their long-term expectations and risk tolerance. Don't try to time the next market downturn.

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.

Generally speaking, investors take greater risk when investing in long duration bonds. As interest rates rise, values may fall. There is a longer time for a debt issuer to develop financial troubles and change their credit rating. Long duration investors suffer the ravages of inflation which increases the cost of living on a geometric scale while their bonds pay simple interest.

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.

When we hear the Federal Reserve is raising their Fed Funds Rate, this has an influence on short-term debt instruments. Since short-term bonds are constantly maturing, they 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.

Except for some short-term selling in 2013, investors have been building up assets in bond holdings since the Fiscal Crisis. This strong demand has kept longer-duration interest rates low. Part of this demand is fueled by Baby Boomers, who are in or near retirement, increasing their asset allocation to fixed income. Another source of demand is investors who think this current market cycle may soon be coming to an end and are positioning their portfolios to a more conservative posture.

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.

Continued from the front:

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 recession with two false positives.

It's important to recognize what is normally happening 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 somewhat unique scenario. Although the Fed Funds Rate has risen and will likely 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 the fears lingering from the last recession haven't subsided. As the cycle continues, fears of a repeat of the last 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 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 another self-fulfilling prophecy.

While markets tend to follow the economy in the long-term, short-term market moves are generally driven by psychology. If market participants believe this signal of impending recession, shifting investment dollars may prove them right. Only time will tell.

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I have found that investors get a bit of paralysis when considering the equity markets. When rising, valuations are too high and headed to the next correction. When falling, investors are afraid to join a "weak" market. In my opinion, the most important action to take is to participate… especially when difficult. Investments work for participants.

There are concerns that the market may not have much room for further growth. The narrative at the beginning of the year was that valuations were too high. As the indices set new records almost on a daily basis, there was rising anxiety. The volatility experienced since the early peak has moved the market sideways for most of this year so far.

I'll pause for a moment here and talk about PE ratios… what are they and why do they matter? It is calculated by dividing the price of a security by the earnings of the underlying entity. This ratio is a way of comparing the relative valuations of different securities and markets. It is considered high when historical values or alternative investment options are lower. The ratio has two components and both are important when considering valuations.

The last bull market extended from the Spring of 2003 to the Fall of 2007. During that time, the S&P 500 doubled. What's interesting is that the PE ratio during that time actually went from about the level it was at the beginning of this year (less than one standard deviation above the long-term average) to lower than the average. Let me say that again… while the market doubled over 4.5 years, the market PE ratio fell! The sideways movement of the market this year has reduced the PE ratio of the S&P 500 back to the long-term average. By this measure, the market is no longer expensive… that was quick!

This doesn't mean that the stock market will only rise from here. Volatility is a natural part of any market. History tells us that the average market correction during any given year is nearly 14% (over the last 38 years)—and that's just the average. Yet, 75% of the time, the stock market finishes the year positive. As long as we have economic growth (even moderate growth), markets should continue to expand. Don't panic when you see the market behave normally by falling during a long-term rising trend. "Normal" means a nerve-jarring market correction at some point in the average year—despite the relative calm of the recent decade of market experience.

The improved forecast for US GDP growth is reflected globally, as well. There is real value overseas. Although it didn't help as expected during recent years, keep a strong global allocation.

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.

Oil is the lifeblood of the economy. As the price of oil has risen, some inactivated rigs have been reactivated back into service. This has bolstered crude oil inventories and should keep the price of oil in check for the foreseeable future.

Economic forecasts are only considered relevant when looking one year into the future. Beyond that, there are too many assumptions to claim accuracy. Currently, economists are not forecasting recession in the foreseeable future.

Do Something

What I've said so far shouldn't be an excuse for inactivity, though. 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.

General economic statistics are from JP Morgan "Guide to the Markets" 3Q2018.