Market Commentary

***Wall Street indices predicted nine out of the last five recessions* –Paul Samuelson**

Last year began with a sharp rally across all risky assets that evaporated in the first significant bout of volatility experienced in over five years. At the end of the third quarter, the S&P 500 was up 10.6% for the year. It then proceeded to fall over 19%, bottoming on Christmas Eve. Stocks outside the United States, in both developed and emerging markets, fared better during the fourth quarter sell-off, but lagged for 2018 due to weak performance during the first part of the year. MLPs suffered from loss harvesting and the typical lack of buyers at year-end (investors tend to defer MLP purchases until the beginning of the year to avoid the inconvenience of dealing with a K-1 for a partial year). However, the rally so far in January – the best beginning of the year showing by MLPs since 2009 – recouped most of 2018's decline.

Markets anticipate events. Market tops tend to occur before the peak in the real economy and bottoms tend to occur well before the end of a recession. Volatility reflects the incorporation of information about new risks. What are the odds of a US recession in the next 18 months? At the beginning of 2018, the market perceived the probability as low, now it sees it as a real possibility. It can be useful to interpret volatility as the market continuously revising the probabilities of different outcomes and incorporating them into asset prices. However, these probabilities cannot be directly observed and narratives devised by investment professionals or the financial press to explain market volatility are just educated guesses.

Market declines, such as experienced last year, do not necessarily indicate the beginning of a longer bear market or recession. Last quarter's -13.5% return may be the first leg down of a bear market, or it may be a blip from which the market rapidly recovers. The S&P 500 has declined more than 13% over a three-calendar month period 23 times since 1950. Nearly two-thirds of the time (15 instances), the market recovered and returned in excess of 20% over the following twelve-month period. Interpreted as a signal for recessions and/or bear markets, a market correction provides a wrong prediction about 65% of the time. The last decline of this magnitude, prior to last year, was in 2011. Stock markets fell over that summer by 16.5%. The financial press at the time cited uncertainty over slow US economic growth, the downgrade of the US credit rating, and fears over the European sovereign debt crisis as explanations. As these fears abated and corporate profitability improved, the S&P 500 went on to deliver an annualized return of 20.4% over the next three years.

A study published by the International Monetary Fund last year showed economists fail to predict recessions[1]. Out of 153 recessions in 63 countries between 1992 and 2014, consensus economic forecasts only predicted four of them 8 months in advance. Economists predicted an average growth rate of 3% eight months in advance for years in which recessions occurred. As economic forecasters predicted so few actual recessions, they likewise made few false recession predictions. Economists perhaps fear looking foolish and losing clients when they predict recessions that fail to occur. Contrarily, if all the other economists predict continued growth, going along with the consensus becomes a good career strategy.

While economists avoid predicting recessions, **financial markets frequently make uninterpretable and false predictions**. One area of the financial markets where forecasts are observable is the market for Fed Funds Futures. As of September 30 last year, the market predicted an 80% probability of a rate hike at the October 2019 meeting. By January, this probability of a rate hike had fallen to zero, and instead the market was predicting a 37% likelihood of a rate cut. Rate cuts are associated with economic slowdowns, so it is reasonable to interpret the probability of a rate cut as the market's view of the probability of a recession. With better economic news in the first weeks of January, this probability subsequently fell to its current level of around 6% with the market now predicting an 80% chance that the Fed does nothing at its upcoming October meeting. These wide swings provide a window into how markets react to new information. Repricing securities to reflect changes in its view of the world, the market began last year projecting accelerating global growth then reversed this view and ended the year projecting perhaps a 1/3 chance of a US recession in 2019.

Last year's decline did not significantly affect our return estimate for the S&P 500 over the next seven years, which remains at 6.2% (4.2% real plus 2% inflation). We derive our return forecasts from current valuations. While worthless for predicting next year's return, current valuations provide effective guidance about future returns over a period of five years or more. The S&P 500's historical average return is approximately 10% since the 1920s (roughly 7% real return plus 3% inflation). Combined with low bond yields, a portfolio consisting of 70% S&P 500 and 30% high quality bonds would have an expected return of 5.2%. This includes two percentage points of inflation, so the real value of this portfolio would increase at 3.2% per year, on average. An investor would not be able to withdraw more than this if they wanted to avoid depleting their capital. Diversifying into areas of the equity market with lower current valuations and correspondingly higher expected returns could improve the potential return of a diversified portfolio. For example, allocating about one-third of the equity portfolio outside the US could add about 60 basis points to the expected return of this portfolio.

US economic data showed a few signs of weakening during the fourth quarter, but most indicators remain comfortably above the average levels of this nearly ten-year-old economic expansion. The record length of time without a recession in the US stands at ten years, encompassing the period between the 1990-91 recession and the 2001 recession following 9-11. While nearly as long as the 1990s, the current expansion has delivered far lower total growth. The economy grew at a rate of 2.4% annualized since the Great Recession ended in 2009. During the 1990 expansion, the economy grew over a percentage point higher, at around 3.5%. Put another way, the US economy delivered in six years in the 1990s (mid-1991 through mid-1997) about the same amount of growth delivered in the nine and one-half years from March 2009 through September 2018. The economy could grow for another six years at the current 2.4% growth rate before it would surpass the total amount of growth delivered in the 1990s.

A major catalyst for the market's revision of global growth prospects came from the emerging picture of a serious slowdown in the Chinese economy. Since 2009, China's economy contributed about one third of global GDP growth. The Chinese economy slowed in 2016, driven by leader Xi Jinping's anti-corruption crackdown. This slowdown led to a collapse in the prices of various commodities and recessions in commodity producing countries such as Brazil. Growth resumed in 2017 and early in 2018, the consensus view was that growth was accelerating. The magnitude of the current slowdown in China is difficult to assess due to the poor quality of Chinese economic data and its possible fraudulent manipulation by authorities in the country. Beijing economist Xiang Songzuo, a professor at the Renmin University of China, said in December that he had read an internal report about the current state of the Chinese economy that used two measures to estimate current economic growth. One measure estimated China's real growth at only 1.67 percent and the other showed China actually in a recession[2]. A video of the speech went viral in China before it was censored, and professor Xiang disappeared from public view shortly thereafter. This may help explain why the country recently announced a large stimulus package to try to boost its economy. However, China's total debt-to-GDP level of 265%, in line with that of Western economies, and lower reserve level relative to the size of its economy restrict its financial flexibility.

At some point in the future, the US economy will go into a recession with an accompanying bear market for stocks. Instead of trying to react in the midst of the storm, **our portfolio strategy entails being prepared for these periods of volatility before they happen.** 'Buy and hold' can be frustrating, but it remains the only viable long-term investment strategy. It works with quality assets that can survive a prolonged economic downturn. Securities prices currently reflect increased global macroeconomic risk. The nonchalant attitude toward risk that typified financial markets a year ago has become more apprehensive. We expect volatility to continue as worries about the timing of the next recession and bear market mount. However, due to the large number of false signals given by market volatility, market timing remains a nearly impossible endeavor.

[1]Zidong An ; João Tovar Jalles ; Prakash Loungani *How Well Do Economists Forecast Recessions?* https://www.imf.org/en/Publications/WP/Issues/2018/03/05/How-Well-Do-Economists-Forecast-Recessions-45672

[2]https://chinachange.org/2018/12/28/a-great-shift-unseen-over-the-last-forty-years/

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2019 Smart Investing Webinar Schedule

April 16, 2019 at 11:30AM Central
Smart Investing Webinar
First Quarter Market Review

July 16, 2019 at 11:30AM Central
Smart Investing Webinar
Second Quarter Market Review

October 15, 2019 at 11:30AM Central
Smart Investing Webinar
Third Quarter Market Review