Are You Prepared? (Part II)

In our last newsletter, you may remember that we talked about how hurricanes are like market corrections – no one knows when they are coming, but it is better to be prepared for the worst when a storm is looming on the horizon.

While not quite a hurricane, the fourth quarter did give us some scary moments and sent us wanting to run for shelter. Little did we know that we would experience such a whirling-dervish in the equity markets across the globe. From its high last September to the third week of December, the S&P 500 index dropped more than 19%. Over the same period, international stocks dropped 14% and emerging markets lost 8%.

The decline was more than just a storm warning. Stocks careened into bear market territory and jolted us out of our peaceful, low volatility, ever-increasing equity dream world, resulting in the worst year-end result for U.S. markets in 9 years. And even though the U.S. economy appears to be thriving, this abrupt pullback may be a harbinger that recession risks are beginning to brew off shore.

We believe there is good reason to prepare for weathering a stormy 2019. After the double-digit returns and low volatility of 2017 gave way to the storm winds of 2018 – seesawing stock valuations, escalating interest rates, gluttonous debt markets, strangling trade tariffs, and intractable political strife – the overarching concern of current markets is that corporate earnings will decline, and global growth will slow dramatically.

Let's examine some of the key warning signals that make us believe that the volatility of the 4th quarter could be an indication of worse storms ahead:

- **Rising Interest Rates, Increased Debt, and Extremely Low Unemployment**

  Though the Federal Open Market Committee was clear in its intention to raise interest rates throughout 2018, equity markets took a precipitous drop in late December when the Fed made its last hike of 0.25%. Since then the Fed appears to have taken a more dovish stance on rate increases. This may be an indication that the FOMC is recognizing some of the same storm clouds that we have identified.

  The effects of higher interest rates are exacerbated by the high level of debt in all areas of the economy. The cost for two major lifetime expenses – housing and education – has increased dramatically over the past nine years. These expenses have outpaced wage growth substantially which creates more risk to the consumer in the event of an economic downturn.

  While low unemployment is generally good for the economy, there is a tipping point at which it starts to have a negative impact. This occurs when wage pressures start to deteriorate profit margins. With non-financial corporate debt at all-time highs ($6.23 trillion), companies that

depend on low labor costs and low debt costs will be increasingly challenged to maintain their current growth rates.

- **Tariffs, Trade, Brexit and Government Shutdown**

  The imposition of tariffs on many of the U.S.'s biggest trading partners has created a murky and indecisive path for manufacturers across the world. The true impact of tariffs has yet to be ascertained; but the uncertainty regarding our trade policies has already spooked the U.S. and international markets. Unless some of the largest trade agreements – such as the one in the works with China – get satisfactorily negotiated, the markets may continue to derail because of the lack of clarity.

  The political standoff in Great Britain has been as frustrating as the one in our own country. Prime Minister Teresa May has been fighting to follow through with the results of the June 2016 voter referendum, calling for the Brits to leave the European Union this March 29. Mrs. May's own party, much less those on the opposite side, has not been able to come to consensus on a plan of any sort; just the type of farce that makes the markets nervous. Will the Brits exit from Brexit, will they strike a new deal with the E.U. that satisfies all sides, or will March 29 arrive with no deal in sight, allowing chaos to reign in Her Majesty's backyard?

  Speaking of chaos, at the time of publication of this newsletter, the U.S. Government has been shut down for more than 30 days – the longest federal work stoppage in history. According to the Trump Administration itself, the stalemate in Washington that led to the shutdown has reduced GDP growth by 0.1% for every week federal offices and agencies were closed. With estimates for 2019 GDP growth ranging from 1.9%[1] to 2.2%[2], a reduction of .4% or more could have a significant impact on our entire economy.

If a recession is on the horizon, what should we be doing *NOW* to prepare?

1) Reassess your appetite for risk.

This is a good time to consider how you feel about the risk level of your investment portfolio – especially if there are changes in your situation that might affect your comfort level. For example, if you are approaching retirement or anticipate needing to withdraw money from your savings, this could be a good time to dial down your exposure to equities. Considering that we have just come through one of the longest bull markets in history, you may want to protect some of that built-up gain, given that the opportunities for future growth seem to be diminishing.

2) Set aside cash for a stormy day.

If you have major expenditures planned for the next year or two, you should set aside some "safe money" so that you won't have to withdraw from your portfolio during a possible downturn. As interest rates have gone up, so have money market rates and you can now find cash funds that are paying over 2%.

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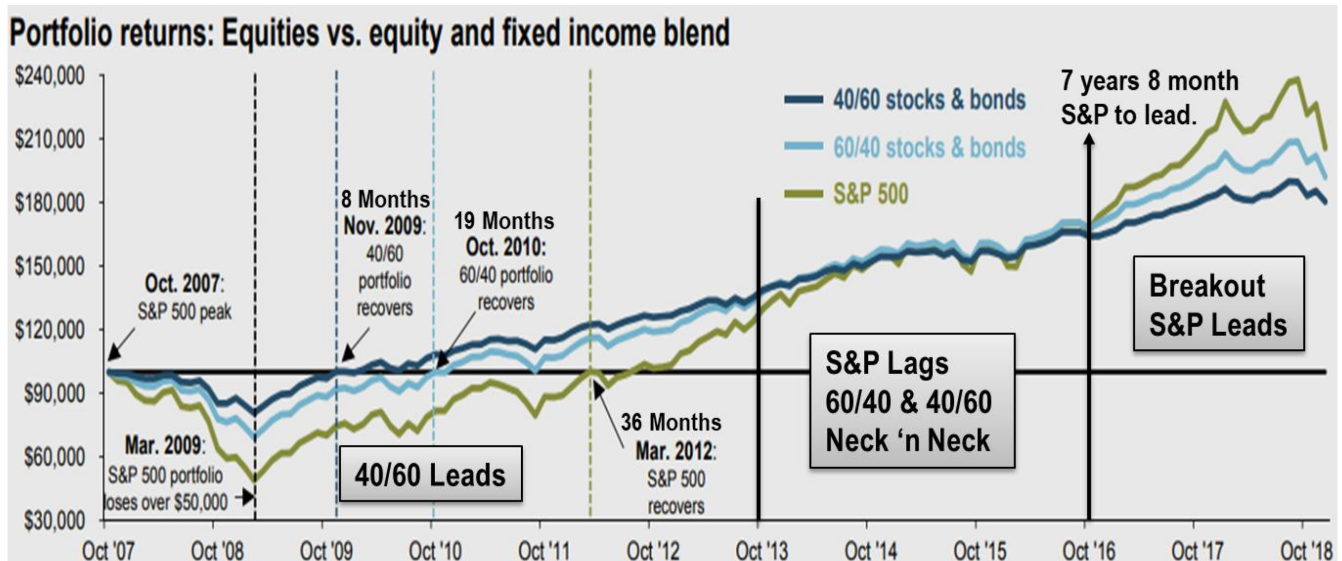
[1]https://www.jpmorgan.com/global/research/global-market-outlook-2019
[2] https://www.conference-board.org/data/usforecast.cfm

3) Remember that losing less means you don't have to earn as much to stay ahead.

Since we don't know when a recession may hit, but we believe that prospects for growth in the near term are poor, it could be worth missing out on some possible upside in order to protect your portfolio from taking a direct hit on the downside. We know from past downturns that there is a correlation between the aggressiveness of a portfolio and the amount of loss in a downward market. The most aggressive portfolios go down the most and the least aggressive go down the least. Also, aggressive portfolios take longer to recover than do more conservative portfolios.

Let's look at the most recent Financial Crisis cycle to see how that played out:



Source: J.P. Morgan Asset Management, Barclays, Bloomberg, FactSet, Standard & Poor's, Waypoint Advisors.
60/40: A balanced portfolio with 60% invested in S&P 500 Index and 40% invested in high-quality U.S. fixed income, represented by the Bloomberg Barclays U.S. Aggregate Index. The portfolio is rebalanced annually. Past performance is not indicative of future results.
Guide to the Markets – U.S. Data are as of December 31, 2018.

The graph above illustrates how an investment of **$100,000** would have fared with three different portfolios:

1. A portfolio consisting of **100% stocks** (S&P 500), as represented by the **OLIVE** colored line,
2. A portfolio of **60% stocks/40% bonds** (Bloomberg Barclay's Aggregate US Bond Index), as shown by the **LIGHT BLUE** line,
3. A portfolio **40% stocks/60% bonds**, indicated by the **DARK BLUE** line.

From the peak in October 2007, the **S&P 500** went down **55%** to the trough in March 2009. The **60/40** and **40/60** portfolios went down **34%** and **22%**, respectively. After the decline, the **40/60** portfolio grew more slowly, but recovered in **8 months** and out-performed the S&P 500 for **9 years** from 2007 - 2016. The **60/40** portfolio recovered in **19 months**. The **S&P 500** took **36 months** to recover and didn't overtake the two more conservative portfolios until October 2016, more than **7 years** from the bottom.

The **S&P 500** had to grow **120%** from the trough to get back to **$100,000**, while the **60/40** and **40/60** portfolios only had to grow **52%** and **28%**, respectively. Thus, from the beginning of

the financial crisis, the more conservative portfolio either lead or grew neck and neck with more aggressive portfolios for a total of **9** out of **11** years.

While some of you may find this phenomenon surprising, the previous chart demonstrates an important lesson about risk – ***if you lose less, you don't have to earn as much to catch up*.**

Reducing risk may result in more real wealth in the long term

Recessions, like hurricanes, come and go and leave in their wakes messes that can take a long time from which to recover. If the next downward market cycle is like the last, you need to ask yourself – given your current circumstances – how long are you prepared to wait for your portfolio to recover? If the answer is "not long," you may want to discuss with your investment advisor the possibility of dialing down the risk in your portfolio; for example, shifting from a 60 stock/40 bond portfolio to a 40 stock/60 bond allocation.

By reducing risk in your portfolio, you may give up some return in the short run in exchange for safety. Although, sacrificing return is not necessarily always the case. In fact, risk reduction may actually improve your portfolio's ability to build wealth over time. The reason for this is that a small reduction in downside loss can have a big impact on long-term returns. Of course, every person's situation is different, and we don't really know what financial disasters, if any, may lie ahead. However, even if the next downturn is not as severe as the last, and even if your timing is not perfect, you might still benefit from losing less.

We will further discuss the relationship of risk and return, negative correlation and how/when to return to your strategic asset allocation in our next market perspectives: **Are You Prepared? (Part III).**