Are You Prepared? (PART I)

By the time the American and National Leagues sort out who will go to the World Series and college football teams wrestle to get to the National Championship game, we will be almost done with a different kind of season that is often fraught with uncertainty and havoc - hurricane season!

In sports, no matter how well prepared you are, the unexpected can happen (think Old Dominion and Virginia Tech!). Hurricanes, too, are unpredictable, and it is wise to take precautions while the sun is shining. Recently, our community was fortunate to have missed the wrath of Hurricane Florence. But not before schools and businesses were closed and thousands of people were instructed to evacuate. The inconvenience of the preparation was a small tradeoff for the reassurance that family and friends were protected no matter which way the storm turned.

Investing is much like preparing for a storm.

Since we never know when the "big one" may hit, it is important develop a plan before there is any sign of turbulence. At the start of hurricane season, you may go to the grocery store for water and batteries or buy a generator. You know it is best to take these precautions early because, if you wait, the lines may be long, or it may be too late. You gauge how much you are willing to spend on preparation given that you don't know in advance how much protection you may really need.

The same is true for investing. It is good to be prepared ahead of time for periods of market turbulence since we never know when they will occur. Building "all weather portfolios" as we do at Waypoint, can help you withstand the normal fluctuations of the markets. As with hurricanes, a good plan can keep your family safe from financial harm and provide you with peace of mind when the markets turn volatile.

Economic measures look good – is this the calm before the storm?

While we try to be prepared for most market conditions, there are times when we may want to review our comfort level with risk and take extra precautions, just as we do when the hurricane trackers are predicting the path of a major storm.

Recently, our economy has been solid with Q2 GDP growth at 4.2%, good corporate earnings (S&P 500 Q3 growth estimated at 19.2%), low unemployment (3.7%) and low inflation (2.2% core inflation). The stock market continues to be strong and consumer sentiment is high (100.1 versus 86.0 average since 1978). Equity market volatility has declined since the beginning of the year and there is little sign of recession in the near-term.

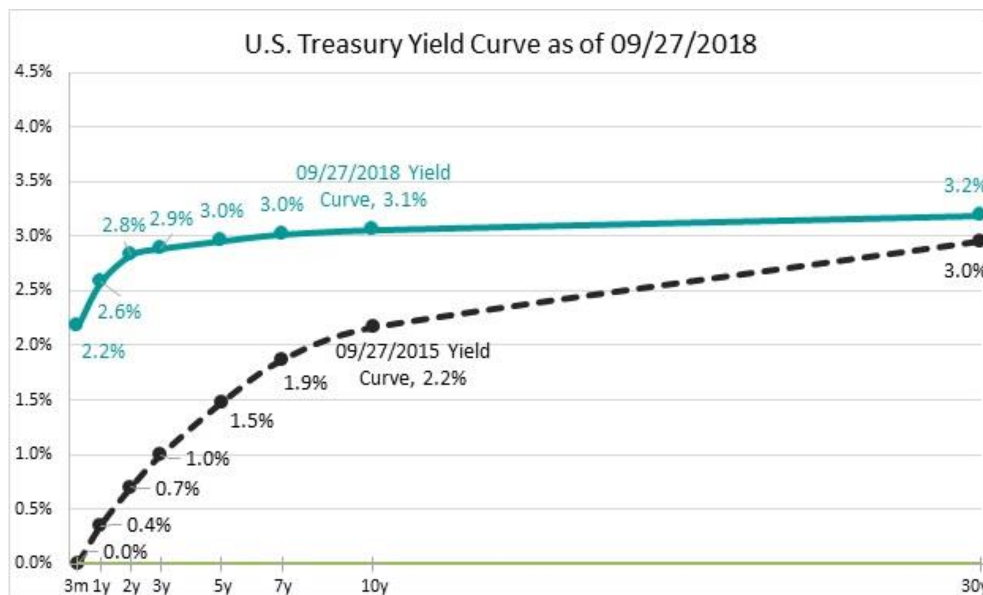
However, there are some current market factors that bear watching.

1) **The US equity market is high.** We are 115 months into a bull market expansion -- the second longest in history. While many prognosticators believe that a bear market is not imminent, they do admit that the likelihood of a downturn is growing

closer. In his paper titled "A Theory of Systemic Fragility," the late economist, Hyman Minsky described the cycle that drives the booms and busts. He wrote that "success breeds a disregard for the possibility of failure." The S&P 500 has experienced a bear market, defined as a decline of 20% from its last high, 32 times since its inception (or about 1 out of every 3.7 years) and bear markets have lasted on average about 367 days.

2) **Interest rates are rising.** The Federal reserve has been enthusiastic about the "bright" outlook for the economy. However, Chairman Powell admits that things may be "too good to be true"[1] and he intends to keep the brakes on inflation with one more possible rate increase before the end of 2018 and possibly three more in 2019.

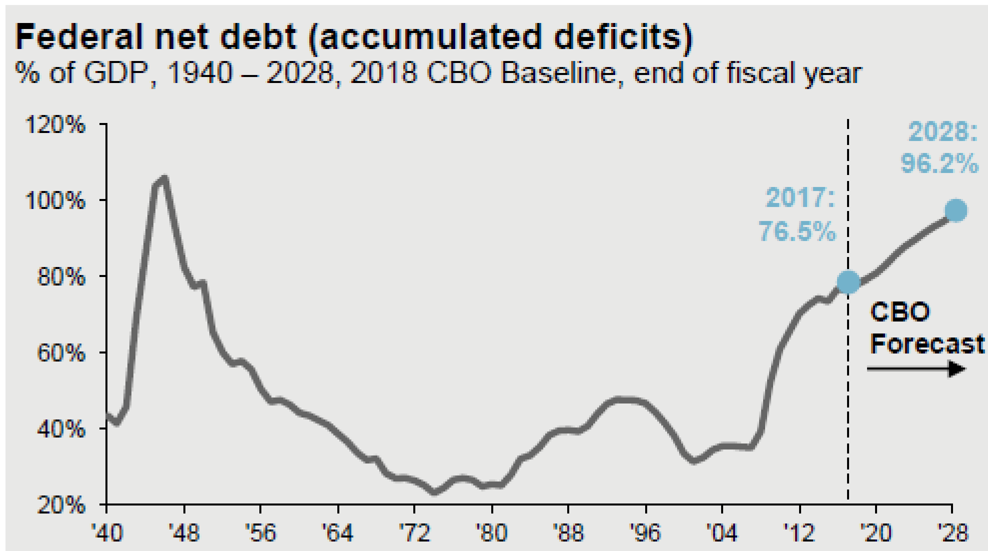
   The yield curve is flat (see chart below), and investors are not being rewarded for going long. Rising rates could result in lower profits for corporations, which would dampen stock prices. Rising rates can also mean higher prices and more costly debt for individuals.



3) **Credit is cheap**. Even though interest rates are beginning to go up, they remain at historic low levels. Corporations have been gorging on cheap credit and have been leveraging up their balance sheets. While manageable now, too much debt can cause big trouble in times of financial stress. In the last decade, the U.S. government took on extensive debt to plug the financial crisis and continues to compound the problem now by approving deficit spending. (See chart below).

   Individuals have been seduced by low rates, too. Credit card debt, mortgage loans, and margin loans on investment accounts are looming ever higher. The amount of credit extended to families for college loans is of particular concern since many Baby Boomers are using their retirement savings to pay back debt for their kids' education.

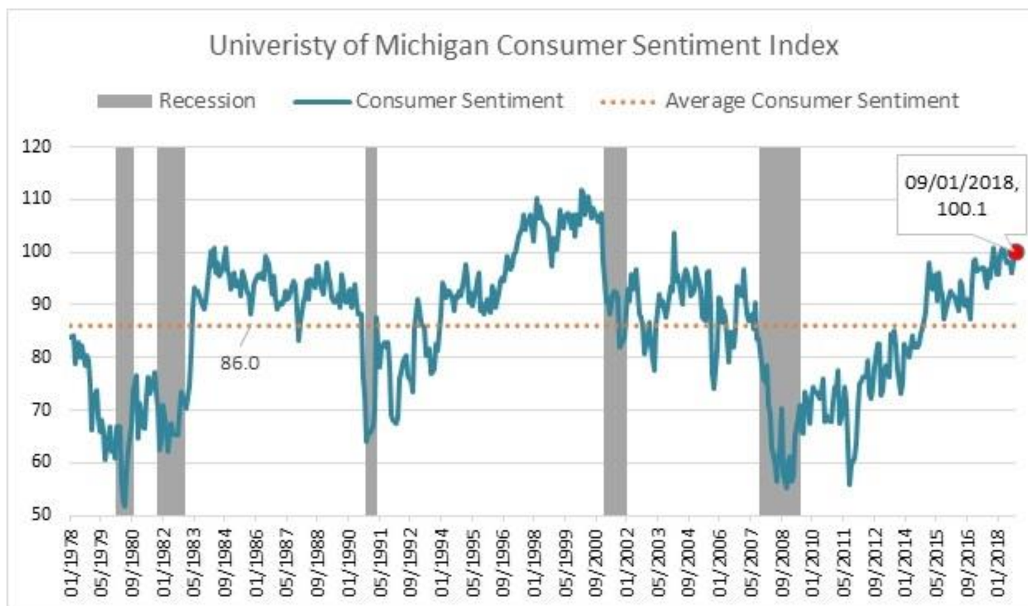
[1] https://www.cnbc.com/2018/10/02/feds-powell-sees-remarkably-positive-outlook-for-economy.html



JP Morgan Guide to the Markets, pg 23. As of 9/30/2018.

4) **Wage growth is ticking up**. While wages have not yet returned to prerecession levels, they are beginning to creep up which is good in some respects. However, higher wages will be a drag on corporate profits and could cause an increase in prices.

5) **Consumers may be too happy.** Investors have enjoyed a decade of market growth and are feeling more confident in their financial positions. People are buying expensive gadgets (do we really need the new $1000+ iPhone XS?), flipping houses (turn off the HGTV!), and taking exotic trips (Anthony Bourdain, we miss you!). Investors tend to take more risks toward the end of a market cycle which can be an indication that "irrational exuberance" is at play. Historically, high levels of consumer happiness have been a precursor to market corrections. (See chart below).



So, where are the storm clouds?

Global economies are likewise enjoying strong results. Still, there are also some areas of concern that could derail the international markets.

- **Political tensions** – Under the current administration, the United States has chosen a nationalistic path, moving away from globalism. Our country has indicated that we will no longer bolster other less wealthy countries at the same level they have enjoyed since post WWII and we are in the process of cancelling or renegotiating most of our major trade treaties. This same sentiment is playing out elsewhere; most notably in Great Britain where Brexit has been a hotbed of political discord and, to a lesser degree, in Italy, Poland and Hungary.

- **Business uncertainty –** The impact of tariffs imposed by the United States has yet to be measured in global terms. Some countries, particularly China, have responded by rolling out their own tariffs in retaliation. There is some uneasiness that this global gamesmanship could lead to serious trade wars. In fact, the World Trade Organization (WTO) recently lowered their global outlook for 2019[2] and International Monetary Fund has revised its global growth forecast down 0.2% to 3.7%.

- **Pressure on emerging economies** – Countries with emerging economies have benefited from a low interest rate environment and a congenial international marketplace. However, as global credit tightens and trade disagreements heat up, developing countries could be the hardest hit. Likewise, the rising dollar is impacting large but lesser developed economies such as China, Russia, Brazil, and India as cash flows away from them into the U.S.[3]

Is there a *Category 5* storm in our financial future?

Just as we can't predict when or with what severity a hurricane may hit, we don't really know if any of the concerns above will derail the economy and cause the markets to change course. However, it seems to us that the risks are more elevated now and that we may want to take extra precautions.

We will cover these precautions in our next newsletter, **Are You Prepared? (PART II)**. Stay tuned!

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[2] "**WTO downgrades outlook for global trade as risks accumulate,"** Escalating trade tensions and tighter credit market conditions in important markets will slow trade growth for the rest of this year and in 2019, WTO economists expect. https://www.wto.org/english/news_e/pres18_e/pr822_e.htm

[3] "**Why The Dollar Will Continue To Surge, Crush Emerging Markets Stocks,"** Simon Constable, Contributor, *Forbes*, July 27, 2018, https://www.forbes.com/sites/simonconstable/2018/07/27/why-the-dollar-will-continue-to-surge-crush-emerging-markets-stocks/#3237928a77af