Meridian Financial Advisors January 2020 Market Commentary

Following a rapid decline in the 4th quarter of 2018 of almost 20%, the S&P 500 closed 2019 with a total return of 31.49%. Once Jerome Powell, Federal Reserve Chairman, backed away from hiking interest rates and began decreasing rates the market took off. Consumer sentiment is high, unemployment is at a historic low, inflation is low, wage growth is ticking up, the market is expensive and yielding less than 2%, Treasuries are yielding less than 2%, the yield curve is now upward sloping and not inverted, everyone is super hopeful as the new year begins with current expectations of almost 10% earnings growth in 2020 for the S&P 500.

The FED

There were a total of 9 rate hikes, or 225 bps, between 2015 – 2018. Easier monetary policy, or lower interest rates, is very supportive of higher markets – both stocks AND bonds go up in price. On December 19, 2018 the Fed communicated they would stop raising interest rates. By January of 2019 the market began to react by rising 8% in the first month.

The first 25 bps Fed rate cut came on July 31, 2019 followed by another by 25 bps on Sept 18 2019 and finally another 25 bps cut on Oct 30 for a total of 75bps cut within 3 months. These low rates helped financial assets but did not help the overall economy. GDP growth came in at 2.2% for the 3rd quarter of 2019 which is the average rate of growth since 2000.

The markets gains have been due in part to perceived Fed Quantitative Easing (QE). Last fall the Fed began buying short term treasuries to add cash to the market to alleviate pressure on short term money market rates. Participants perceived this move as another round of QE or adding cash to the market and reducing interest rates to boost the economy. I do not believe the current Fed actions are quantitative easing but short-term technical interventions. If in fact they do end these interventions next June, the implications for the market will likely be negative, and we would certainly expect to see increased volatility in anticipation of this.

While we do not expect a recession this year, we are closely monitoring any signs of economic weakness. One such indicator that we watch carefully is the slope of the yield curve. The yield curve inverted May 24, 2019 and stayed inverted through Oct 10, 2019 – 5 months. On October 11 the difference between the 10 yr treasury and the 3-month T bill was positive at 0.08. The yield curve was no longer inverted. On December 31, 2019 the spread was 0.37.

If you look at a historical chart showing the difference between the 10 yr Treasury and the 3 Month T Bill you will notice that prior to every recession the yield curve went positive after being inverted for a period of time. (See attached chart) After going positive we then fell into recession. The last 3 recessions began after the yield curve was no longer inverted. After being inverted for 14 months in February 1990 the curve turned positive and we went into recession July 1990. The curve was inverted for 8 months from July 2000 to February 2001. In March 2001 the curve went positive and we went into recession in April 2001. In July 2006 the curve was inverted through July 2007. It turned positive in August 2007 and we went into recession December 2007. The average length of an inverted yield curve since 1969 is 14 months. The most recent inversion lasted only 6 months. Some people believe for that reason it is different this time, always a dangerous sentiment.

Valuation and Sentiment – Perception is more important than reality

After 2018's correction in the 4th quarter, the S&P 500 was trading at 16x 2019 earnings which relatively speaking is not expensive. Today we are north of 19x expected earnings for 2020, a historically high level. Throughout 2018, recession fears due to the inverted yield curve and a slowdown in manufacturing were rampant, but as we have witnessed in the past, there is often talk of recessions that never happen. Investors are worrying once again about how to position their portfolios given the tug of war between the fear of missing out on continued market upswing and the fear of a possible correction. On any given day, contradictory comments can be heard with some calling for the beginning of a new bull market while others worry that we are on the brink of another recession.

The Leading index for the US turns down in advance of a recession. It includes housing permits (1 to 4 units), initial unemployment insurance claims, delivery times from the Institute for Supply Management (ISM) manufacturing survey, and the interest rate spread between the 10-year Treasury bond and the 3-month Treasury bill. The last reading in Nov came in at 1.37; anything above 1 is not indicating recession.

The AAII 8 week bullish moving average was at 38% on Jan 2, 2020. The percentage of investors who are bullish has been trending higher from the low 20s in August 2019 to the low 40s in the last few weeks. Bearishness has dropped from the upper 40s in August 2019 to the low 20s today.

Sixty-four (64%) percent of stocks are trading above their 200-day moving average, a historically high level. By contrast, only 37% on August 27, 2019. This suggests investors are feeling confident. Maybe too confident. While the AAII numbers are not at extremes nor is the percent of stocks trading above their 200-day moving average, these sentiment indicators suggest to us that now is a time to err on the side of caution.

It is a dangerous business trying to time the market based on theories and guesses. As John Kenneth Galbraith once opined, "There are two kinds of forecasters: those who don't know and those who don't know they don't know." We don't control the market. What we can control is how we are positioned in terms of our asset allocation; how much should we have in stocks, bonds and cash. The less in stocks should result in less risk. More in bonds should result in less risk. More in cash leads to less risk of loss. More bonds and cash however also lead to more risk of loss of purchasing power. This means what $1 buys today will buy less in the future. Remember in 1980 a 1 lb loaf of bread cost $0.50. In 2010 that loaf cost $2.99. According to US Bureau of Labor Statistics prices for bread were 83.9% higher in 2019 than 1997. Stocks are the only way to keep up with inflation which is why we are hesitant to reduce equities too much even for the most conservative portfolios.

We have positioned your portfolio to withstand whatever is coming considering your time horizon, risk tolerance and specific goals and needs. If at any time you are uncomfortable or just want to talk about your financial position, please do not hesitate to call us.

FRED — 10-Year Treasury Constant Maturity Minus 3-Month Treasury Constant Maturity

Source: Federal Reserve Bank of St. Louis

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