A Cautionary Tale

Volume V

There are many risks when investing in financial markets. In addition to the obvious risk of the loss of capital there are other, perhaps less obvious risks. There are the risks of being too early, or too late, in establishing or liquidating positions. There is the opportunity cost of missing a major sector move, or perhaps a more speculative investment theme in favor of a more likely, potentially less volatile and less profitable investment. There is the risk of seeing potential returns diminished by excess trading and repositioning, allowing unnecessary taxes to diminish returns. It's always a balance between risks and return. This month we offer a cautionary tale about wants and needs, emotions and discipline, speculation and investment, and "The Boy Who Cried Wolf".

http://mythfolklore.net/aesopica/barlow/59.htm

And lest we forget; in the end the wolf did, in fact, eat the sheep, and in some versions of the tale the boy as well.

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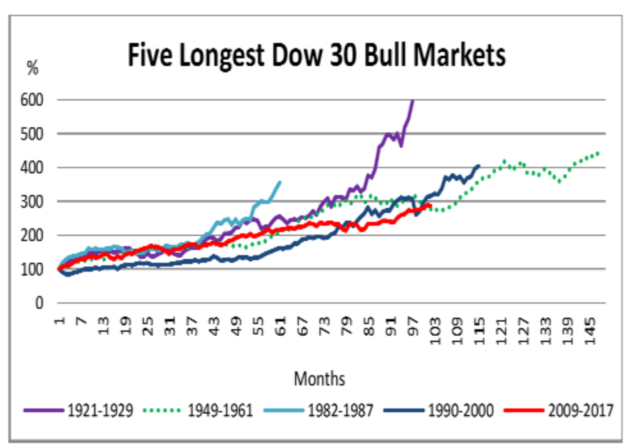
Late Cycle Blues

While we generally pay more attention to the broader S&P 500 when talking about the stock market, the much longer history of the Dow Jones Industrials is more useful when examining longer trends. An examination of the Dow Industrials chart along the bottom right, going back to 1900, reveals that today's bull is the third longest bull market in U.S history, even surpassing the Roaring 20's super-bull market, which was up near 600% before the Crash of 1929.

In fact, it's the third longest bull since the 1949 bull market that began after WWII and lasted over 12.5 years. It has now been over 4000 days (nearly 8.5 years) since the Dow has seen a 20% correction that traditionally defines a bear market. The Dow is up over 230% from the 2009 lows established in the midst of the *Great Recession*. This is well above the 130% average gains of bull markets since 1929, and at over 100 months, it's also well over the average bull market duration of only 46 months.

It's not unreasonable to believe that the current bull could continue to roam for another 12 months or so to become the second longest bull market on record. And certainly one might argue that there is nothing inherent in its current longevity that would prevent it from doubling its length or returns.

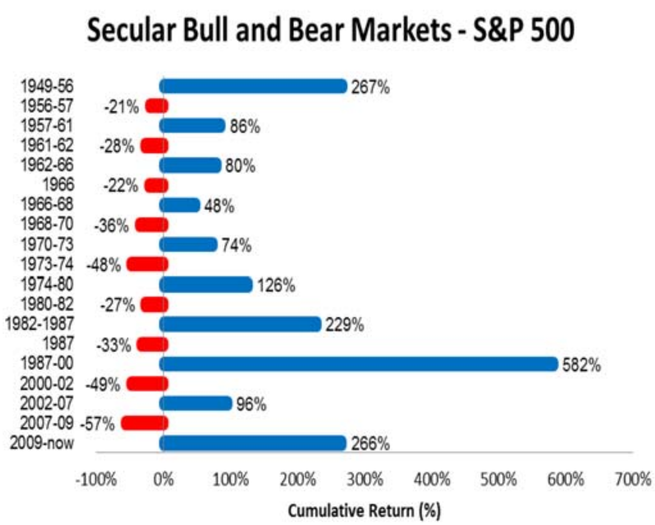
It has already outlasted the 1921-1929 bull that lead up to the Crash of 1929, and the subsequent super-bear market (-89%) over the next several years. However, it has yet to surpass the 1990-2000 bull market leading up to the bursting of the Tech Bubble in 2000, and its subsequent brutal bear market (-49%) over the following two years. Notably, those who bought at the tops of these two super-bulls had to wait over 6.5 years in the latter case, and over 25 years in the former case just to break even again. The reader might take a moment to reflect on the possibilities of positive <u>and</u> negative outcomes as we continue our tale.



Source: CFRA/S&P Global

Bulls and Bears

After reviewing the history of bull markets in the Dow it would behoove us to examine the potential downside as well; this time examining the broader S&P 500 index. The table below examines the history of market cycles since the early-1950s showing that bear markets occur with some degree of regularity within a full bull-to-bear market cycle, although their magnitude, frequency, and duration vary greatly. There have been nine bears in total, with an average loss of over -35%, with the last two bears averaging over a -50% loss!



Source: CFRA/S&P Global

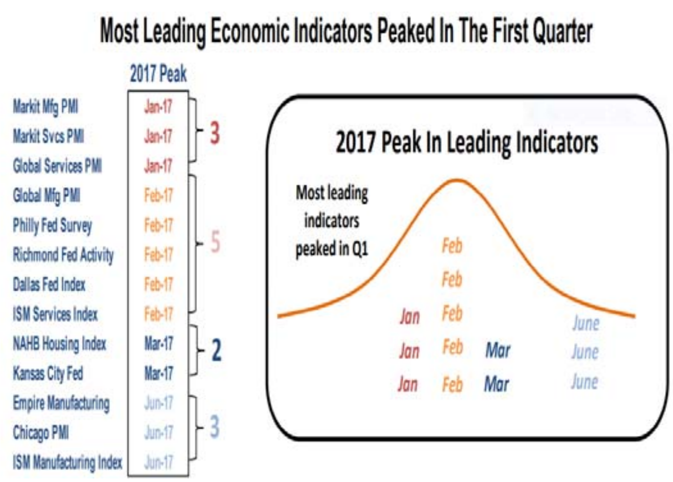
Many casual investors who had significant gains in the late-90's tech bubble also had horrific losses as the bubble burst in the 2000 bear market. While investors invariably prefer to focus on the upside, the diligent investment manager keeps a wary eye on the potential for downside risk at all points in the cycle. While longer term strategic goals drive wealth accumulation, shorter term tactical investment decisions often determine the degree of risk and potential loss an investor experiences. The ability to take risk off the table in a timely manner is a characteristic that often separates the investor from the speculator.

Cycles, Cycles, Cycles

We have noted for quite some time the ongoing disconnect between "hard" data metrics and "soft" data surveys. The former represent actual results of economic activity (car and housing sales, GDP data, housing starts, rail shipments, etc.) and have been softening all year. The latter include surveys of purchasing managers, small businesses, and consumer confidence levels, etc., and tally questions capturing whether participants subjectively perceive their economic environment is getting better, staying the same, or getting worse.

As an example of soft data, the Purchasing Managers Index (PMI) is a survey of selected purchasing managers, asking them to compare this month's trends with the prior month's trends in manufacturing. The general trend of the underlying factors that are reviewed, as well as the overall summary, are presented in the form of a diffusion index of opinions on future results, rather than actual data revealing recent conditions.

In a nutshell, "hard" data represents how conditions are and "soft" data represents what conditions are expected to be in the future. Until the recent unexpected upside revision in Q2 GDP was announced, many key economic metrics had been deteriorating for most of the year. It's interesting to note that while they are still forecasting continued economic growth, the PMI and Federal Survey data releases, as well as other Leading Economic Indicators (LEI) actually started to peak in Q1, and have continued to decline throughout the summer. So we are now entering a period of the economic cycle where selected leading economic indicators, both hard and soft, appear to have peaked. This is important because the Fed monitors the LEI to help determine its stance on existing and future monetary policies.



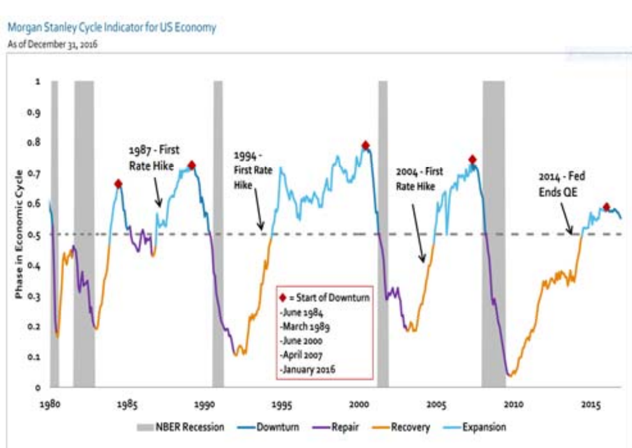
Source: Cornerstone Macro

The Fed may now find itself in a position where despite the recent release of unexpectedly strong (backward-looking) GDP results, the more forward-looking indicators may be showing signs of a slowdown developing. Many market observers have been expecting the Fed to continue its tightening of interest rates in the final months of the year. We have been less certain that this would occur, and have been correctly forecasting a stabilization of bond yields in the current trading range for most of the year, with a possibility that rates could actually fall further as the global economy continues to cool.

Discounting is the Key

One of the most interesting characteristics of the financial markets, and one that is most often misunderstood by the investing public is the “discounting” nature of the markets. Markets are made up of individual investors, some of whom are very good at noting changes in both economic and earnings trends, and acting accordingly. Daily asset pricing is determined by the collective decisions of buyers, sellers and those who choose to take no action, with the price moving up or down based upon the cumulative amount of the assets bought or sold. Because much of the actual economic data is collected with weeks, or even months lag time, often by the time the data reflects a slowdown we are usually well into a recession. As a result, market indices will typically begin to top well before a recession begins and bottom well before it ends. We have found over time that more experienced investors anticipate such changes in trend rather than waiting for them to occur.

The graphic below displays several prior economic cycles, and their various stages, and highlights a proprietary economic cycle indicator used by Morgan Stanley Research. It measures “the deviation from historical norms for macro factors including employment, credit conditions, corporate behavior and the yield curve.” The graphic reveals that leading economic indicators similar to the ones discussed above often provide plenty of lead time to prospective changes in overall economic activity. Such indicators also allow investors to anticipate pending changes in factors that drive sales, earnings and presumably stock valuations and prices. By analyzing and reviewing leading indicators investors can have a better idea of where they are in both the economic and market cycle. It appears we have been heading into the later part of the cycle.



Sources: Bloomberg, Haver Analytics, NBER, Morgan Stanley

What’s the Risk?

As bulls age, investors typically forget the pain, and possibly terror, they felt during the last bear market and get caught up in the excitement of new highs. They clamor to take on more risk, often moving well beyond their natural risk tolerance levels. Many clients (and professional investors as well) are typically afraid to miss out on capturing every bit of upside that might be available as markets approach the top. Investor enthusiasm has remained high which often clouds the reality of the increasing risks as markets mature, earnings trends weaken, and valuations get stretched. Many investors want to be smart enough to “catch the top”, at times all but ignoring the increasing risk of being wrong. But what happens when they do in fact miss the top? What’s the risk? How bad could it really be?

S&P 500 Price Returns - 1929-2016
An Examination of Losses

	Loss Threshold	Number of Years	Average Loss
Single Year	>10%	19	-20%
Single Year	>20%	6	-34%
Single Year	>30%	3	-31%
Multi-Year	>30%	4	-47%

Sources: S&P. Federal Reserve Bank of St. Louis

We covered the sometimes dramatic losses following bull markets on page 2, and we note that, by definition a minimum loss of 20% is involved in any bear market. But what are the odds of something worse, or even far worse, occurring when markets turn down? The table above takes a look at the distribution of losses in the S&P 500 greater than 10% in market downturns since 1929. We note that single-year losses greater than -10% have occurred 19 times, with an average loss during the decline of -20%. Of those 19 years, 6 went on to be greater than -20%, with an average loss of -34%. There were 3 years where the losses exceeded -30% in a single year, averaging a -31% loss. And finally, recognizing that some bear markets are multi-year phenomenon, there were 4 bears where losses exceeded –30% and their average losses were 47%.

The risk of missing the top and foregoing additional gains is painful to some investors. However, as we approach a potential top in a bull market that is long in the tooth, prudence would suggest perhaps a bit more caution. Remember, there is seldom advanced notice of how bad the bear will be.

Wants vs Needs

So what are the indicators telling us? We have cautioned for quite some time that we feel we are late in the economic and market cycles, but have also felt we were not yet approaching a recession, and a likely corresponding bear market. There are an increasing number of indicators that are beginning to validate that we are indeed past the peak, yet we have been nearly fully invested for most of the year and have continued to assert that caution was warranted in our opinion. And yet, the markets have ignored our caution and continued moving higher all year with not so much as a 5% correction; an aging bull yes, but not yet a bear. As the cycle extends we are mindful of the factors that clients deem important. Earlier this year we began to shift their prominence in our decision making, with a higher emphasis on risk control and diversification.

The challenge for a judicious investment manager as a bull market rolls on and on is to avoid being perceived as "crying wolf" by repeatedly warning of an imminent downturn that doesn't appear. At the same time, we have a responsibility to safeguard our clients' wealth from significant, perhaps irrecoverable, losses. We suggest the odds are much higher for a significant downturn over the next 12 months than of a meaningful rally. Our stance remains largely fully invested, but we are very watchful for changes that signal an increasing danger. There may in fact be a wolf lurking in the shadows. We remain on guard.

What do clients normally want ?

- **Appreciation/Growth**
- **Income/Yield (steady income**)
- **Diversification**
- Be Opportunistic
- Tax aware
- Dynamic Allocation
- Risk Control

What do clients need right now ?

- **Risk Control**
- **Dynamic Allocation**
- **Diversification**
- Be Opportunistic
- Income/Yield (steady income)
- Appreciation/Growth
- Tax aware

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Now What?

We have remained mildly cautious on the broader equity markets even as they have regained recent highs. Our perception of market risks remain elevated and we maintain our underweight positions in small caps, international and emerging market equities. We maintain our positions in high quality, medium duration bonds, but would begin to lower weightings to longer duration high yield bonds and interest rate sensitive securities as the economy appears to be slowing and risks build.

U.S. markets have continued to provide a better risk/return profile than many overseas markets. While valuations in Developed International and Emerging Markets are somewhat attractive we remain concerned about a potential global slowdown gathering steam.

If you would like more information please contact us at 954 809-6363.

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