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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

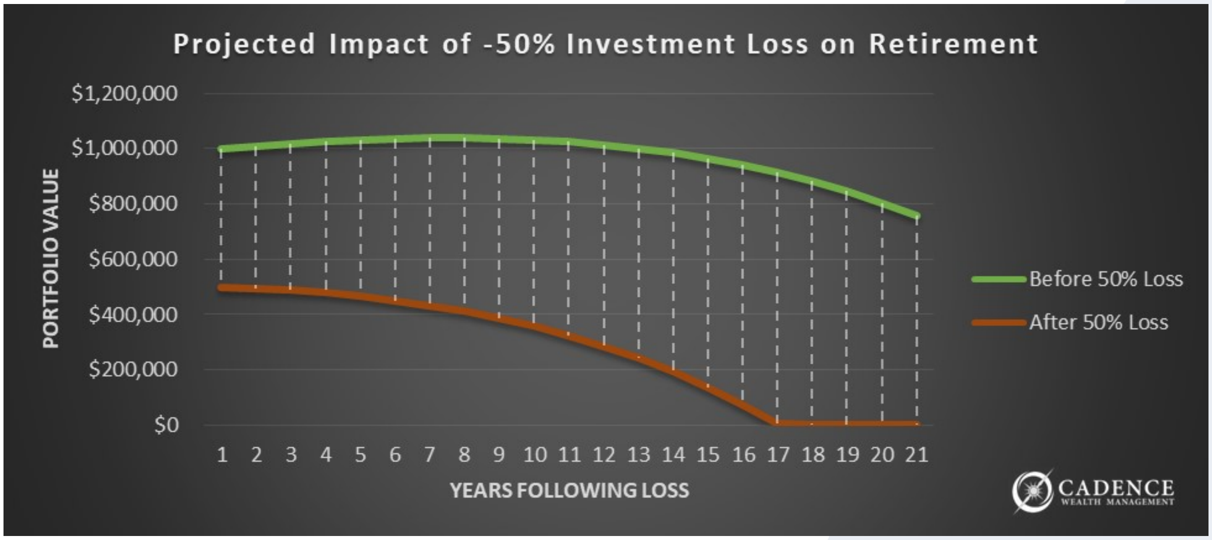
There Will Be A Downside To This Investment Cycle

Since the US stock market bottomed after the Financial Crisis in March of 2009, large cap US stocks have returned around 15% per year. The vast majority of other investment categories have not enjoyed nearly the returns of the US stock market, however as that is the investing area that receives the most media attention, its behavior over the past ten years has shaped a lot of our expectations for what will happen going forward. Our brains have a tendency to assume the conditions to which we have grown accustomed will keep going, a tendency which has been labeled "recency bias", but the upward part of this investment cycle cannot continue forever.

If the only investors who were assuming the stock market was going to continue paying larger than average gains and not experience a large loss were those with high appetites for risk and enough time to recover from a large downturn, the harm from another crash would be minimized. However, recency bias plagues conservative investors too, and many of them, including those in retirement or close to it, have also been driven far enough by the fear of missing out on large gains to once again expose their investments to a higher amount of investment risk than they can probably afford, just like during the Tech Bubble and the years before the Financial Crisis. Available data backs this up by exposing, for example, how most 401(k) investors, including those nearing retirement, have 70% or more of their investments in stocks as opposed to something more conservative. Fortunately for risky investors, they have been rewarded for taking large risks since the last historic market crash. Unfortunately for those same investors, and for many who do not want to take large risks but have been lulled into complacency by the longest bull run in history, the downside of the current cycle gets closer every day.

And make no mistake, there is a downside to this cycle. Without central bank intervention here and in other countries, it probably would have arrived already. When creating long-term plans and strategizing on how to fund them, investors make assumptions around what their long-term returns will be. Selecting an assumed average return for planning purposes is deceptive, because what we know is that it's not making 5% versus 7% over time that will determine someone's ability to afford their goals, specifically retirement, but it's the pattern of returns over time that matter. A smooth 5% return is far different than a volatile 5% return for one main reason: large losses matter. Avoiding them is the key to longer-term success, far more than the average return over time. We talk about minimizing losses frequently, but let's look at how sustaining large losses impacts a retired couple's spending.

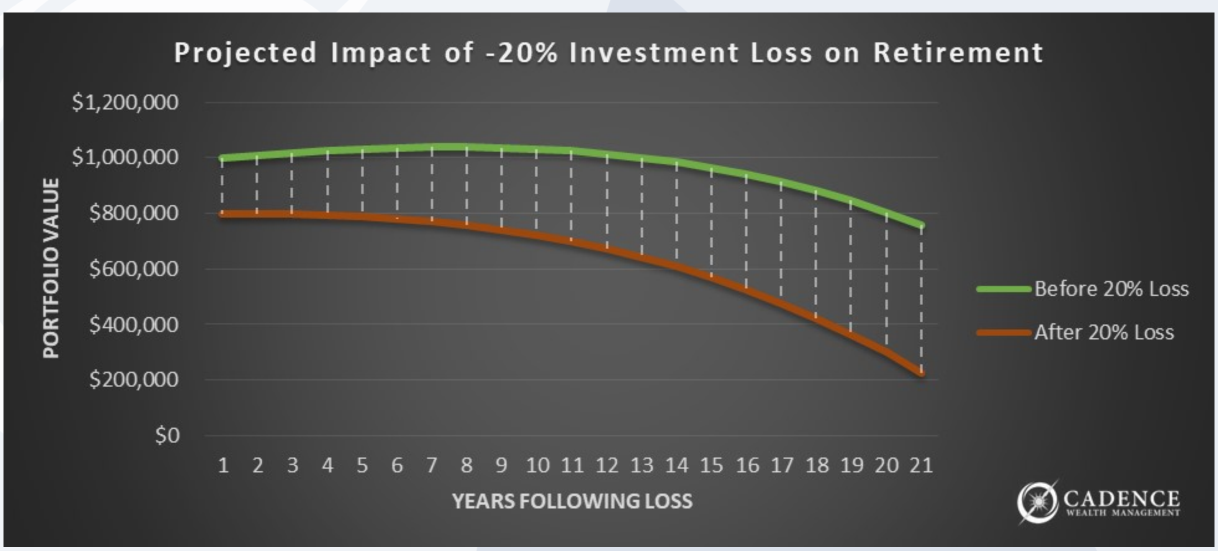
A retired couple with $1,000,000 in investment assets and $40,000 in social security income needs to take $40,000 out of their portfolio to afford their $80,000 per year lifestyle. However, were that portfolio to lose -50%, continuing to take that $40,000 out of their investments every year would jeopardize their ability to pay for their lifestyle throughout retirement:



After such a large loss, it would make sense for this couple to reduce their expenses in order to not take too much out of their investments and threaten their long-term financial stability. An example for this couple would be to also reduce the amount they are taking from their investments by -50%, so taking out $20,000 instead of $40,000 every year.

Were this scenario to happen to you, what would you cut from your expenses? Would it be fun things, like trips, hobbies, or nights out at restaurants? Cutting out entertainment is difficult enough, but how about having to go without everyday things, like going cheaper with your diet, or cutting out one car, or even potentially selling your house to unlock the equity because you just can't cut enough out of your budget to handle how much you need to take out of your investments? Retirees tend to spend to the level of their means, so even were someone to have more or less to work with than this example's amount, large losses will dramatically impact their plans.

Now consider another retired couple experiencing only a -20% value loss in their portfolio:



Without cutting anything out of their budget, this couple is already in much better shape than the other that lost -50% and has many more years left in their portfolio. However, they could also cut back a bit to compensate for losing -20%, and cutting their expenses by a similar -20% requires them to only cut $8,000 out of their annual budget. How much easier would it be for you to reduce your annual spending by $8,000 as opposed to $20,000? Were neither of these two couples to adjust their withdrawal amount, it's obvious which couple runs the greater risk of taking too much from their investments to be able to recover from their investment loss.

This is why we have been preaching caution for the past few years. Clients and regular readers of our newsletter know we pay attention to the data that says many investment categories are over-valued and are very susceptible to meaningful and sustained downward pressure. We not only analyzed recent data, but we are also mindful of historical periods where unlike the last two stock market crashes, stock values plummeted but did not bounce back quickly. Though some time periods have had multiple large losses like the 2000's did, even just one large loss can be "too many large losses".

Avoiding large losses, especially into and during retirement, is imperative for most people's long-term plans. Even though there were some years of true discomfort, fear, and sleepless nights within recent memory, recency bias has pushed many conservative investors to buy into the idea the current bull market will continue for longer than it will. There is a downside to this cycle; it really will arrive some day. Avoiding large losses in the face of that downward cycle is the best way to achieve your goals over the long haul.

What's Changed Over the Last Month?

Simply put, stocks have continued to rise in February while growth data has continued to weaken – fairly decisively. If all one cares about is investing in what's currently going up, then this rally in stocks seems like a no-brainer. The only problem is that the preponderance of evidence suggests that this rally is the textbook bear market variety, which means it will likely change course just as quickly as it began. If one's looking to generate fast losses, there's really no better way. Our position on portfolio composition for the time being hasn't changed. We will change it when the evidence suggests it's a safer time to do so, but at this point, losing -50% percent in stocks has never looked easier.

Current Valuation

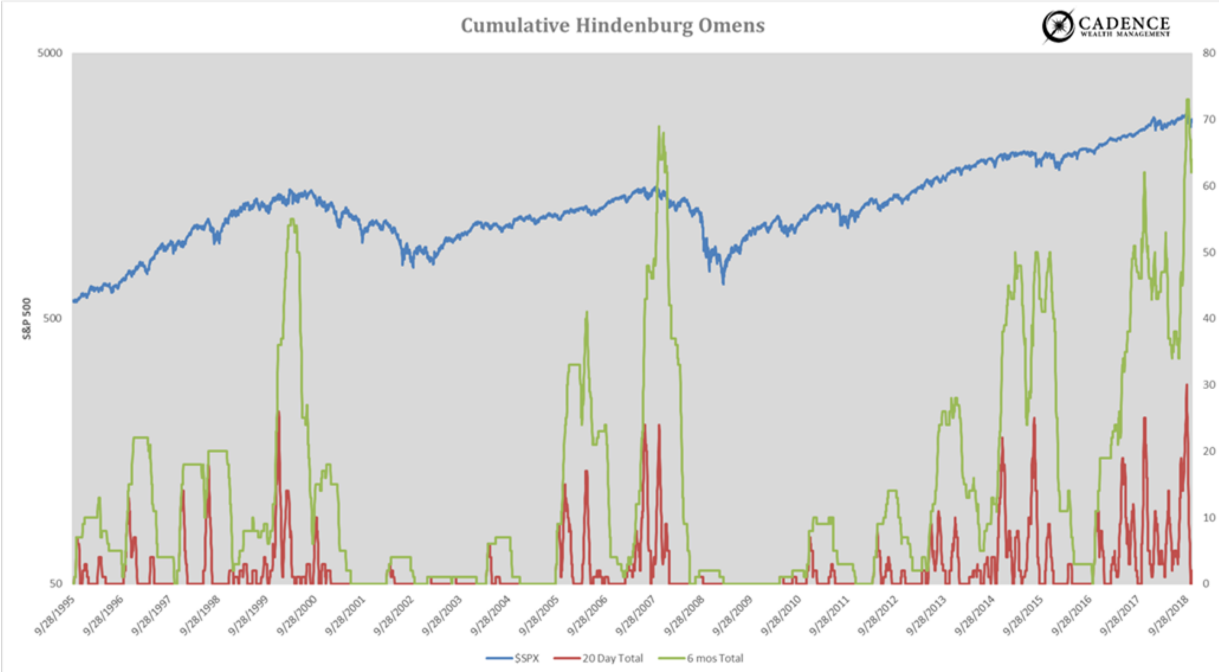
We're roughly 5% from the highs established last September, which is to say if we were at record high valuations then, we still pretty much are. On a margin-adjusted 10-year price to earnings basis as well as a median price to revenue basis, we're off the charts – higher than the 1920's mania and 1990's technology bubble. Those two episodes as well as the next two most expensive markets over the last 100 years all resulted in more than -50% declines in stock indices. We don't think it's smart to gamble our clients' financial futures on the fact that this current scenario will end any differently. As we've discussed ad nauseum in the past – it's basic math.

To put things into perspective, if you're worried that a conservative stance recently may have caused you to miss the boat, the chart on the next page should assuage that fear at least a little. Getting back to average valuations, as we've done in every major market cycle to date, results in the S&P 500 on the upper right-hand side of the chart moving all the way down to the lower horizontal line right around the 1000 level. This reflects roughly a two-thirds loss in the index and does not take into consideration an overshoot, which if you believe in the definition of "average" has to happen from time to time.

We can assure you that you won't hear any Wall Street executives or financial media talking about price targets on the S&P 500 anywhere near the 1000 level. In fact, it's rare that you'll even get a 12-month price target for markets that's negative at all. Simply put, Wall Street would rather operate in a world where the business and market cycle were one-directional. The downward part of the cycle is bad for investment assets and therefore bad for fees and business. Talking about it merely accelerates its arrival. However, cycles exist in markets just as they do in nature. Denying this fact doesn't do anything to help investors preserve their capital over the long term. This tendency not to hear realistic assessments of the downward part of the market cycle until we're already in one reminds us of a quote that we read once – spoken by somebody whom we'd certainly credit if we only remembered the source. "You can't get a person to understand something when his income depends upon his not understanding it".

Historically Weak Internals

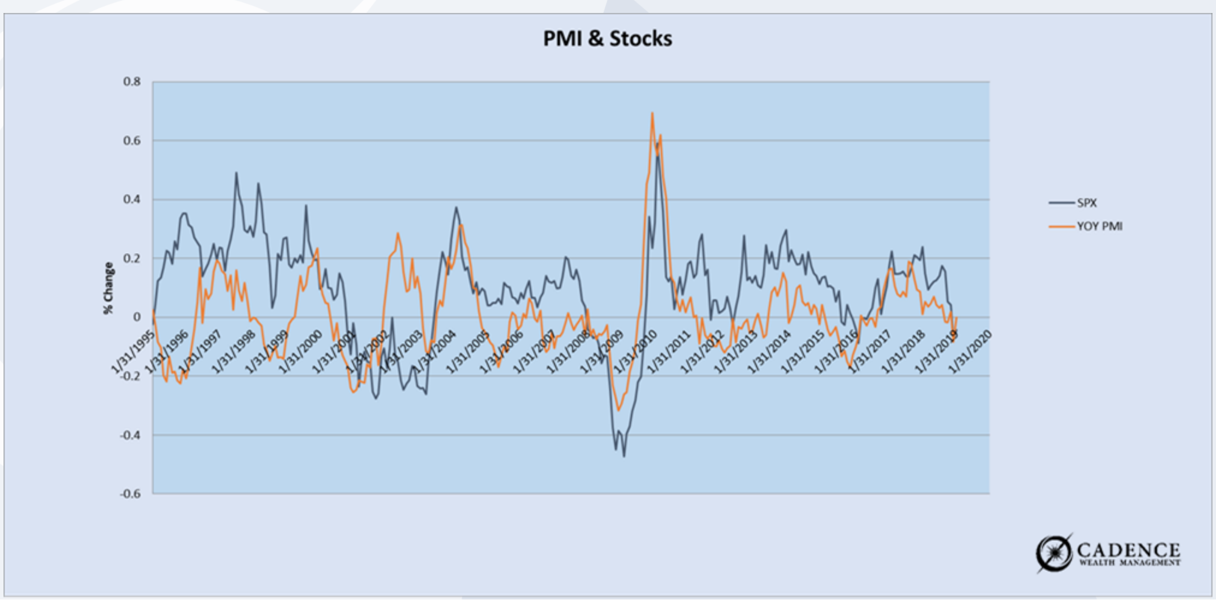
A few months ago, we discussed how even though the market indexes were reaching all-time highs, the average stock within the market wasn't sharing in the success. We capture this phenomenon by looking at days when at least 2% of stocks on the exchange are making new lows while at least the same amount are making new highs. The accumulation of these days within a 2-month and 6-month period is what's shown in the chart on the next page. Historically, when we see a high degree of divergence between stocks in the market, cycle turning points have tended to follow. The most recent bout of divergence (which has been rather chronic in nature the last few years) reached epic levels coming into the fourth quarter of last year. You'll see this in the chart by the green and red lines spiking up on the right side. The green line reflects total "Hindenburg" occurrences over 6 months while the red line represents those over 2 months. Notice what happened the last time these lines were in similar territory. It's not surprising that this most recent spike was soon followed by the worst December stock market performance in almost 100 years. It also wouldn't be surprising, as we can see from the experiences on the next page, if that were only the beginning of a longer cyclical downturn in markets.



The Economic Cycle

Every month the Institute for Supply Management (ISM) puts out a report that measures manufacturing activity within the economy (PMI). It's a good proxy for what gross domestic product ultimately ends up being, which is the measure of economic activity most referenced. What we can see very clearly in looking at the year over year change in PMI is that it is very cyclical. There's almost a rhythmic ebb and flow to the data, that not coincidently, the year over year performance of the stock market tends to rhyme with. In short, the success of companies within the economy is very closely tied to what's happening with the economy. We could argue that they are one and the same and so long as stock prices reflect that success or lack thereof, the charts should overlap – which they do most of the time. You'll see in the chart below the yellow (PMI) and black (S&P 500) lines which both reflect the year over year changes in each, moving in relative synchrony. Knowing that PMI is cyclical rather than linear can help us tremendously with risk management within our investment portfolio.

Another thing you'll see from the chart below is that the trend in PMI has started a decisive move lower beginning in the fourth quarter of last year. This is reflected by the orange line on the right side of the chart. How far it will go is the million-dollar question that nobody knows for certain the answer to, but that's not to say there aren't clues. In search of these clues we look for supporting evidence amongst other leading economic indicators/patterns.



Assessing Broader Economic Trends

To get a glimpse into what may be happening within the broader economy, we have to look at a broader swath of macroeconomic data to see if we can spot uniformity or patterns. Most data that comes out tends to be lagging, meaning it states the obvious by the time we see it, but some can give us more of a read on what may be developing right now in real time. Below is a mix of indicators that we track that can clue us in as to where the economy (and thus business environment for public companies and by extension their shares) may be headed.

Macro Dashboard

Economic Indicators	As of	Next Release Year Ago	Year Ago	1/31/2019	12/31/2018	11/30/2018	10/31/2018	9/30/2018	8/31/2018	7/31/2018	6/30/2018
New Orders	11/30/2018	8.0%	8.6%	4.1%	6.8%	7.5%	10.3%	9.2%	6.1%	9.2%	7.9%
Industrial Production	1/31/2019	3.7%	2.8%	3.8%	4.1%	4.5%	4.4%	5.7%	5.5%	4.1%	3.5%
Retail Sales	12/31/2018	10.0%	14.7%	7.9%	10.7%	10.3%	9.7%	10.3%	10.3%	9.7%	10.7%
PMI	1/31/2019	5.4%	1.1%	0.0%	-8.4%	1.9%	-1.7%	-1.6%	4.3%	3.2%	4.2%
CPI	1/31/2019	2.2%	2.1%	1.6%	1.9%	2.2%	2.5%	2.3%	2.7%	2.9%	2.9%
PPI	1/31/2019	2.9%	2.6%	2.0%	2.5%	2.6%	2.9%	2.8%	3.0%	3.4%	3.4%
Business Sales	11/30/2018	6.6%	8.1%	4.2%	5.9%	6.5%	7.8%	8.2%	8.2%	8.4%	6.9%
Avg Weekly Hours - DG	1/31/2019	0.5%	0.0%	-0.5%	0.0%	0.0%	0.0%	0.2%	0.7%	0.5%	0.5%
Housing Starts	12/31/2018	19.7%	4.8%	-15.8%	5.5%	-8.9%	16.3%	10.2%	-3.3%	-0.5%	17.3%
CCC/BBB Spread	2/27/2019	16.6%	20.8%	44.0%	23.1%	4.6%	8.6%	7.6%	12.2%	3.7%	2.1%
Rates	2/26/2019	0.0%	76.6%	119.7%	129.9%	0.0%	108.8%	116.1%	0.0%	106.6%	115.3%

What you'll notice in the column labeled 1/31/2019 is that it's almost completely red. What this means is that all of these economic data points were weaker on their last release than the prior period. The trend over the last few months has been weaker, not stronger. In addition, the two columns to the left of that one shows the rate of growth achieved by each of the metrics one year ago this month as well as for the upcoming data release. In general, the greater the growth rate achieved for the same measuring period a year ago, the harder it's going to be to achieve growth on top of that result. This in essence is how cycles work. Things grow really well for a period of time until they can't grow at the same rate. Then growth slows and starts to go in reverse, like a ball being thrown into the air. Gravity brings it back down until it eventually lands in the hand that will toss it back up again. In short, the business cycle appears to be moving south with some pretty hefty "year-ago" period data coming up in the next few months. This makes a re-acceleration of growth on top of already strong growth a pretty tall order. We're also seeing this same trend in corporate earnings for the 4th quarter of 2018. It's moving the wrong way, which does not support the rapid rise in stock prices over the last 2 months. Quite the opposite in fact.

Putting It All Together

We've recently received some feedback that we should re-introduce the bullet points at the end of our technical pieces to make for quicker reading and a more effective synopsis. We're not sure why we got away from it other than maybe to minimize the tendency to repeat ourselves when making points we feel strongly about. Whatever the reason, it was unintentional and this piece could probably benefit from a few choice bullets to shake you from your chart-induced slumber.

- ➔ Principal preservation remains the focus given where we are in the market and economic cycles. The potential for large stock market losses remains too high at this point to invest in stocks to any significant degree.
- ➔ The strongest of rallies occur within bear markets (longer-term downtrends). Don't be too quick to assume the worst is over. When the data points change, we could feel better about investing in stocks again. It hasn't yet. All evidence suggests we're in the midst of a slowdown.

- Both market signals via stock price divergence and recent economic data point to a high likelihood that we're in the midst of a cyclical downturn. How far it will go we don't know, but the potential for this to be the beginning of a much larger and longer slowdown or outright contraction has really never been greater.

- The only thing that's really changed in the last month has been rising stock prices. On the economic front, things have deteriorated. In addition, the more defensive asset classes of treasury bonds, gold and silver have held up well in the face of the blistering rally in stocks. To us, this speaks volumes. At this point, we remain more concerned with maintaining principal and achieving returns that are more likely to stay in our portfolios over the coming months and years rather than taking a flyer on rapid gains that evaporate even quicker.

CADENCE WEALTH MANAGEMENT