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MARCH 2019 INVESTMENT COMMENTARY

LET'S REVIEW ... MARKETS, ECONOMY, AND OUTLOOK

Over the last twelve months, I have repeatedly discussed in this commentary my concerns about unrealistic rosy economic forecasts and the resulting bullish equity market forecasts. Last May I wrote:

I believe that now is the time to begin to prepare for the end of this current market and economic cycle. There is no way to know WHEN these cycles end; however, we do know that these cycles WILL end at some point. We do know that recessions have historically been caused by Federal Reserve tightening, excess leverage, and financial or geopolitical shocks.

No one has a crystal ball to see into the future, but by knowing what experts to listen to and what data points to key in on, one can increase the probability that forecasting can be more precise. The Second Quarter of 2018 was the strongest quarter of the year for economic growth with a 4.2% growth in GDP. This growth rate was heralded by many and used as justification for making forward growth projections much higher than had been the trend of the previous eight years. I have been very skeptical of this argument and highlighted my rationale why the current economy is still within the bounds of long-established economic growth trends in the September 2018 commentary which can be found in the Commentary Archive section of the Seven Summits Capital website. I wrote in this June commentary the following:

Of course, the debate now turns to whether or not May is the beginning of a new uptrend for the broad markets or simply an up month within the sideways trend that has been in place since March. As I indicated above, I see a reason to be cautious, and I have begun to prepare for less hospitable markets in the near to intermediate future.

I remain skeptical that both global and U.S. economic growth will accelerate much from the current 2.50% to 3.0% range.

The U.S. equity market continued to rise steadily during the summer months of 2018 and through the end of September. For the September commentary I wrote the following about my concerns regarding the economy and market levels:

Some leading indicators could be seen as signs that our long economic recovery may be about to wane. These indicators include new housing starts, existing home sales, and new car sales. Recent weakness in these areas, which historically have been viewed as leading indicators, gets lost in the prevailing sentiment that the U.S. economy has shifted into a higher gear and is structurally healthier than it has ever been. The exuberant sentiment is a function of overt exaggeration, for political purposes, of data points and persistent puffery that accompanies cherry-picked strong economic trends.

As we now know, the current U.S. stock market cycle peak occurred on October 3rd, 2018. The October 2018 commentary included the following passage:

We do not hope for a big correction or bear market, neither do we fear such a period. However, we do attempt to calibrate portfolios for mounting risks during the late years of an economic cycle in order to manage risk. We do not know how to time corrections and bear markets. However, we do believe that we know when conditions warrant caution.

All major U.S. broad stock market indices slid into a three-month correction culminating in an 18% plus correction which bottomed out on December 24th, 2018. This correction garnered most of the headlines during this period of time, however underpinning this sell-off was very tangible signs that economic growth assumptions are coming from the likes of White House economic advisors calling for 3% plus GDP growth for as far as the eye can see increasingly on shaky ground. The Federal Reserve, beginning in December and continuing into 2019, has reacted to economic weakness overseas and weakening leading economic indicators in the United States by removing expectations of further interest rate hikes in 2019. This about-face by the Federal Reserve provided enough assurance for U.S. equity investors to enable a strong rebound in the broad equity indices during January and February.

The Federal Reserve abrupt shift away from tightening monetary policy may have prevented the late 2018 stock market correction from becoming a protracted Bear Market. However, the economic weakness and slowdown in corporate earnings growth appear to be "baked in the cake." On Friday, March 22nd the U.S. equity markets dropped by the most since early January on the closely watched shape of the U.S. Treasury security yield curve. One of the most accurate predictors of an impending recession in the U.S. economy in the next 12-18 months is an inversion (short rates exceeding long rates) of this yield curve, which occurred on March 22nd.

The most reliable economist who I follow when it comes to predicting economic growth and potential recessions is Paul Kasriel, previously Chief Economist of Northern Trust. Dr. Kasriel is now retired, but thankfully he continues to publish his analysis periodically. He released his latest analysis on March 25, 2019. His research piece was published by Haver Analytics and is titled The Flattening Yield Curve – Maybe it is Not Different This Time. This economic analysis performed by Dr. Kasriel relies upon an extensive study of the relationship between several different leading economic indicators and what is called Gross Domestic Purchases. Dr. Kasriel concludes with the following statement:

"The fed began raising the federal funds rate regularly at the end of 2016, and the spread between the yield on the Treasury 10-year security and the federal funds rate began trending narrower in 2018 – the narrowing in the yield spread being a conclusive indicator that monetary policy was becoming more restrictive. As a result, the pace of economic activity has started to slow."

Dr. Kasriel ends his published research piece by stating that:

"The Fed might have to lower the federal funds rate pronto if an outright recession is to be avoided in 2019."

There is a reason that I stated last year in my commentaries that I would be slowly and methodically reducing portfolio risk during one year ending May 2019. As we enter April, I am still very focused on lowering portfolio risk profiles through asset allocation, equity selection, hedge positions, and cash holdings.

As I suspected last year, we will have a much clearer picture of how close we are to the end of this economic cycle by mid-year 2019. I have never advocated significant strategy shifts in response to cyclical macro factors. Therefore, a growth equity portfolio will remain substantially exposed to equities. However, the types of equities owned will reflect my outlook over the coming 18 to 24 months. Balanced Growth and Income portfolios will likewise remain balanced. However, the weight of traded equities and the composition of the owned equities will reflect my outlook.

I apologize for the tardiness of the March 2019 commentary. Ever since skipping the December 2018 commentary in favor of a January 2019 "End of Year" publication I have been running two weeks behind in publishing the monthly commentary. I hope to get back on schedule in the coming months.

Happy Spring!

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