WealthShield

November 16th, 2018

WHAT IF WE ARE IN A BEAR MARKET?

The reason we have a rules-based framework for investing is that we would be lost without one. We would be driven in total by our emotional state, instead of our rules that we have tested in various market conditions and scenarios. Dr. Daniel Crosby, in his book, The Behavioral Investor, highlighted that under emotional conditions traders and investors became self-focused to the point where "they were no longer attentive to their rules." The ability to remove the emotion from the decision making is critical to success in investing.

Our framework is based on four key influences that help us ascertain where we are in the current market cycle. Valuations, or how high or low current market prices are relative to intrinsic value, is one of those influences that help us understand the sentiment of market participants. In markets that have high valuations, market participants are judged to be optimistic about the future. On the other hand, when valuations are low, market participants are pessimistic. When levels of valuations are at extremes, in the top or bottom quartiles, we are able to determine whether future returns are going to be above or below average.

Federal Reserve policy is the second component to our framework and is also extremely important when determining where we are in the business cycle. The reason being is that the Fed is usually easing policy aggressively at the start of the business cycle and tightening at the end. When the Fed is easing policy, this is constructive for economic growth and inflation. Conversely, when the Fed is tightening credit conditions, growth can often slow as a result. It is best not to fight the Fed.

Market trends are an extremely important component to our framework. When broad market indices are moving upward in price, we believe this is indicative of positive economic growth expectations. Global stock markets are the sum total of all the intelligence of all the participants and therefore, price can be an extremely useful variable when determining the future trajectory of growth.

Intermarket trends are also helpful in that it allows us to visualize relative strength between different asset classes. When we compare historically risky assets with those that are more defensive, this allows us to formulate opinions on how market participants are thinking. The old Wall Street saying is that the stock market has predicted 9 of the last 7 recessions. Therefore, following market prices helps us navigate the short and intermediate term twists and turns of the business cycle environment.

The last main part of our framework is economic growth. We monitor leading indicators and inflation data to determine where we are from the perspective of a growth and inflation matrix. The relationship of growth and inflation allow us to draw inferences as to the future trajectory of interest rates, Fed policy, and also determine potential market reactions. This last component is key to us getting a better overall picture of the total business cycle, especially considering the other aspects of the framework.

Currently, we are highly valued in the US as measured by several historically accurate valuations metrics. We are not going to bore you with highlighting those here, but instead we will point you to our October Trend Report where we discussed several in great detail.

The Fed is tightening policy and looks set to continue despite the probability of overshooting the neutral rate and accelerating the current economic growth slowdown. Market trends have also broken down, as can be seen by the chart below of the Total World Stock Market ETF (VT), which represents approximately 98% of the global investable equity universe:

Chart 1: Vanguard Total World Market ETF in a negative trend

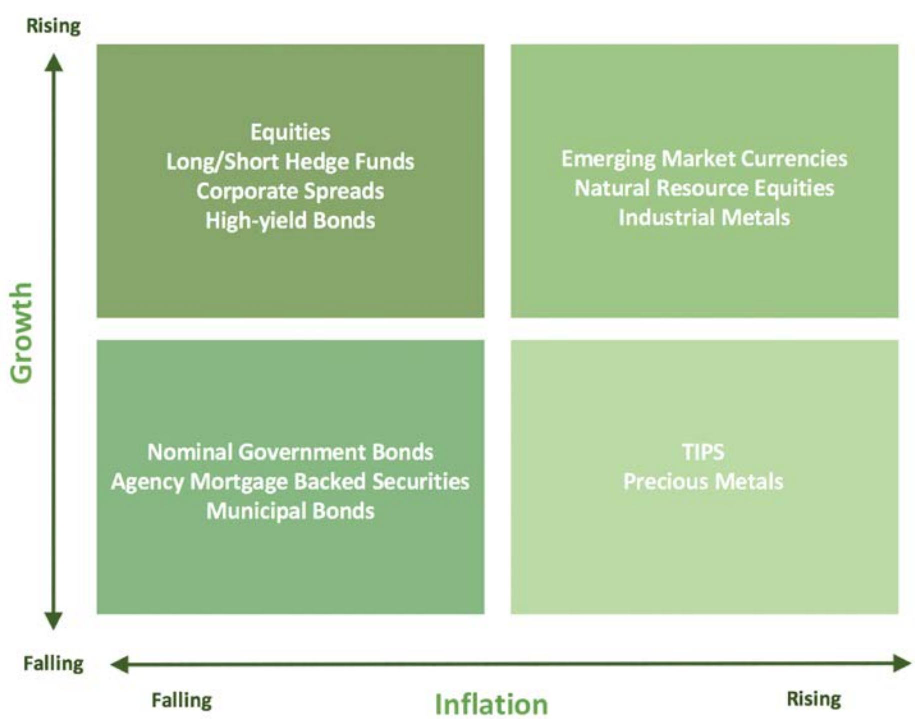
Lastly, growth and inflation are slowing currently and we expect this trend to continue. Economic growth is the last piece of our framework that is not flashing a red signal. It is also the piece we want to focus intently on during the rest of this piece.   The diagram on the following page (courtesy of Hartford Funds) presents a growth and inflation matrix that illustrates, at a high level, how we view the world dependent upon what quadrant we are in.

In the top left quadrant, growth is accelerating and inflation is decelerating. This environment is one that is typically supportive of risky assets (assuming other factors within our framework are green as well). High Yield credit spreads tend to tighten in this environment and risk-on regimes typically emerge.

When the environment is characterized by the top right column, growth and inflation are accelerating together and risky assets are usually still in favor. However, the environment for Treasury bonds becomes extremely negative as this type of environment is typically met with a Hawkish stance from the Federal Reserve. Real assets, natural resources, equities, and emerging market currencies are all asset classes that could benefit from this type of environment.

The bottom right quadrant is when growth is slowing but inflation is rising. This is a negative domain where precious metals, certain commodities, infrastructure investments, and Treasury inflation protected securities can be useful. The Fed is in a pickle during a stagflationary environment (this quadrant), as hiking rates can create accelerated growth declines. Allowing inflation to accelerate can also create dire circumstances.

The bottom left quadrant is one where economic growth and inflation are both slowing simultaneously. This is a negative condition for risk taking. We believe we are currently in this quadrant. The ECRI weekly leading index is down 2.6 percent year over year suggesting a declining growth rate in the US. GDP has retreated from the highs made earlier in the year. Inflation has also peaked, in our opinion, and we have seen some pretty aggressive moves in oil in the recent weeks that possibly confirm our suggestion. Furthermore, the US dollar has demonstrated relative strength against other currencies, suggesting a deflationary pulse is present. During this environment, Treasury bonds, cash, and other defensive assets tend to be the best place to be. Equities and other risky assets are things to be underweight. The Fed tends to react in a dovish fashion when growth and inflation are declining simultaneously as they fear deflation.



Source: https://www.hartfordfunds.com/insights/featured-perspectives/AFrameworkForThinkingAboutRisingInflationThinkFunctionNotForm.html

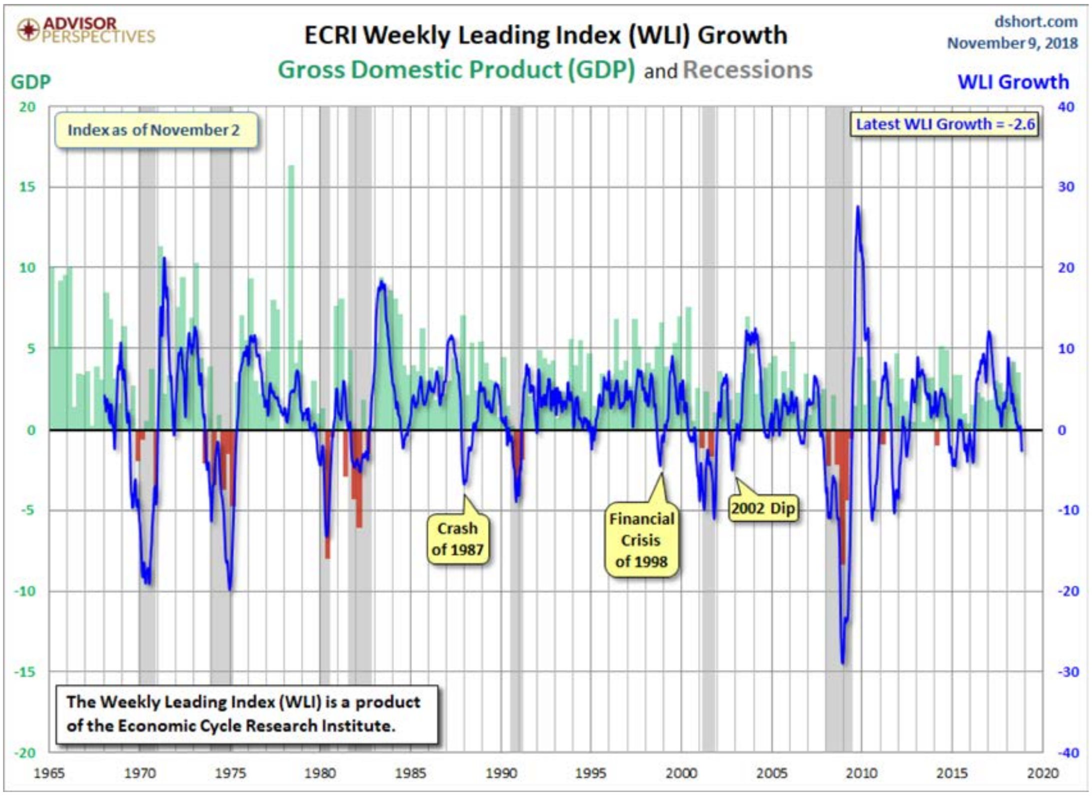


Chart 2: The ECRI WLI growth rate is now at 2.6% year over year. This is indicative of a cyclical slowdown in US growth. This indicator is comprised of an amalgamation of proprietary leading indicators constructed and calculated by the Economic Cycle Research Institute. The chart illustrates the correlation between the ECRI WLI (the blue line) and economic growth (the bar chart).

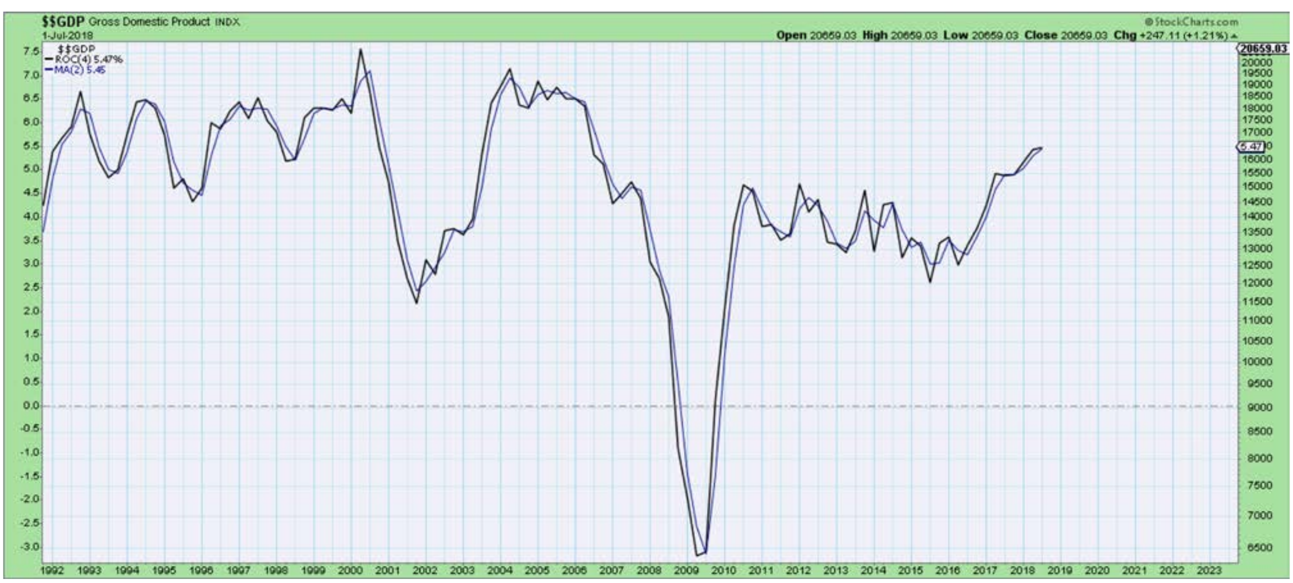


Chart 3: Nominal GDP has yet to roll over as shown by the year over year percentage change (black line) crossing below the 6 month smoothing line (blue). If nominal GDP rolls over, it will confirm our belief that growth is in fact slowing.

Chart 4: Oil is directly correlated with the year over year growth rate in CPI (inflation). Recently, we have seen a big decline in oil prices, suggesting to us that inflation is set to slow considerably.

Chart 5: The US Dollar is our primary indicator for our outlook on inflation. When the dollar is moving up, inflation is typically moving down. Conversely, when the dollar is moving down, inflation is typically moving upward. Very rarely do we see the dollar and inflation moving in the same direction, like the late 2016, early 2017 time frame. The inverse correlation broke down shortly after the Presidential election, only to resume in early 2018.

MOVING FORWARD…

The evidence suggests that we are in the lower left quadrant. It is our belief that we are early on and that economic growth and inflation are just starting to slow down. The playbook for this environment is defensive in nature. This is especially true when the other three components of our framework are suggesting a similar posture. Upon nominal GDP rolling over in confirmation of leading economic indicators, the economic growth component of our framework will move from yellow (caution) to red (outright negative).

We hope we are short-lived in this quadrant and it doesn't spill over into a larger deflationary bust. Unfortunately, we can only make decisions based on what the data is telling us now, and now the data suggests to stay defensive.

DISCLOSURE:

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