Monthly Commentary

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Agitation Overdone

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Early in February the S&P500 and other indexes fell into correction territory. Recall, a correction in the financial markets is a 10% or greater decline from recent highs, which occurred on January 26th. Pullbacks, even in strong uptrends, are historically considered normal. But this was the first drawdown of -5% or more in 404 trading days running since February 11, 2016. Is the correction overdone? Perhaps, but it was probably overdue. Market agitation was brought on by 3 occurrences – feelings that valuation was stretched; a big jump in volatility; and uncertainty about inflation (more below). Also, many investors remain concerned that valuations are stretched, and they became shocked by increased volatility following 23 months of calm and steadily rising stock prices.

The market correction sliced value from bonds and stocks - both domestic and foreign - during February. There was no place to hide, other than owning money market funds which generate negative returns after the effects of taxes and inflation; but that also requires perfect timing (selling out and buying back). By the end of February, a chunk of the losses were recovered, albeit daily volatility is still present. February market performance was very selective or narrow, with the 10 largest company stock names accounting for 45% of the rebound of the indexes; those same names accounted for 33% of gains in 2017 and 27% in 2016. Client portfolios of all objectives also experienced a drawdown in value during the month, and show minimal returns for the YTD.

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Style	February	YTD
Barclays Bond Idx	-0.9%	-2.1%
Avg US Stock Fund	-3.6%	+0.6%
S&P 500	*-3.7%*	*+1.8%*
Large-Cap Stocks	-3.8%	+1.4%
Mid-Cap Stocks	-4.2%	-1.1%
Small-Cap Stocks	-4.3%	-1.9%
Foreign Stocks	-4.8%	+0.2%

Client Objectives (Stocks/Bonds)	February	YTD
20/80	-1.0%	-0.5%
35/65	-1.4%	-0.4%
50/50	-2.1%	-0.4%
65/35	-2.6%	-0.0%
80/20	-3.1%	+0.5%
95/5	-3.4%	+0.8%

While corrections are never comfortable, most eventually evolve into new rallies. That evolution process typically involves 3 components – *price, time, and emotion*. It is an important part of the process to convert optimism to pessimism and replace complacency with a sense of urgency. By most measures, *price* was/is sufficiently stressed, and the bulk of the decline is likely behind us. The other two components of the process – *time* and *emotion* - are less clear and may be incomplete. Most corrections can point to two of the three components playing out at the low. The February drawdown took 10 days to erase -10% (at closing prices), or -12% on an intra-day low; 83% of stocks declined -10% or more, with the average stock losing -14%. On February 9th, the market staged a recovery rebound during the ensuing week, climbing almost 8%. Sharp "V-shaped" rebounds can occur, but are unusual; more often rebounds are "U-shaped", requiring *time* of a couple/few months to occur. Given the recent rise this year in bullish sentiment, it seems probable that additional *time* and evaporation of bullish *emotion* are needed before the bottom is sure. We are starting to chip away at sentiment (*emotion*) about 5 weeks into this corrective phase. Remember though, most corrections prove to be buyable entry points to the next rally.

Last month our commentary, "Super Bull; or Not?" presented a timely perspective of the backdrop for continuation of the current bull market. It also shared how the final years of three super bull markets were very strong, yet how each incurred several corrective drawdowns during the process. The current bull market run exists at a time when underlying economic fundamentals could become another super bull run. Writing such a commentary takes "guts" particularly when written as the current correction was drawing down. One is always humbled in this business whenever they think a prognostication of the future seems likely. On that score, two recent key items could derail the optimistic outlook. One is inflation or interest rates, and the other is political uncertainty via potentially restrictive trade policy.

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There are two scenario views that exist for bonds and stocks, influenced by rising inflation and interest rates. First, bond yields (interest rates) move higher (too high, too fast) to the point that they weaken the economy and hurt the stock market. [This may be evolving into the current consensus view.] More often however, a move higher in bond yields (and interest rates) reflects a stronger economy and higher earnings for company stocks. As long as inflation is rising in a moderate way, the bull can run longer. Moderate is a critical word. In recent days, the markets seem rattled by the prospects of a faster-than-moderate rise of inflation. It's hardly galloping ahead. But, it is turning up enough from low levels that market participants are taking note. The camp looking for inflation to stay low forever is quickly packing up and clearing out. The recent tax cut stimulus and no austerity will lead to higher inflation per unit of growth. Will inflation rise faster than growth? We hope these fiscal policy boosters are not too much that they would spark inflation higher. Will the Fed - and its new member composition - raise interest rates faster and/or too much? Agitation is probably overdone if the new Fed pursues a gradual, careful hiking of interest rates that is not too much or too fast; because there is concern strong action would hurt the economy and asset values (hurting consumers and businesses, both domestic and foreign).

Investor worry boiled again at February-end; a "too much to take" attitude developed. Inflation concerns were exasperated and enhanced by tariff (trade) war rhetoric. Political uncertainty does not help when it is directly tied to inflation. Tariffs are "stagflationary" – they add to price pressures as they raise product prices. Global markets get stressed when new political rhetoric could potentially change the economic landscape. Tariffs would reduce global economic growth while raising inflation via taxation (tariffs); that is the definition of "stagflation." Any sustained trade conflict threatens the synchronized global economic expansion. We hope, and expect, that tariff-talk is more "bark than bite;" but tensions could linger, and thereby allow *time* and waning *emotion* to bring about a correction bottom.

Where does that take us as we invest client portfolios? We are watching and investing carefully. …Historically, the S&P500 rallied until just *before* a recession started; a recession started *after* the Fed was done tightening since monetary policy works with long lags. The end is spotted when the yield curve inverts (short interest rates are higher than longer rates), AND junk bond yields surge higher (they always do at the end). For bonds, we remain intentional to own very short maturity (duration) bond mutual funds; generally focusing on corporate bonds where there is an interest rate spread over Treasuries. Regarding stocks, we de-risked by owning more large company stock funds and less small-stock focused funds, AND rebalanced slightly from high valuation growth-style stock funds into value. International equities still look attractive relative to domestic; yet trade war rhetoric bears close watching.

In general, we expect the current correction to run its course in both *time* and *emotion*, and the economy to retain its strength with moderate inflation. Generally, good economic news is good for stocks; good news is still good news. Slowing global growth when inflation expectations are above 2% would be viewed negatively for stocks/bonds. We are reminded though, about traits of two investors, one real and the other fictitious – they remain invested through various environments. Warren Buffett is the classic long-term investor who rarely sells (and avoids the enemy of taxes); we also often talk about the "Rip Van Winkle" investor who takes long naps and never sees the market corrections. When Rip awakens, he is amazed by how his investment portfolio grew. For long-term investors focused on their long term goals, market agitation is always overdone and presents opportunity.

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