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Traub Capital 2019 Q1 Outlook

2018 Backdrop

Whew! 2018 is in the books and a lot more volatile than in the past few years. The ups and downs we saw are actually a much more "normal" pattern than seen in recent years. It seemed so unsettling just because we had gotten used to seeing much less volatility.

To recap, since the time of the market bottom in March 2009: the market was a bit bumpy during the initial stages of its rebound until September 2011; from that date, the upward trend continued pretty smoothly. We saw a period of remarkably little volatility for about four years from September 2011 up until July 2015. The ensuing volatile period was short, lasting just about a half a year. Then from February 2016 through January 2018, the market was again quite surefooted in its upward climb. During that period, there were a total of zero significant overall market declines.

In 2018, the market returned to a more normal pattern with a 6% rise in January, followed by a 4% decline in February– a pattern which continued throughout the year.

We should recognize the volatility as the normal market. The relative stability in the periods from September 2011 to July 2015 and from January 2016 to February 2018 is the exception.

In 2018, September through December saw the most fluctuation and more numerous declines. It is interesting to note that over those four months, the average daily volatility was roughly 1%. Historically, there have been six other similarly volatile periods in the market going from the end of 2018 back to 1929. Of the seven volatile periods, five of them showed a 1% average daily volatility, one, (the period from August to December 1987) experienced an average daily variance of 2%. The seventh volatile period would be in 1929 where the measured daily volatility was 3%.

The stock market starting in 1929, of course, was a disaster. In that decline, the US economy descended rapidly into a tailspin. The downturn was amplified by the impacts of the Smoot-Hawley Tariff Act and the monetary tightening of the Federal Reserve – both policy initiatives have been studied extensively and both initiatives have been roundly criticized. In 1929, the economy was headed for a contraction or what we today would call a "recession". The bad situation was made far worse by what are now labeled as very poor policy initiatives instituted at the time.

In this outlook, we are not delving into the differences between today and 1929 as that would fill volumes and would conclude that the similarities between today and1929 are virtually nonexistent. We are not headed into any similar economic period.

In this review, we are looking at a shorter historical period of 45 years from 1973 to September 2018. In this 45-year period, there were four periods where volatility was at least 1%. These four periods also all showed downturns exceeding 10%. In just one of the historically volatile periods did the market experience further declines after the volatility. The volatile period that saw further declines was the period in mid-1973 and that period was accompanied by an economic recession in the US. The other volatile periods were not accompanied by an economic recession and the markets recovered fairly quickly.

So a key question to explore is whether the country is going to be experiencing an economic recession in 2019. If so, we would expect further market declines. If not, based on the historic situations noted above we would expect a relatively short recovery period.

Volatile Periods 1973 through September 2018

Looking at the volatile periods from 1973 through September 2018, they do show some similarities to today and these similarities are worth exploring. We have chosen this period because it is "relatively" recent, good data is available and it includes enough data points to be meaningful. Table 1 includes a summary of the four time periods from 1973 through September 2018 that experienced market volatility of 1% or more; along with another eight periods that showed a correction of more than 10%. These twelve periods comprise the corrections that were experienced during that 45 year time frame. Six of those periods were accompanied by an economic recession and six were not. The six periods of economic recession in the table are highlighted in light blue.

Table 1, see note below

Period Number	Period Date	Volatility	Recession	Correction %	Time for S&P 500 to Recover
1	Nov '73 – Mar '75	1%	Yes	40.5%	5 years
2	July '77 – Mar '78	<1%	No	14.7%%	11 months
3	Jan '80 – Jul '80	<1%	Yes	16.9%	5 months
4	July -81 – Nov '82	<1%	Yes	20.1%	3 years
5	Aug '87 – Dec '87	2%	No	33.2%	2 years
6	July '90 – Mar '91	<1%	Yes	19.8%	8 months
7	July '98 – Aug '98	1%	No	19.4%	5 months
8	July '99 – Oct '99	<1%	No	12.1%	4 months
9	Mar '00 – May '00	1%	No	10.1%	3 months
10	Aug '00 – Mar '03	<1%	Yes	47.3.	6.25 years

11	Dec '07 – June '09	<1%	Yes	56.4%	4.25 years
12	Jan '18 – April '18	<1%	No	10.1%	6 months

Note: The dates in the table are not completely precise. The dates of recessions are determined by the National Bureau of Economic Research. For recession periods, these are the dates used. The dates of the recessions generally do not coincide with the dates of the market peaks and troughs. In recession periods the market high and low are measured from the highest and lowest values of the S&P Index during that time. For non-recession periods, the start and end dates mark the periods of volatility and again rarely coincide with the market high and low. As in the recession periods, the amount of the correction is determined from the high and low values of the index during the period. The time to recover is measured from the peak to the time the index again reaches the peak value. We use the word "correction" to mean drop in value from the peak. This is the customary term in the investment industry.

From Table 1; since 1973 there have been six recessionary periods. These periods are shaded light blue. All of these recessionary periods showed a drop in the S&P 500 index. The average decline was 31.8%. The average time for the S&P 500 index to recover from its previous peak was 3.3 years. For this analysis, we are using the S&P500 Index, which does not include dividends. If dividends were included, the peak to trough values would be slightly different, but not significantly so and not so the conclusion would be different.

In addition to various market behaviors during recessionary periods, the market obviously also experiences declines and volatility during non-recessionary periods. However, in sharp contrast to the results in recessionary periods, in the six non-recessionary periods with high volatility or with market declines of over 10%, the average decline was 16.6%. The average time to recover was 9 months.

Economic Outlook

From the analysis in Table 1, it is clear that there is a marked contrast to the ensuing stock market behavior following market declines or following increased market volatility when that period is accompanied by an economic recession. The difference in outcomes when a market decline is accompanied by recession and the outcome when not accompanied by a recession beg the question as to whether we are now entering an economic recessionary period. The answer is an emphatic "NO". As such, we do not expect a lengthy time for the market to recover its footing. Let's look at the economic data to assess the potential for an upcoming recession.

A key variable in the economic outlook can be found in the labor market reports. These reports indicate a very strong economic picture and one that will most likely continue for some time. The most recent report showed increased employment of over 300,000 jobs in December accompanied by an uptick in the unemployment rate to 3.9% up from 3.7% in November. You might ask how unemployment can go up with a very strong increase in hiring and the answer is in the labor force participation rate. The rate increased from 62.9% in November to 63.1% in December. The increase in the number of people who are employed or are actively looking for work more than offset the number of new jobs created. More people looking for jobs have kept wage inflation modest at 3.2%. Wage inflation is offset by increased productivity and with increased application of technology to keep overall inflation in check at less than the Federal Reserve target of 2%.

It is interesting to note that at a 63.1% labor force participation rate, the nation still has a lot of extra labor force capacity. At the turn of the 21st century, the labor force participation rate was over 67% - fully 4% higher than today. Adding 4% to the labor force participation rate would keep the unemployment rate steady while adding 300,000 jobs every month for well over 3 years. The extra capacity in potential workers will keep wage inflation low, overall inflation low, and allow for corporations to increase earnings at 10% per year for 2019 and a further increase in earnings in 2020, albeit at a lower rate of increase. Low inflation will also afford the Federal Reserve the opportunity to keep the Federal Funds rate low and we expect only one increase in that rate in 2019.

Continuing modest interest rates compared to the past decade will also afford continuing levels of housing starts in the 1.3 million range – a positive impetus for economic growth. Good housing starts will couple with increased spendable income arising from the increased labor force participation rate to drive overall economic growth to roughly 3% in 2019.

Our forecast of a 10% increase in corporate earnings is in line with, but slightly higher than, the consensus increase in corporate earnings of 8%.

There have been many recent headlines about the “inverted yield curve” and how a yield curve inversion has led in the past to recessions. The “yield curve” looks at the interest rates paid for deposits held for various periods. Currently, the interest rate on overnight deposits with the Federal Reserve is 2.4%. The interest rate on funds lent for a period of 30 years is 2.97%. The difference between these two rates is fairly flat, but nonetheless it is sloping upward with increasing time. There are different rates for deposits at three months, six months, one year, three years, five years and 10 years. The one month, three month and six month rates are currently about 2 1/2% as is the three year rate. That said, the generally accepted comparison for the yield curve is the difference between the 10 year rate and the overnight rate currently 0.31% (2.73% less 2.42%) – not a lot, but still positive. The worry is that with a couple more boosts to the Federal funds rate, it will take it to almost 3%, higher than the current 10 year rate.

The overall inflation rate is a major determinant of the 10 year and 30 year interest rates. That overall inflation rate will remain low – we believe less than 2%. Expectations of inflation of less than 2% will keep the 10 year rate at its currently low point. However, with inflation remaining low, there will be little push for the Federal Reserve to increase the Federal Funds rate. As such, we are expecting just one rise in the Federal funds rate for 2019 and a continued positive tilt to the yield curve. In the past, even when we did get an inverted yield curve, the stock market typically doesn’t peak around that time- it usually peaks at least several quarters later.

Stock Market Outlook

We have seen that for periods of volatility in the stock market where there is no recession on the horizon that these periods tend to be relatively short lived – averaging nine months for the past 45 years. It is not unreasonable to project that nine months from the start of this market correction, the overall market will be back to its previous high. That would imply an increase of 17% and that increase would be realized before September of 2019. We would expect that there would be some continued volatility and that after getting to a high value, there will most likely be another pullback. That pullback would leave our forecast for 2019 to be a bit below 10% for the year with some possibility of a further increase.

Conclusion

We have seen a pretty steep drop in the overall market value this past fall and plenty of doomsday press coverage. We view the negative press coverage and the pessimism to be a positive indicator. Once everyone is fully invested in the market and is comfortable with their positions, there is no more money to be invested. Once everyone is comfortable, we will be worried. Negative headlines are your friend and we look for a fairly positive return from the equity markets next year.

We have given little coverage of the bond markets in this report but we see interest rates overall to be stable resulting in stable bond prices next year. This would suggest bonds should return in 2019 about what they currently yield. That would suggest about a 3% return for the investment-grade bond market. The combination of our outlook for stock and bonds leads us to conclude that the portfolios we have chosen in the past year remain correct and we do not foresee major changes to asset allocations going forward.

As always, we will be on the lookout for changes in economic variables which would change our outlook and we thank you again for your faith in Traub Capital and thank you for being a client.