MID-CONTINENT CAPITAL

CONSILIUM*

Volume 31 ~ July 2017

*advice; judgment; resolution; wisdom

It May Be Late, But It's Probably Not Over

The S&P 500 stock index posted a total return of 3.1% for the quarter ending June 30, its seventh consecutive gain and the 17th quarterly rise in the last 18. More importantly, this string of positive results comes after an economic and market expansion that has just entered its ninth year. This has been an impressively long winning streak for US equity investors by any measure.

Expansions do not die of old age, it is often said, and correctly so. But the longer an economy is expanding, the more likely it is that bad economic and investment decisions will be made on the erroneous assumption that then-present conditions will last forever. Inevitably, as the economy reaches the limits of its near-term growth potential, the Federal Reserve begins to raise short-term interest rates and tighten monetary policy to ward off an actual or potential increase in inflation. As the flow of credit to the economy is reduced, these marginal investment and business decisions are reconsidered, and business activity slows materially. Projects get cancelled, hiring plans eliminated, and assets propped up by excessive debt are sold into weakening markets. Eventually a self-reinforcing cycle of job cuts, income loss, and declining demand propel the economy into recession.

Every post-war cycle has followed this script, and there is no reason to believe this time will be different.

Unfortunately for investors, knowing how events may play out isn't helpful without knowing *when*. Numerous strategists and economists have tried to gain fame by being the seer who "called the market top", only to be reminded that "the" top can only be seen in hindsight. Some focus on stock market valuations, which are indeed high by historic standards – but they have been higher, and can go higher. Others believe that at 4.3% unemployment, our labor resources have reached their limits – but there is a substantial pool of workers that still could be coaxed into the labor force, and worker productivity may yet propel the economy forward. <u>There are no clear thresholds for valuation, debt levels, or other economic measures that reliably provide a "sell" signal ahead of time.</u>

This is no small matter, for the simple reason that exiting the stock market too early in a powerful bull market can be very costly. According to Merrill Lynch, over the last dozen market cycles, S&P 500 total returns in the final 12 months before the peak averaged over 25%. While we are always looking forward with our individual stock selections in client portfolios, we therefore believe it is actually wiser to rely on firm backward-looking indicators to gauge broader economic and market conditions for signs of trouble. Such conditions as

- a sharp increase in the unemployment rate and claims for unemployment benefits
- an inversion of the "yield curve", i.e., short-term interest rates above long-term rates
- a decline in retail sales, adjusted for inflation
- a meaningful widening of "credit spreads", i.e., relative interest rate costs for private borrowers

have invariably provided reliable recession signals after the fact and still in time to protect equity portfolios from the worst of any downturn. There is no need to anticipate the next market peak and risk leaving significant returns on the table – these and other indicators that we monitor closely will almost certainly tell us when a tipping point has been reached. Most importantly, all of these signals are flashing "green" at present, indicating that investors should give the bull market the benefit of the doubt.

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On the very day that this issue of *Consilium* was being written, cable television pundits and commentators, in the span of just a few minutes, could be heard lamenting (1) the existential threat posed by North Korea, (2) the slowing rate of employment growth, (3) that the Affordable Care Act may be "unfixable", and (4) that the US faces an imminent fiscal crisis. Also on this same day, the well-regarded *Wall Street Journal* columnist Greg Ip, who writes on Fed policy and economic matters, opined that investors "should be on guard for a repeat" of "mayhem".

Our view is that there are always serious problems, and risks, whether the market is up or down. But as Morgan Housel of the private equity firm Collaborative Fund recently wrote, there is no reason that pessimism should be an investor's default position. Skepticism should not be mistaken for critical thinking, or taken more seriously than optimism. We recommend being open to all potential outcomes, and that includes the possibility that the current economic and market cycle may have much further to run than any "expert" deems likely.

Sources: FactSet, Wall Street Journal, Bloomberg, collaborativefund.com/blog/