

CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

September 21, 2018

Selling too Soon???

New highs in the US stock market have been achieved this week. The rest of the world lags far behind and there are growing signs of economic weakness. Caution is useful now.

For some months, Core has been engaged in an ongoing process of lowering risk in our clients' equity-oriented portfolios, on the view that economic growth is weakening and that stock and bond markets face price declines in the period ahead. As you may be aware, the primary measure of the US stock market, the S&P 500 index made a new high in late August, again yesterday. Today it set a new intra-day high, before closing slightly lower on the day. By this measure, it appears that Core may be selling too early. However, given the impossibility of timing the stock market and selling at the top, our view is that selling too soon is better than selling too late.

Although we observe the recent new highs in the S&P 500, there are any number of negative aspects to the behavior of the stock market. For example, (a) the stock markets in the rest of the world are still some 15% below the January highs, (b) more than one half of the total gain in the S&P in 2018 comes from just six stocks, including Amazon, Apple and Microsoft, while the other 494 stocks in the S&P 500 have gained a mere 3%, and (c) the recent new highs in the S&P have accompanied by much weaker participation. That is, many fewer stocks are rising and more are falling this time than in January and more stocks are setting new 52 week lows in price than are setting new 52 week highs. Narrow advances like this one, led by a handful of very large growth stocks, are a sign of a market making a final top in price.

Another feature of market action that seems to confirm the notion that we are in the last inning of a long baseball game is that defensive industry groups are now leading the advance, while the formerly strong cyclical industry groups are in decline. In the recent few months, defensive sectors like consumer staples (i.e., groceries, gasoline and the like), health care, utilities and telecoms are rising, while the sectors that advance in early stages of economic and stock market advances, like industrial stocks, basic materials, financials and technology stocks are faltering. Among the portfolio changes we have been making since mid June is the selling of cyclicals and the buying of defensives. Thus, we have sold the industrials, bank stocks, and half our tech stocks in favor of consumer staples, small company stocks, health care and utilities.

By

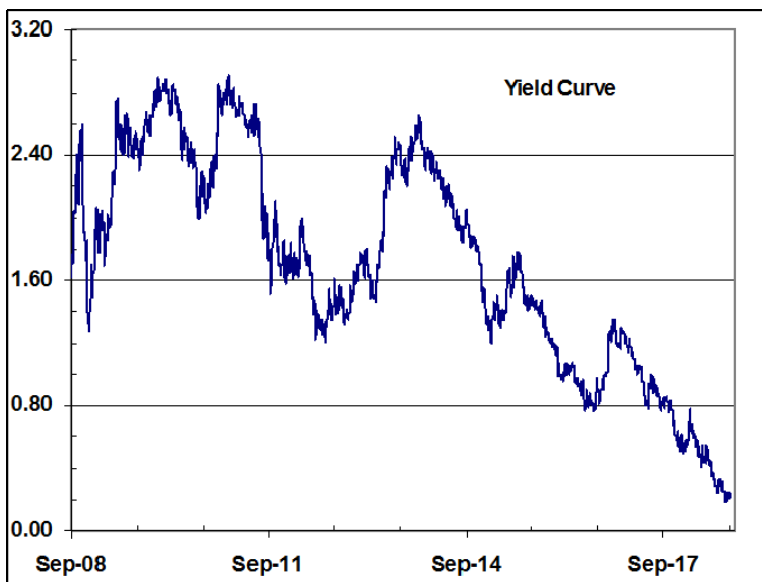
Jack Mayberry

Apart from selling the cyclicals and buying the defensives with the proceeds, we have sold some equity positions outright and have roughly doubled holdings in cash, bonds and preferred stocks. This 'de-risking' of clients' portfolios is a process; a process that may continue as we evaluate changes in the economy, the actions of the Federal Reserve and the political dynamics, including the Trump administration's imposition of tariffs and trade wars—or 'skirmishes, as Jamie Dimon puts it.

The Federal Reserve's governors meet next week and are almost certain to raise short-term rates by another one quarter of a percent. It seems quite likely that another rate rise will follow at the December meeting. More are likely in 2019. Concurrently, the Fed is allowing the total assets on its balance sheet--the nearly four trillion dollars of government bonds and other securities it holds--to shrink as it undoes some of the effects of the bond-buying program--Quantitative Easing--it undertook in the aftermath of the financial crisis. Slowly the Fed tightens monetary policy. The typical outcomes of Fed tightening are recession and a bear market in stocks. In the thirteen cycles of tightening of monetary policy since the Second World War, a recession developed ten times. We may be some distance from recession and from a bear market, but we are much closer to the end of this economic expansion and bull market in stocks than we are to its beginning in 2009.

Inflation. Among other things that will keep the Fed on its monetary tightening course is inflation. The steady increase in employment coupled with the reasonably strong economy have given rise to the unusual situation in which there are

more job openings than people seeking work. Indeed, so tight is the labor market that more than all of the net new jobs created in the last three months have been filled by those without more than a high school education. This unfilled demand for labor is finally, albeit rather slowly, pushing up wages. The so far still modest wage 'inflation' is very likely to push up prices of goods and services with it. The long period of subdued inflation, indeed at levels considered dangerously low by the Fed and many economists, appears to be coming to an end. At the same time, the burst of economic growth in the second quarter of this year is already subsiding. Is the dreaded 'stagflation' at hand? (The horrible term was coined in the seventies to describe the combination of high inflation and stagnant economic activity that characterized the latter part of that decade.)



The nearby chart shows the yield curve over the last decade, specifically the difference between the yield on the ten-year treasury bond and that of the two-year treasury note, expressed in basis points or hundredths of a percentage point. (For example, if the yield on the 10-year note is 3.00% and that of the 2-year is 2.00%, the difference is one percent or 100 basis points.) Normally, the yield on the 10-year exceeds by a comfortable margin that of the 2-year. When the yield on the 10-year falls below that of the 2-year, it is referred to as an inverted yield curve or a negative term spread. It suggests that economic weakness is at hand. As can be seen, the difference has been falling steadily for three years and is near to zero. As stated in a recent paper by the Federal Reserve Bank of San Francisco, "[e]very US recession in the past 60 years was preceded by a negative term spread, that is, an inverted yield curve. Furthermore, a negative term spread was always followed by an economic slowdown and, except for one time, by a recession." As the Fed continues its raising of short-term interest rates, the yield on the 2-year note is almost certain to rise, making an inverted yield curve more likely. Should a recession come, the next bear market in stocks is highly likely to accompany it.

COREComments



CORE ASSET MANAGEMENT

PO Box 1629
 108 Caledonia Street
 Sausalito, California 94966
 (415) 332-2000 • (800) 451-2240
 fax (415) 332-2151
 www.coreasset.com
 info@coreasset.com