Investment Commentary: 2/2019

Equity markets experienced a sharp snap-back rally in January, after a rough end to 2018. The S&P 500 finished the month up 8%, while small-cap stocks and real estate investment trusts did even better, up 11.3% and 11.8% respectively. **Returns were boosted by signals from the Federal Reserve that it would be more patient with rate increases, and by improving rhetoric towards China from the Trump administration.** Foreign stock markets joined the party, with developed market stocks up 6.6% and emerging market stocks up 8.9%. Global stocks recovered some of the losses incurred in the fourth quarter, although some headwinds remain. Ranging from political uncertainty to signals from economy suggesting that growth continues to slow. Core bonds finished the month up a little over 1% as interest rates stabilized, while high-yield bonds snapped back with a gain of 4.5%, after a difficult fourth quarter performance.

"Returns were boosted by signals from the Federal Reserve...and improving rhetoric towards China"

In this month's commentary we discuss the potential for the economy and financial markets to experience a "Reverse Minsky" moment that extends this cycle longer than expected. We also discuss which stock sectors tend to perform best when the Federal Reserve takes a pause from a tightening cycle. Lastly, we discuss the potential for U.S. assets to underperform if we win the trade war against China.

The Reverse Minsky

The famous economist, Hyman Minsky, once said that "stability begets instability." The implication Minsky was making was that periods of economic stability often encourage excessive risk-taking, which ultimately leads to instability and economic demise. Just think about the run-up to the financial crisis and the excessive risk that took place during seemingly stable times, now that was a Minsky Moment! **However the opposite can also be true, that instability begets stability.** The Bank Credit Analyst (BCA) recently made the case for a Reverse Minsky moment with the following statement:

> *Following periods of intense financial stress, lenders become circumspect about whom they lend to, while borrowers become reluctant to take on debt. The result is economically bittersweet. On the plus side, the newfound caution of lenders and borrowers alike ensures that financial imbalances are slow to build up again. On the negative side, sluggish credit growth restrains spending. The net effect is a recovery that is often slow and uneven, but one which lasts longer than expected.*

The current economic cycle is set to become the longest in history as of this July. Given the magnitude of the "Reverse Minsky" since the Great Recession, **we have to consider the possibility this economic cycle may last much longer than most investors anticipate**. Especially when we consider the lack of major financial imbalances in place and the Fed taking a dovish pause to its monetary policy.

For perspective on the causes of economic recessions in the U.S. we can refer to a recent Goldman Sachs study, **Learning from a Century of US Recessions**. According to their study of the past 100 years, **there are five major causes of recession in the U.S.: industrial shocks and inventory imbalances; oil shocks; inflationary overheating that leads to aggressive rate hikes; financial imbalances and asset price crashes; and fiscal tightening.** According to Goldman, the first three causes have become structurally less threatening. We will be watching for signs the last two (financial imbalances and fiscal tightening) are becoming a threat to the current economic cycle. However, at this time it doesn't appear to be the case!

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Which Sectors Perform Best When the Fed Pauses?

Ned Davis Research (NDR) did a recent study to determine the historical impact a Fed tightening pause has on sector performance. According to NDR, a Fed tightening pause is a break in a series of Fed rate hikes of at least five months before the tightening cycle is resumed. At this time, we don't know if the hike on December 19th will end up being a pause or if it will be the last hike of this cycle. Of note, there have only been four cases since 1973 of the Fed putting a tightening cycle on hold, and they typically occurred late in the economic cycle in response to weak economic data. Similar to the economic environment today. The NDR table (right) shows the median sector returns after a pause in the tightening cycle**. After the first few weeks the materials and energy sectors have been the best and most consistent performers, which is in-line with late cycle sector behavior.** Overall, valuations are reasonably attractive in the energy and material sectors and investors may be well rewarded for adding some exposure to these areas in their portfolios.

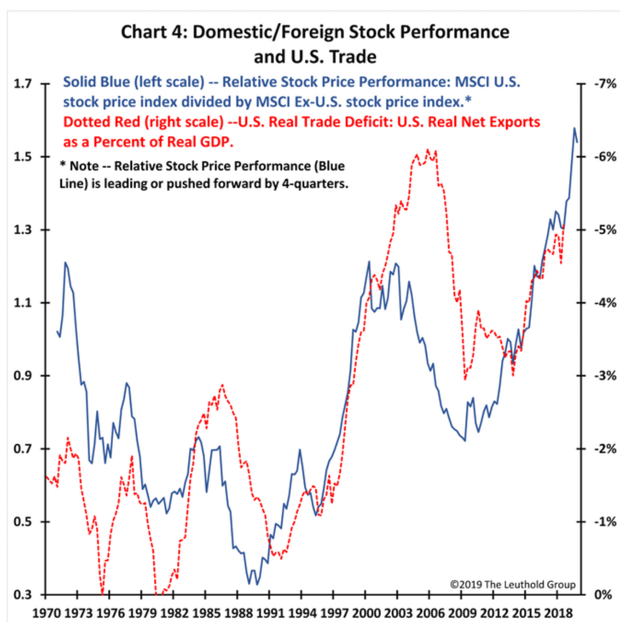
SECTOR PERFORMANCE AFTER FED PAUSE

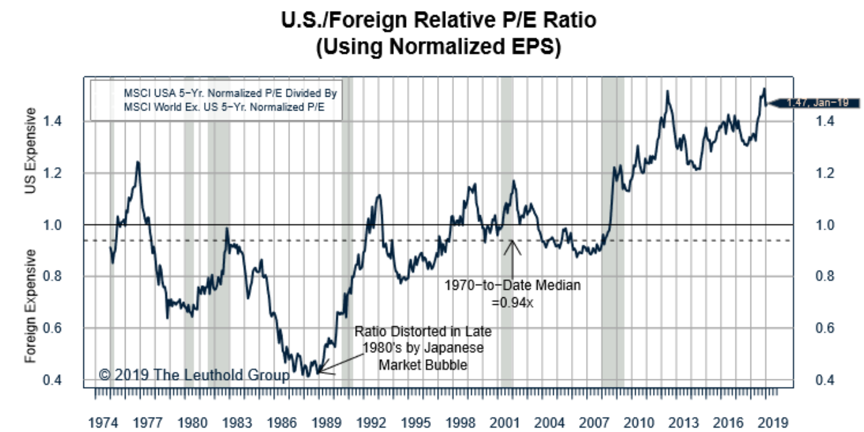
21 Days After			63 Days After			126 Days After		
S&P 500 Sectors	Median Gain %	Batting Average	S&P 500 Sectors	Median Gain %	Batting Average	S&P 500 Sectors	Median Gain %	Batting Average
Utilities	2.6	100	Materials	4.5	100	Materials	6.8	100
Financials	3.0	75	Energy	4.2	75	Energy	2.4	75
Communication Services	0.1	75	Communication Services	2.9	75	Communication Services	0.3	75
Consumer Staples	0.0	75	Industrials	3.2	50	Consumer Staples	0.8	50
Health Care	-1.9	75	Utilities	2.6	50	Industrials	0.5	50
Industrials	-1.0	50	Consumer Staples	1.7	50	Utilities	-1.8	50
Consumer Discretionary	-1.2	50	Financials	1.5	25	Financials	-2.3	50
Information Technology	-0.9	25	Health Care	0.5	25	Health Care	-1.0	25
Materials	-1.9	25	Information Technology	-1.7	25	Consumer Discretionary	-1.2	25
Energy	-3.3	25	Consumer Discretionary	-2.4	25	Information Technology	-3.5	25
S&P 500 Index	0.0	N/A	S&P 500 Index	0.3	N/A	S&P 500 Index	-0.7	N/A

Real Estate not included due to lack of history. Fed pause = at least five months in between increases in the target rate. Pause cases: 08/14/1973, 11/01/1978, 12/05/1980, and 12/16/2015. Source: Dow Jones Indices

What happens If We Win the Trade War?

The Trump administration has been fiercely battling on several fronts to win the global trade war against China (and others). **The economic impact of the trade battles is yet to be determined, however U.S. investors may be surprised by the outcome if we actually win the trade wars.** The chart on the right from the Leuthold Group shows a close relationship between the U.S. trade deficit and the relative performance of U.S. stocks to international stocks**. The reality is, that since 1970, U.S stocks actually perform better when the trade deficit worsens. Suggesting that if President Trump wins the trade war with China (and others) and the trade deficit improves, U.S. stocks may underperform their foreign counterparts.**





When you combine the increasing odds of a reduction in the U.S. trade deficit with better valuations overseas, the case to begin overweighting foreign stocks relative to U.S. stocks makes sense. The chart on the left from Leuthold shows the relative valuation for U.S. stocks, using normalized earnings, compared to foreign stocks. Clearly U.S. investors that are hoping Trump wins the trade war, may be surprised it could lead to the underperformance of U.S. stocks, stay tuned!

If you have any questions about your portfolio strategy and would like to discuss how to position your investments to navigate the current environment give us a call.

- AWM Investments (February 2019)