MID-CONTINENT CAPITAL

CONSILIUM*

Volume 35 ~ July 2018

*advice; judgment; resolution; wisdom

For Serious Investors – Data, not Forecasts

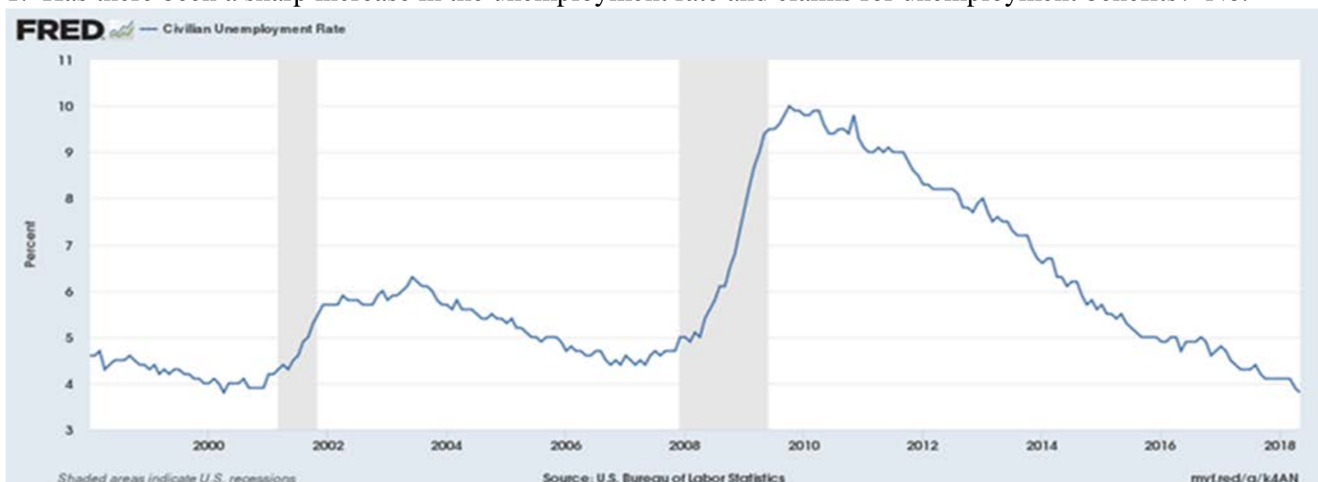
Predictions of imminent doom have been all too common during America's nine-year-old economic expansion. Investors and their enablers in the financial media have obsessed over Federal Reserve policy, election outcomes, terrorism, currency devaluations, Brexit, fragile banking systems, surging oil prices, collapsing oil prices, tax cuts, tax increases, trade policy, nuclear proliferation, and a host of other would-be justifications for pessimism. It is understandable that stock market participants wouldn't want to see their gains given up in spectacular fashion, as in 2000 and 2008 – but the probability of such outcomes is nearly always overestimated, resulting in premature selling, holding too much cash, and positioning portfolios too defensively. Instead of the rare pain of major financial loss, investors experience the chronic frustration of "missing out".

In several issues of *Consilium* over the years, we have encouraged readers to try to ignore meaningless (but totally normal) volatility and "noise" that lead to bad decision-making. Rampant nervousness, concern and skepticism are properly seen as the building blocks of sustained market advances – the figurative "wall of worry" that bull markets climb. World-class athletes freely admit to being nervous when performing, but they embrace the sensation as a key part of the experience of competing. Likewise, the best investors accept that stomach-turning volatility is the price that the markets extract for offering strong returns over time. If worry vanishes and only euphoria remains, there will be no one left to buy stocks – and then, the bull market will indeed be on borrowed time.

Prognosticators are paid to predict, and as noted, calls for a stock market "top" are much more popular these days than suggestions that the current cycle could last well into the future. A year ago in *Consilium* we asserted that trying to make such a forecast is pointless, and we would like to reiterate here that there is no reason for an investor to try to anticipate the end of the current bull market, for two reasons. First, there is considerable potential upside remaining for however long the economy has life - the final year of a market cycle typically features well-above-average returns. And second, if a recession is on the horizon, factual evidence to that effect will accumulate in a timely enough manner to allow for appropriate portfolio adjustments.

We cited a handful of reliable economic measures – not forecasts – that could a keep an investor from exiting the market too early. Where do these measures stand today? The charts that follow provide vivid evidence that there is no compelling evidence of an imminent economic downturn, and any market "expert" calling for one is engaging in baseless, evidence-free speculation. Will these conditions change, and turn unfavorable, in the future? Yes, unquestionably. But the prudent – dare we say, "scientific" approach – is to monitor and observe, rather than make hasty forecasts that could leave significant gains on the table.

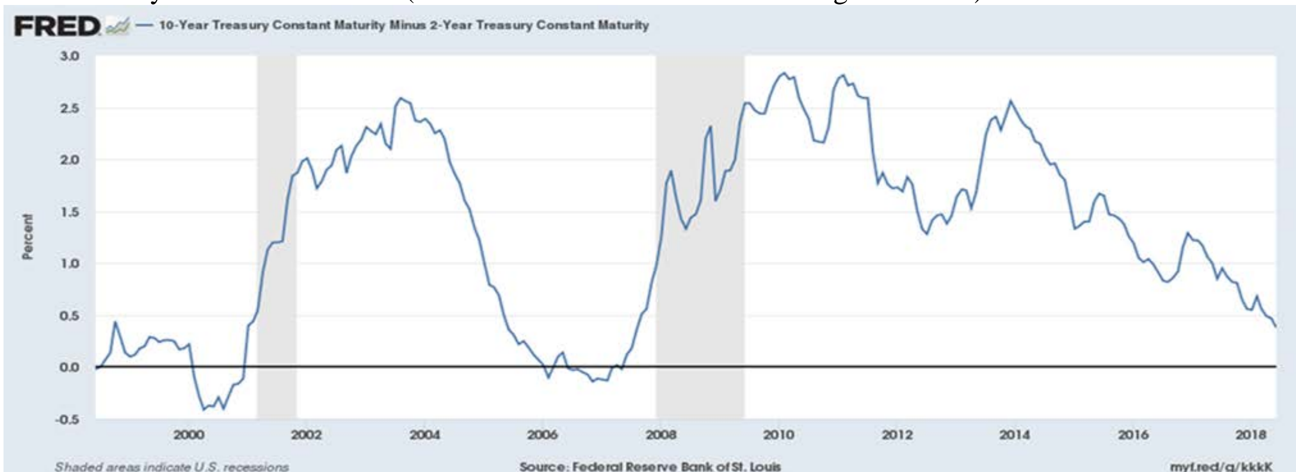
1. Has there been a sharp increase in the unemployment rate and claims for unemployment benefits? No.



Please turn to next page

2. Have "credit spreads" (relative interest costs for private borrowers) increased meaningfully? No.

3. Has the "yield curve" inverted (i.e. short-term rates in excess of long-term rates)? No.



We will conclude with an example from market history that perfectly illustrates this important point. Throughout 1994, much as in recent years, the Fed had been raising short-term interest rates to "cool off" a strong economy and tamp down potentially rising inflation. By that December, the spread between 10-year and 2-year US Treasury yields (the same series depicted in the chart above) had fallen from 1.56 percentage points to just 0.15 percentage points in less than nine months. Then, as now, concerns that "the yield curve is about to invert" led to many early recession forecasts. But the yield curve did not become inverted. Instead, short-term rates stabilized as the Fed paused its tightening program for several years. And from the end of 1994 to the end of 1999, the S&P 500 index rose by a history-making 251%.

But what about when the yield curve finally does invert? Over the last five recessions, the S&P 500 rose every time from the date of initial inversion until the recession officially began, up by an average of 13% over 21 months.

We do not suggest that history is about to repeat – but we believe this and other examples support the idea that investors are best served by the use of hard data and evidence, with a large dose of patience, rather than giving in to unsupported fear and worry. There will be a legitimate time for worry, but that time has not yet arrived.

Sources: LPL Financial, Federal Reserve Bank of St. Louis