Portfolio Management, LLC

Building Wealth Wisely

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The Good, the Bad, and the Ugly

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The Good

After a late year swoon in 2018, investment markets experienced a strong rebound in the first half of 2019. In fact, the U.S. stock market just enjoyed its best first six months of the year in over 20 years. Bonds and international stocks also performed well, as reflected in the following robust year-to-date returns:

- 6.1% return for the Barclays Aggregate Bond Index,
- 17.4% return for the S&P 500 Index, and
- 11.8% return for the MSCI Foreign EAFE Index.

The current bull market in U.S. stocks is the longest one on record. Although U.S. stocks seem fully valued on an absolute basis, most foreign stocks look attractive based on historical valuations. Dividend yields in the U.S. currently exceed most government bond yields, helping stocks seem relatively attractive compared to bonds.

Moreover, our nation's economy is still performing moderately well this year, with the current expansion now poised to become the longest one ever for our country. Unemployment is at a 50-year low, with over 20 million jobs created since 2009. U.S. household net worth has increased by $47 trillion, and consumers have more spending power. Inflation remains low.

Financial markets have been supported by reduced tax bills for most Americans and strong fiscal stimulus from Washington. The Federal Reserve and many central banks around the world have continued to provide accommodative monetary policies with talk of future interest rate cuts.

Unlike in previous strong periods of stimulus and growth, few imbalances have built up in the economy over the past 10 years. Although this recovery has been a long one, it has also been one of the most anemic on record.

The Bad

The current economic expansion can certainly continue, but it is facing growing risks. Fiscal stimulus is starting to fade, global trade is weakening, and government policies emanating from Washington have become increasingly erratic. The world seems more chaotic with each passing month.

Adding to the uncertainty is the high risk of potential exogenous shocks, especially given the seemingly endless policy risks surrounding trade and foreign policy. The potential for financial conflict with China and military conflict with Iran has risen substantially in recent months. Any major missteps – economic or geopolitical – could lead both our nation and the world into recession in 2020.

Due to high levels of uncertainty, corporate leaders have already become more cautious with their capital spending and expectations for future profits. This is leading to lower levels of manufacturing and trade activity around the world. Most experts don't anticipate a recession this year, but the economy has certainly slowed down since last year. Furthermore, the yield curve is increasingly flat – an indication that investors are anticipating even slower growth ahead.

The Ugly

Neither President Trump nor Congress has taken any steps to rein in government spending. The U.S. deficit is projected to exceed $1 trillion this year, an increase from $779 billion last year. Such a high deficit at this point in an economic expansion is unprecedented. Our national debt now exceeds $22 trillion, which amounts to a debt load of over $175,000 for every household in the U.S.

Our government continues to ratchet up spending each year, with talk on the horizon of Medicare for all, student loan forgiveness, free college tuition, infrastructure spending, and a far-reaching Green New Deal. Moreover, given already accommodative monetary policy, the Federal Reserve won't have much dry powder available to help pull us out of a recession.

The Game Plan

Despite the possibility of lower growth around the world, we are maintaining a long-term strategy with client portfolios. If the Federal Reserve remains dovish and the U.S. reaches an agreement with China on trade, the economic expansion and bull run in stocks will most likely continue for some time. There's no reason the expansion must come to an end. Australia hasn't had a recession in nearly 28 years.

As seasoned investors like to observe, the market climbs a wall of worry. However, in light of the higher level of risk and uncertainty, we have taken some precautions in most client portfolios, including:

- maintaining a neutral to lower allocation to equities,
- emphasizing investments of higher quality,
- keeping a high level of liquidity,
- overweighting higher quality bonds with short-to-intermediate maturities, and
- being ready to rebalance portfolios to take advantage of market declines.

As a reminder, periodic downturns are a normal part of investing. The stock market experiences a 15-20% correction every other year on average and declines over 20% in value about every four or five years on average. Although past performance is not a guarantee of future results, the benefits of long-term investing have always outweighed the disruption of shorter term declines.

Investors are best served if they maintain a long-term perspective. In fact, checking one's investment account too often usually leads to lower long-term returns for investors. Most investors feel the pain of losses far greater than they feel the satisfaction of gains. Frequently checking the value of our accounts tends to increase our focus on short-term volatility instead of long-term gains.

Succumbing to short-term or emotional decision-making can lead to the avoidance of unpleasant volatility, resulting in overly guarded portfolios. Lower risk almost always leads to lower returns. Successful investors tend to maintain a long-term, disciplined strategy and keep short-term results in perspective.

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