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Building Wealth Wisely

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Milestone or Millstone

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The bull market in stocks just became the longest one in U.S. history. Since the stock market low on March 9, 2009, the current up cycle has now lasted nine years, five months and 13 days without undergoing a 20% decline that traditionally defines a bear market. Stocks have quadrupled in value, going from 676 on the S&P 500 Index to 2,862. This bull market now exceeds the 9+ year expansion that ended in March 2000.

The current milestone is a record that few could have predicted back when stocks plunged over 50% during the last financial crisis. The long rally has added trillions of dollars to the wealth of investors who stayed the course. It's been an extraordinary run.

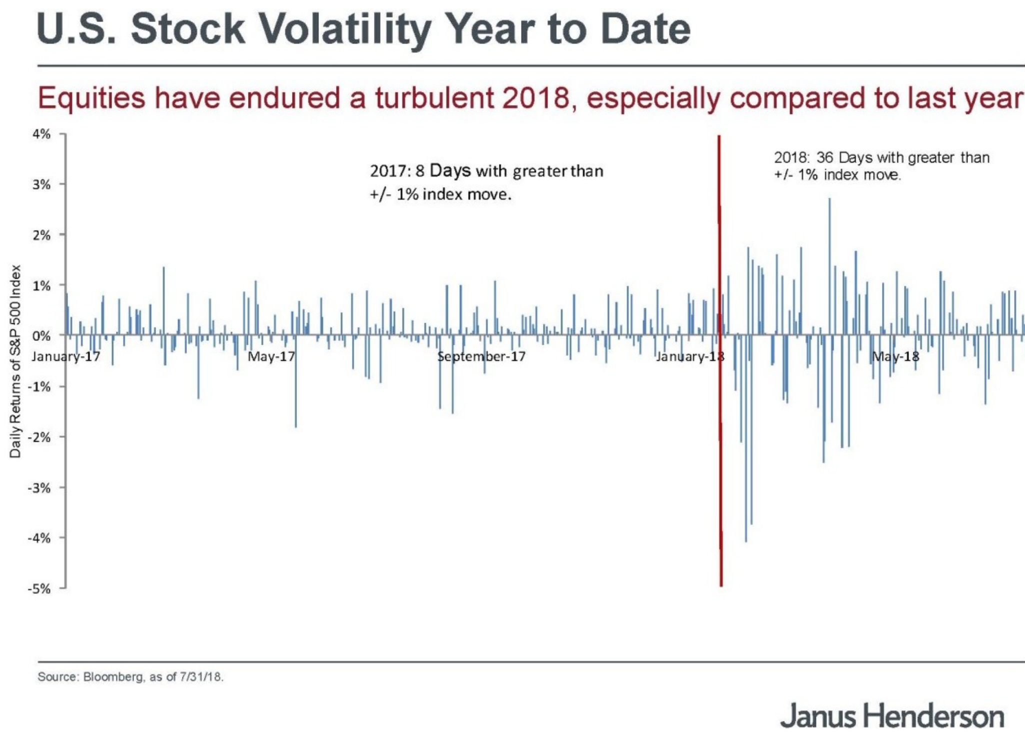
Today's landmark achievement begs the question: can the bull market continue? U.S. equity valuations look stretched. Interest rates are on the rise, and inflation has reared its ugly head. Many of the recent tax law changes are temporary. The possibility of impeachment proceedings is growing in Washington, and many investors are increasingly concerned about a global trade war. Today's milestone could easily turn into a millstone around our necks.

On the positive side, economic growth is the strongest in years. Unemployment is the lowest in decades. Most of last year's tax law changes for businesses are permanent, and corporate earnings are soaring. Many leading economic indicators are still positive, and equity valuations don't look that expensive given real bond yields are less than 1% after inflation.

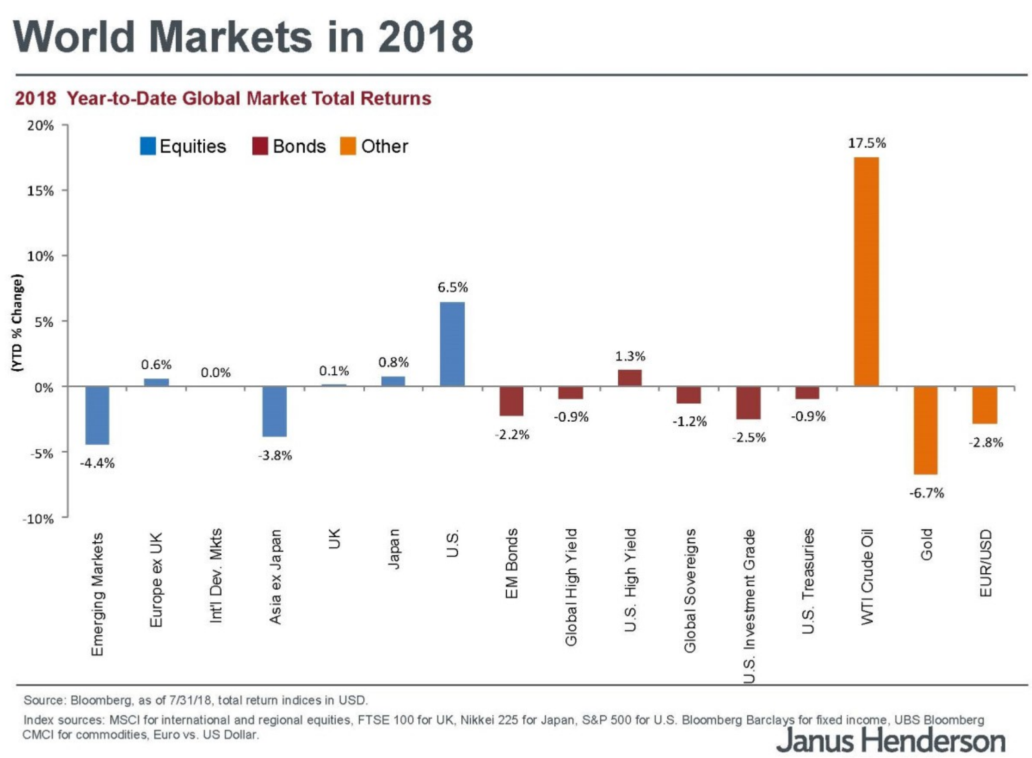
Acknowledging bull markets usually don't die due to old age, overvaluation, or political events, our view of the financial markets has become a bit more cautious since our last commentary at the beginning of the year.

If the Federal Reserve raises interest rates too far or the White House triggers a global trade war, we could definitely see a downturn. When the seeds of concern start sprouting in investors' minds, worries of a decline can easily turn into a self-fulfilling prophecy. Due to doubts and uncertainty, we suspect the larger global economic cycle might have already entered a maturing phase.

Uncertainty often yields volatility. The chart below shows how markets have been much more volatile in 2018 than in 2017.



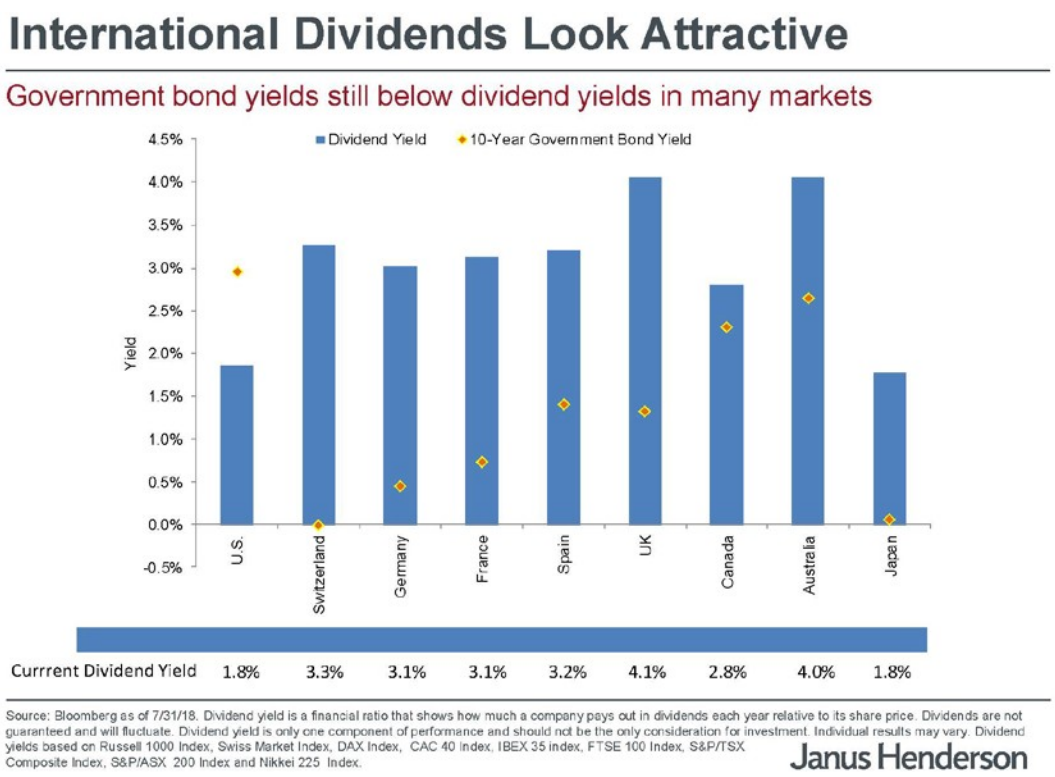
Despite the increased volatility, U.S. stocks have managed to perform relatively well this year. But almost all other investment categories have come under some degree of pricing pressure in 2018. Fixed-income returns have been negative for the most part due to rising interest rates, and many international equity markets have declined in value due to apprehensions of a global trade war.



Whereas U.S. stocks are near all-time highs, international stocks are actually in correction territory with an -11% decline year-to-date as measured by the MSCI EAFE Index. International equities have not been particularly rewarding for investors over the past 10 years. In fact, international stocks have underperformed their U.S. counterparts over the past 3, 5, and 10-year periods.

Some of this underperformance might be due to international economies lagging the U.S. by a couple of years. On a longer cyclical basis, U.S. and international markets often take turns outperforming, and sometimes the outperformance is dramatic and long-lasting. The S&P 500 has turned in strong gains over the past 10 years, outperforming the EAFE Index by 3.8% per year on an annualized basis.

International stocks currently enjoy more favorable valuations than U.S. stocks and also offer higher dividend yields. Moreover, contrary to the tightening monetary trends in the U.S., monetary conditions around the world are still very accommodative. Foreign stocks could be set up for a secular period of outperformance.



Our firm, staying true to a rebalancing strategy, has been taking profits in U.S. stocks and adding to international stocks in client portfolios (we try to maintain $1 in foreign equities for every $2 we hold in U.S. equities). Our rebalancing efforts haven’t helped portfolios so far this year, but eventually there should be a reversion to the mean, as what goes around comes around.

In addition to rotating into international equities, we have also been taking some profits in U.S. equities in order to add to fixed-income investments in most accounts. Bond yields (and even money market yields) have become more attractive this year, motivating us to add to bonds and lengthen average maturities at the margin.

Even if U.S. stocks are near a peak, our firm remains committed to building and maintaining well-diversified portfolios – each one designed for the specific needs, circumstances, time horizon, and risk tolerance of the client. Every account has a target asset allocation, with the portfolio spread across specific amounts of stocks, bonds, cash and other investments.

No one really knows when the current bull market will end. Even though this bull run is now the longest one on record, the bull market of the 1990s went up almost 100% higher, reaching a gain of 417%. While the uncertainties we're facing in 2018 seem to loom large, investors have been expressing concerns about the market every year since the New York Stock Exchange started in 1792.

Our firm's philosophy is to use the inevitable ups and downs in the market as an opportunity to rebalance client portfolios back to their target asset allocations. We believe this approach offers the best opportunity to buy low and sell high in a systematic manner, avoiding the pitfalls of market timing and instead using volatility to our advantage.

While proper portfolio construction and disciplined on-going management can't eliminate declines, adherence to sound investment principles can moderate risk and tackle downturns in a strategic manner. We believe this style of investing helps our clients weather the storms of an unpredictable world and stay focused on meeting long-term objectives.

Please contact us if you have questions about the investment game plan we have in place for you.