Portfolio Management, LLC

Building Wealth Wisely

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Party Like It's 1999

It doesn't get much better than this. From an investment perspective, 2017 comes close to being a perfect year. An improving economy, better earnings, and more business-friendly policies helped trigger a strong stock market rally. U.S. stocks, as measured by the S&P 500 Index, surged 19% in 2017 and delivered positive returns in every single month of the year for the first time in modern history. Stocks have also been up for 9 years in a row – the first such stretch since the period ending in 1999.

Also for the first time in many years, almost all readings of economic conditions appear favorable, and the world's major economies all seem to be on a synchronized path of growth.

- U.S. corporate earnings are strong, and the odds of a recession appear low.
- Unemployment has fallen to the lowest level since the Great Recession.
- Europe is stabilizing and starting to play catch-up with the rest of the world.
- U.S. stocks, while fully priced – if not stretched in value – continue to present opportunities as the economic recovery broadens.
- Emerging markets have performed well but still seem attractively priced.
- Interest rates in the U.S. are stable and likely to remain relatively low for longer.
- Restrained oil prices and a competitive business environment have kept inflation below trend lines.
- Dramatic tax reform in the U.S. has been a bonus kicker for financial markets.

S&P 500 Index 2017

Source: MacroTrends

Many investors already know the positives from last year, so our remaining comments will focus on future considerations. In a separate communication, we will update clients on some of the most important features of the recent sweeping tax law changes.

- U.S. and global growth should continue to improve during 2018.
- The rate of corporate earnings growth may slow but should sustain equity prices.
- Market volatility will likely climb, and market gains will be tougher to come by.
- The U.S. economy should benefit from the effects of tax cuts.
- New tax law provisions should boost business capital spending.
- Regulatory hindrances to business activity should continue to abate.
- Unemployment should continue falling.
- Tightening labor markets and rising wages will increase inflationary pressures.
- The Federal Reserve will continue to raise interest rates in a cautionary manner.
- International equity markets – which have more modest valuations – should outperform U.S. markets.

What Can Go Wrong?

Even though financial conditions are almost universally positive at this time, it's important to remind ourselves that investment markets have a habit of fluctuating in value – often unexpectedly. The stock market tends to experience a 10-15% correction every year or two, and stocks have suffered a bear market (a decline greater than 20%) every 4 or 5 years on average.

It has been almost nine years since we have experienced a bear market downturn, which is one of the longest expansions on record. It has been almost 2 years since we've experienced even a 5% dip, the longest stretch of low volatility in 20 years. When the next downturn comes, there might not be much of a buffer for stock prices due to current levels of optimism and valuation. We're not expecting the sky to fall, but our outlook for future gains has dimmed.

No matter how benign current conditions might seem, we must always be prepared to weather the next storm. We don't know for sure what the catalyst will be for the next decline – it could be a military confrontation with North Korea, a move towards greater trade protectionism, a spike in interest rates, fallout from a Bitcoin blowup, or a constitutional crisis in Washington. Of these risks, rising interest rates is perhaps the most worrisome.

Market corrections can come at any time, but bull markets usually don't die due to old age, overvaluation, or political events. Meaningful downturns are usually associated with economic recessions. Most recessions are caused by restrictive monetary policies put in place to fight inflation and economic imbalances. Most recessions are preceded by an inversion of the yield curve (when the 2-year Treasury yield is higher than the 10-year Treasury yield). Inflation has ticked up, but it remains relatively tame. The yield curve has flattened, but it remains positive.

Interest Rates and Inflation

If inflation escalates more than anticipated, financial markets face a whole new paradigm of risk. Fixed-income investors have enjoyed a secular bull market in bonds that has lasted over three decades. This exceptionally long-term trend dating back to the Reagan presidency could very well be reversed if the Federal Reserve raises interest rates too quickly or too high.

Many of today's investors have never experienced a bear market in bonds. During the four decades following WWII, yields on the 10-year Treasury Note increased from 2% in 1941 to 15% in 1981. During the 10 worst years of that bear market in bonds, the average bond lost over 2% a year in value. This annual loss might not seem like much, but bonds also lost value in real terms due to a 4.5% inflation rate during this stretch.

10 Year Treasury Rate

Recessions shaded in gray

Source: MacroTrends

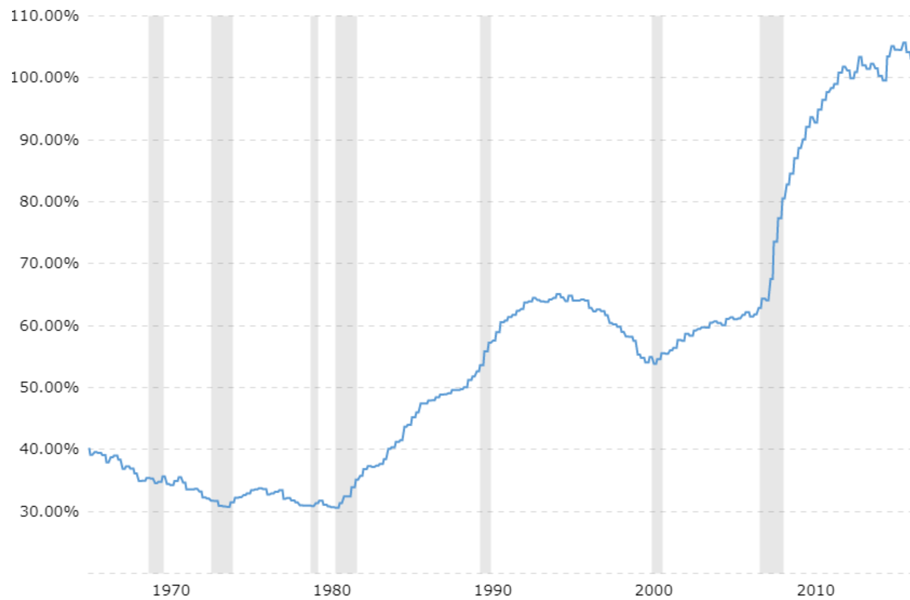
During this period in history, the net worth and purchasing power of many nest eggs were devastated. With many people now living to over age 90, bond market losses (which can easily become a permanent loss of capital) are more of a threat for many retirees than stock market losses (which tend to be shorter-lived).

Adding to long-term concerns is the growing level of U.S. national debt. The U.S. has not always been such a high debtor nation. Domestic government debt has grown substantially over the past 10 years. National debt more than doubled during President Obama's two terms

in office, and total government debt now exceeds 100% of our nation's gross domestic product. President Trump has shown minimal interest in taming the deficit.

Debt to GDP Ratio Historical Chart

Recessions shaded in gray



Source: MacroTrends

Only one other major developed country, Japan, has more debt than the U.S. as a ratio to GDP. High debt levels have resulted in stagnant growth for several decades in Japan. An aging society has contributed to Japan's secular slowdown, and our nation faces similar demographic challenges. Without reform of U.S. entitlement programs like Social Security, Medicare, and Medicaid, our economy could begin to mirror that of Japan's.

Game Plan

All of the aforementioned risks serve as reasons why we at Portfolio Management, LLC build and maintain well-diversified portfolios – each one designed for the specific needs, circumstances, time horizon, and risk tolerance of the client.

When the inevitable ups and downs in the market occur, we 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 uncertain world and stay focused on meeting long-term objectives.