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In Touch

a review for our valued clients and friends

A publication of Trent Capital Management, Inc.

Perspective and Outlook

Stock market volatility has led investors to search for ways to minimize fluctuations and protect capital. Given how calm 2017 was for markets, the recent volatility seems extreme, but is closer to historical norms than the previous year.

On average, one-day declines of 2% or more occur about five times per year, markets experience a decline of 10% or more once per year, and drawdowns of 30% or more occur every five years. Over the long-term, these declines are nullified by the general uptrend of equity markets, with the market rising roughly three out of every four years. Markets significantly outpace inflation over the long-term as well.

"A challenge for investors is avoiding knee-jerk decisions."

The challenge for investors is avoiding knee-jerk decisions based on short-term volatility. Studies continue to illustrate that excessive trading in a portfolio will generate poorer performance over time than a well-diversified portfolio using a buy-and-hold strategy. It is always wise to avoid making any investment decisions based on emotions or fear.

This advice is particularly timely, given that the Dow Jones Industrial Average, S&P 500, and NASDAQ Composite Index all recorded their worst performance for the second half of a year since 2008, with the NASDAQ actually dipping into bear market territory on an intraday basis.

Some analysts are concerned by recent movement in both the 3 and 5-year Treasury yields, thinking that they are a signal for a recession. However, this is probably a mistake. Recessions have often followed periods (with a lag) where the Fed funds rate was higher than the 10-year yield. Currently, the 10-year yield is about 70 basis points above the Fed funds rate and within the normal range.

A big reason why 10-year yields have remained below what would be considered normal is that the Fed has kept short-term rates close to zero. Longer-term bonds, such as the 10-year Treasury, reflect both current short-term rates and the forecasted path of rates in the future. With yields staying around zero for such a long period

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OUTSIDE THE BOX

The Fed

The media's recent narrative is to pin blame on Fed Chief Jerome Powell for heightened volatility in the markets. As markets sat near record highs in early October, Powell commented that "we're a long way from neutral." This remark came right after the Fed had bumped the federal funds rate up from 2% to 2.25%. Many inferred from this comment that the Fed would maintain its rate hike pace into 2019.

A market downturn followed. The new conventional wisdom says that the Fed drives everything. While entrepreneurship, profitability, lower taxes, and deregulation are the real major forces in the market.

Stock prices have always been about these, and less about the Fed. No one can predict corrections, and investors would be better served to focus on fundamentals rather than market timing.

Looking back, Powell's comments were not inappropriate. In September, data suggested a neutral rate of 3% for federal funds, which is about four rate increases from where it is now. As always, it is prudent to focus on fundamentals and not event-driven conclusions. The former reveals trends, while the latter is merely a distraction from what is important.

Trent Capital Management

A Disciplined Approach to Investing

Perspective and Outlook

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of time, longer-term yields were depressed as a result.

Even though the Fed has increased short-term rates by 200 basis points from where they were, many do not believe they will increase much more. In fact, some believe that artificially low rates are the only reason that the economy recovered from the Great Recession. These same people also tend to believe that more rate increases will tip the economy back into recession.

For those who believe that a recession rivaling the previous one is coming in the next decade, current 10-year Treasury yields make a lot of sense. However, it is more likely that the bond market is anticipating a much bleaker outlook than economic data would indicate.

The next recession, whenever it should come, is very unlikely to resemble the last one. The previous recession was fueled by grossly-overvalued home prices and mark-to-market accounting rules that generated a once-in-a-lifetime panic. With changes to mark-to-market rules and banks that are much better capitalized than they were a decade ago, another crisis-like scenario is very unlikely.

What is likely is a much softer recession, and even more likely is that one will not occur until at least 2021.

> "I have learned that peace is not the absence of trial, trouble, or torment but the presence of calm in the midst of them."
> - Don Meyer

TCM Digest

James Billingsley, *Economist*, January 4, 2018 … "Stocks have been unusually volatile in recent weeks. The S&P 500 was up or down more than 1% nine times in December, compared to only eight times in all of 2017."

Dan Weiner, *Adviser Research*, December 29, 2018 … "There is always going to be something to worry about. Want a list? Government shutdown. Tariffs. Brexit. White House investigations. Oil prices. Growing budget deficits. Growing national debt. Federal Reserve policy. Johnson & Johnson and asbestos. But history shows that in the long scheme of things, these short-term blips are footnotes to the wealth production that the stock market generates."

David Trent… "The 2008 financial crisis was a function of a massive housing debt bubble, derivatives tied to that debt, and a heavily over-leveraged global financial system; which ultimately took the entire global economy down with it. We don't see the extreme of excesses that had built up back then. Banks, according to the Federal Reserve and their stress tests, are much better capitalized and prepared this time around."

Market Commentary

INDEXES 1/1/2019 - 1/10/2019	
S&P 500 - Large Cap US Stocks	3.65%
MSCI EAFE - Foreign Stocks	3.95%
Barclay's Aggregate Bond Index	0.01%

There were many economic data points that surged ahead in 2018. Worker productivity, which is a catalyst to long-term growth and an increasing standard of living, was very strong. Wage growth accelerated due to falling unemployment. Household net worth rose while household net worth remained historically low. And for the first time in recorded American history, the number of open job postings exceeded the number of people seeking employment.

Earnings of S&P 500 companies collectively increased by more than 20%, driven by GDP growth and tax reform. In addition, cash dividends were at record levels.

Going forward, the major unknown remains trade policy. Fed decisions and the psychological impact of an aging bull market will affect investor decision-making as well. Negative investor sentiment usually leads to lower prices, which eventually reward disciplined, long-term investors. As Warren Buffet once wrote, "Fear is the foe of the faddist, but the friend of the fundamentalist."

Insight Spotlight

Bank Stability

Bank liquidity and capital have been at comfortable levels for quite some time (currently well above regulatory requirements). This is because regulators have taken significant action since 2008 to prevent another crisis. Since then, liquid assets in the banking system have increased by more than $3 trillion according to the Federal Reserve Board.

After it's June assessment, the Federal Reserve reported that over 30 major financial institutions, including banks such as JPMorgan, Citi, and Bank of America, have maintained capital levels above the minimum requirement for three years in a row.

The Trump administration is considering a rollback of some regulations, which creates the possibility that liquidity and capital levels could again be an issue in the future. However, these rollbacks would likely only apply to small and mid-size institutions, leaving current requirements in place for major institutions such as the ones above.

Questions or comments about our newsletter?
We want to hear from you! Call us at 501-868-7772

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IN TOUCH

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