The Quarterly Perspective

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ABOUT

Harman Wealth Management

At Harman Wealth Management, we provide private, advanced, independent planning and investment management to individuals, families, and institutional clients.

We value in-depth economic research, evidence-based investment methods, and rigorous risk management. We are committed to insightful, objective solutions, and always working solely for the best interest of our clients.

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When Unwelcomed Policy Unsettles Markets: Lessons from 1994

Trade and Fed policies troubling investors in the fourth quarter.

By the end of the third quarter, one would have likely found a fairly happy investor mood. Afterall, a market that swung through an early year correction had found its way back to a +10.5% return in the S&P 500 total return index.

Even in light of the heated rhetoric, the trade front had witnessed victories up until that point. A positive meeting with European leaders in July was followed by a new, improved trade agreement with Mexico and Canada.

Markets Disconnect from Fundamentals

Since that point, though, the overall mood has reversed. While somewhat normal October volatility was witnessed prior to the mid-term election, sentiment soured as trade tensions escalated with China. Additional discontent has been aimed at the Federal Reserve, following a path to lift interest rates even though inflation remains moderate.

All in all, its an odd turn for sentiment in the face of seemingly strong fundamentals. While the economic cycle is clearly long in its duration, plenty of signs show support for further growth.

Echoes of 1994?

Perplexed investors needing comfort can look to the similiarities between today and the events of 1994. Like today, the economy was demonstrating solid fundamentals across employment, manufacturing, and corporate earnings, yet the S&P 500 struggled to end the year up just +1.32%. So, what was going on?

Like today, a controversial, first-term president was intent on improving the U.S. economy. Under the mission, "We must compete, not retreat," President Clinton initiated a trade war with the then rising Asian power, Japan. At the time, the U.S. had grave concerns about the expanding trade deficit, obstruction to Japanese markets, as well as other unfair trade practices. President Clinton threatened tariffs repeatedly along the way in 1994, even threatening 100% tariffs on Japanese luxury auto imports.

At the same time, the Federal Reserve had taken an aggressive stance in lifting rates, initiating the first hiking cycle in over five years. The Fed progressed under criticsm, citing the economy's own strength as justification for its actions. Like today, market participants feared it was overdone when inflation remained at modest levels.

Eventually, both the Fed and President Clinton softened their stances, with each operation coming to a conclusion in early 1995. And, even though fundamental growth moderated from the year before, markets rallied as tensions eased.

Of course, today's situation, no matter how close it resembles 1994, is still unique in its own way. But, the lesson of 1994 is still no less poignant: what policy can take away, policy can also give back. Uncomfortable policy standoffs eventually come to a conclusion and markets can be very rewarding when they do.

Markets show recent turbulence, but the economy still has signs of strength.

+12.8% 2018 projected growth of the S&P 500 earnings.

3.5% 3rd Quarter GDP Growth

(Source: BEA)

2.4 Million Jobs Added in the last 12 Months.

(Source: BLS)

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Risk budgeting involves thinking about the downside potential of a fund category before chasing the upside return.

Considering the Risk Budget in a Late-Cycle Economy

A Multi-dimensional Look at Portfolio Risk

Too often, investors chase returns without being sensitive to the overall risk their portfolios carry. However, with the economy running deep into the existing expansion, it is important for investors to consider their overall risk.

Risk budgeting involves thinking about the downside potential of a fund category before chasing the upside return. It seeks to manage risk by both (1) moving stock exposures up and down as well as (2) choosing where to place those stock exposures.

So, while stock performance to the upside or downside is never guaranteed, history can shed light on some important patterns for how categories have responded under disstress in the past.

Since 1990, there have been **10** full episodes where the S&P 500 declined worse than -10%:

[1]represented by the Russell 2000 Index

[2]represented by the MSCI EAFE Index

THREE POTENTIAL WAYS TO REDUCE RISK IN A LATE STAGE ECONOMY

1. **Large Over Small.**
   In general, small cap stocks are considered a traditional diversifier in a portfolio. Under some situations, they have been able to deliver higher returns. Unfortunately, though, they have also consistently declined more during a downside market episode. Since 1990, there have been ten full episodes where the S&P 500 declined worse than -10%. In eight of those, the Russell 2000 index (representing U.S. small cap stocks) has declined more.

2. **U.S. Stocks over Foreign**.
   Foreign stocks have shown a troubling tendency to slide with U.S. stocks when suffering a downside episode. What's worse is that they tend to lose much more during those events. When represented by the MSCI EAFE index, foreign stocks have declined to worse levels in nine of last ten major episodes.

3. **High Quality Companies over Low.**
   Quality can be a fuzzy term. But, one way to judge a company's financial quality is by examining how much it has borrowed. Usually, during times of economic distress investors become worried about overborrowed companies as loan delinquencies and defaults increase. This can lead to both risky stocks and bonds getting sold off to uncomfortable levels.

...what may look like helpful risk diversification by name (small caps, foreign stocks, etc.), may not really help when you need it most.

When building durable portfolios for a risky environment, these important historical patterns can be invaluable. They point to some important truths. First, what may look like helpful risk diversification by name (small caps, foreign stocks, etc.), may not really help when you need it most. Secondly, proper risk budgeting should move well beyond the simple question of what percentage is allocated to stocks.

The Russell 2000 index is an index measuring the performance of approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.

The EAFE Index is a stock index that serves as a performance benchmark for the major international equity markets as represented by 21 major MSCI indices from Europe, Australia and the Far East.

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The silver lining to the modest inflation numbers is realizing this economy isn't following the old models. As a result, it may also call for a different policy playbook.

Where is the Inflation?

Late Cycle Characteristics but, Yet, Little Inflation.

One peculiar development supporting the argument that the economic expansion could go a lot longer is the absence of an old economic boogeyman: inflation. Conventional economic models suggest that by nine years into an expansion, high inflation should be a chronic economic challenge. Instead, the latest release of the Consumer Price Index shows inflation sitting at a modest 2.2% compared to prices a year ago.

So, why has inflation defied economic models. We look to three leading causes:

DEMOGRAPHIC SPENDING HABITS
According to the Kaiser Family Foundation, 30% of the U.S. population was older than age 55 in 2017. This is significant because spending growth tends to slow after age 55. A 2015 study by JP Morgan showed that peak spending belongs to households between age 45-49, but really starts to slow after age 55.

EMPLOYMENT COMPOSITION
One potential reason for modest inflation is the changing composition of the workforce, since we are seeing the massive exit of older, high paid boomers. Essentially, the transition to lower wage, newer employees is helping producers restructure their workforce and keep prices down.

SUPPLIERS OUTPACING DEMAND GROWTH
An economy running at full speed is supposed to stretch producers' ability to supply commodities and goods. However, we see a world where global suppliers seem to be running ahead of demand. A good example comes from oil production. New technologies are helping to find and extract new oil reserves at a faster rate than consumer demand.

IMPLICATIONS?
The silver lining to the modest inflation numbers is realizing this economy isn't following the old models. As a result, it may also call for a different policy playbook. If the recent resetting of oil prices remains in place, it could mean the Federal Reserve worries more about inflation being too low in 2019 rather than being too high. Furthermore, if investors were hoping for the Fed to cease their rate-hiking path, then the groundwork may already be laid.

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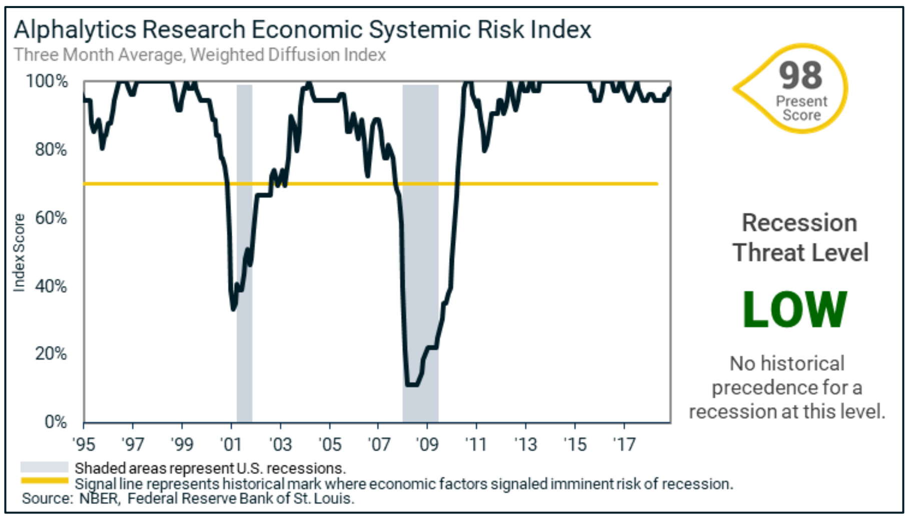
The economic fundamentals remain consistent with further historical growth. This includes lending, capital investment, manufacturing, and consumption.

Business Cycle Risk Profile

- The economic fundamentals remain consistent with further historical growth. This includes lending, capital investment, manufacturing and consumption.
- Manufacturing, assisted by the tax cut, has sustained high growth levels throughout 2018.
- The economy remains at "full employment" with the unemployment rate at 3.7%. Initial claims for unemployment insurance is at generational lows.
- Consumer loans have yet to show signs of distress. Delinquency rates remain at cyclical lows. Retail spending has remained at healthy growth rates.
- At its current level, the index value reflects no historical precedence for a recession.



Interpreting the Index Score:

- The index score measures nine economic factors that have demonstrated co-movement with the deteriorating conditions of the past seven recessions dating back to 1970.
- When the index score is at 100, it means all nine of the factors are measuring at levels consistent with past economic expansion.
- When the index score is below 100, it means that one or more of the weighted factors has moved to a level consistent with past economic contractions.
- In aggregate a score of 70 or higher is interpreted as a composite profile consistent with past economic expansion. A score lower than 70 is interpreted as a composite profile consistent with past economic contraction.
- Markets can, and sometimes do, demonstrate volatility even though the economic factors are measuring consistent with expansion.

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Interested in Adaptive Business Cycle Investing?

Today's markets, economies, and policies are more complex than ever, challenging investors on what to watch and when to take action.

At Harman Wealth Management, we understand sound investments are uniquely supported by the conditions that favor them. And, when conditions change, so do the investments that benefit.

That's why we conduct rigorous and disciplined tracking of the U.S. business cycle. We also track the cyclical factors that shape our investing environment, like currencies, commodities, and rates. We embrace a world where investing dynamics are constantly evolving and believe it's imperative to have an investment strategy that adapts with it.

With Adaptive Business Cycle Investing we invest consistent with business cycle forces, aligning investments with the conditions driving returns in the present, rather than chasing what worked in the past.

About Harman Wealth Management

At Harman Wealth Management, we provide private, advanced, independent planning and investment management to individuals, families, and institutional clients.

We value in-depth economic research, evidence-based investment methods, and rigorous risk management. We are committed to integrative advanced planning by aligning investment objectives with business cycle opportunities and risks.

At Harman Wealth Management, our aim is to help clients realize their goals within a disciplined, insightful, and rewarding relationship.

For more information about Harman Wealth Management or investing with the business cycle, contact us at 281-719-8601.

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In general, the bond market is volatile as prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. Bonds are also subject to other types of risks such as call, credit, liquidity, interest rate, and general market risks.

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