The Quarterly Perspective

Policy Takes the Lead

Trade optimism and Fed patience supporting the market recovery.

After a frantic fourth quarter sell-off, it seems investor sentiment has completely flipped. Since the market bottomed on December 24th, the S&P 500 index has finished up for nine of the last ten weeks. So, what's behind the sudden mood swing? We examine three develoments at the center of the market flip-flop.

The Federal Reserve

While the Fed was merely attempting to "normalize" interest rates, the market spoke loud and clear about the latest rate hike. Fearing the Fed had overreached and tightend too hard, the market sold off by another six percent after the announcement of another rate hike on December 19th.

The Fed changed course immediately in 2019. On January 4th, Fed Chairman Powell publicly anounced the Fed's intentions to pause. Instead of two expected rate hikes for 2019, the Fed could afford to be patient, while exercising flexiblity in their future policy course.

… Indeed, policy has responded so far in 2019. As markets move forward, our investment thesis will continue to monitor the key moves ahead for central banks.

The U.S.-China Trade Tug of War

The threat of a trade war sat heavy over markets for much of 2018. Instead of seeing a silver lining in the president's moves, the mainstream media stoked fears of protectionism, escalation and retaliation. But, to the contrary, negotations have taken a positive turn, and a near-term resolution is now expected. Best of all, the new agreement may include a boost to U.S. exports. This includes the Chinese agreeing to purchase more U.S. goods and removing tariffs on long-standing U.S. exports like autos.

Fundamentals Are Reinforcing Further Growth

On the first Friday of 2019, the BLS employment release showed new jobs grew by a resounding 312,000 jobs in December – a quick confirmation that fundamentals weren't as dire as the sell-off suggested. Since then, a stream of data supports a persistent and resilient level of growth in the U.S. Although not without some areas of concern, the economy continues to reveal solid growth in key areas like manufacturing and industrial production.

Making Sense of Markets

Over time, market investing can have very perplexing moments. Big moves don't always make sense. Investing isn't always easy and times like December can be the most difficult to navigate. However, we point to our supportive conclusion from the last *Quarterly Perspective*: "what policy can take away, policy can also give back."

Indeed, policy has responded so far in 2019. As markets move forward, our investment thesis will continue to monitor the key moves ahead for central banks. But, just as much, we focus on evolving fundamentals as our late-stage economy approaches its tenth year of expansion.

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Christopher Riggs leads portfolio strategy and research for Harman Wealth Management. He writes extensively about the economy and markets. His responsibilities include macroeconomic analysis, portfolio construction, and leading the HWM investment committee.

Along with the founder of Harman Wealth Management, Dean Harman, Riggs also heads Alphalytics Research, a subscription-based research service to investment professionals across the U.S. The service emphasizes rigorous and robust data analytics in the context of the U.S. business cycle.

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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Past Performance is No Guarantee of Future Results

Everyone loves climbing stock prices and long bull markets, but they aren't free of consequences.

For investors looking for high quality income, the late-stage can be an untimely moment for building income portfolios.

Four Classic Signs of a Late Stage Economy

Customary late cycle dynamics have emerged.

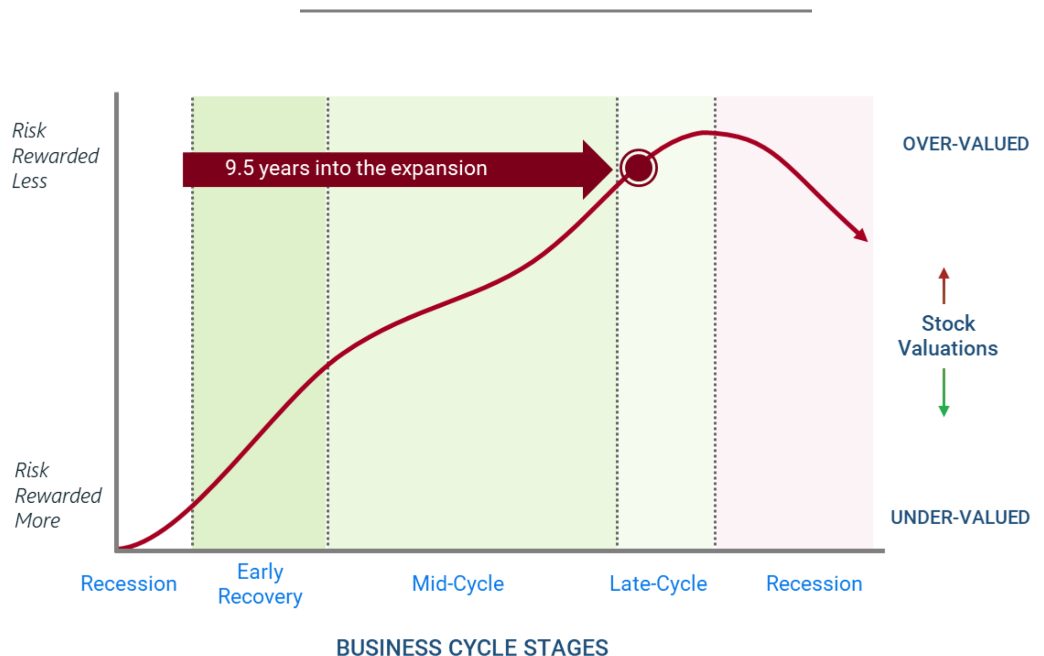
When examining the economy through the business cycle lens, investors can see how different stages of the economy carry common characteristics. This helps investors build a map of where things stand and potentially anticipate what's next. So, what are those signs typical of late-cycle expansions? Consider the following four:

1. **Full Employment**
   In November, the unemployment rate dropped to 3.7%, the lowest since 1969. While it sounds great, it is also symptomatic of an aging economic cycle. Adding new employees to the workforce is a resource for new growth, and unfortunately, the low unemployment rate shows the resources are closer to exhaustion.

2. **Peak Credit Conditions**
   What's peak lending look like? The conditions include high loan demand, easy borrowing standards, and low delinquency rates. This, of course, was all assisted by the tax cut of 2018. In fact, data from the Federal Reserve showed the delinquency rate across all loan types reaching the lowest point in more than thirty-two years.

3. **High Stock Markets Valuations**
   Everyone loves climbing stock prices and long bull markets, but they aren't free of consequences. One trade-off for high stock prices is lower relative dividends. For investors looking for high quality income, the late-stage can be an untimely moment for building income portfolios.

4. **Wage Inflation**
   Wage inflation is a natural by-product of a tight labor market. Whenever employers compete for workers, compensation starts to trend up. So far, the data has shown a moderate upward climb. Many economic forecasts expect wages to pull the overall inflation metrics up over the next year.



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Balancing Risks Beyond Our Borders

U.S. Growth Standing Out in a World of Slowing Growth

...slowing growth across the next five largest economies is becoming a major concern.

While the U.S. economy maintained momentum through the tax cut fueled- 2018, many global peers are not sharing in the same strength. In fact, slowing growth across the next five largest economies is becoming a major concern (see graph below).

Already, each region has looked to policy makers to initiate more stimulus in order to assist economic resilience. In early January, China made significant moves to enable more lending. Later in March, they reduced consumption taxes with plans to do more in 2019. Likewise, the European Union committed to keeping rates at low levels and resurrected its own lending stimulus program.

Nonetheless, in a global economy the problems of our peers can eventually bleed over to our shores and there are several ways it can happen.

- Slowing demand from our major partners could facilitate a slowdown in the U.S.
- Slowing overseas growth could impact U.S. companies with foreign-sourced revenues.
- A fear-driven market sell-off overseas could increase market volatility at home.

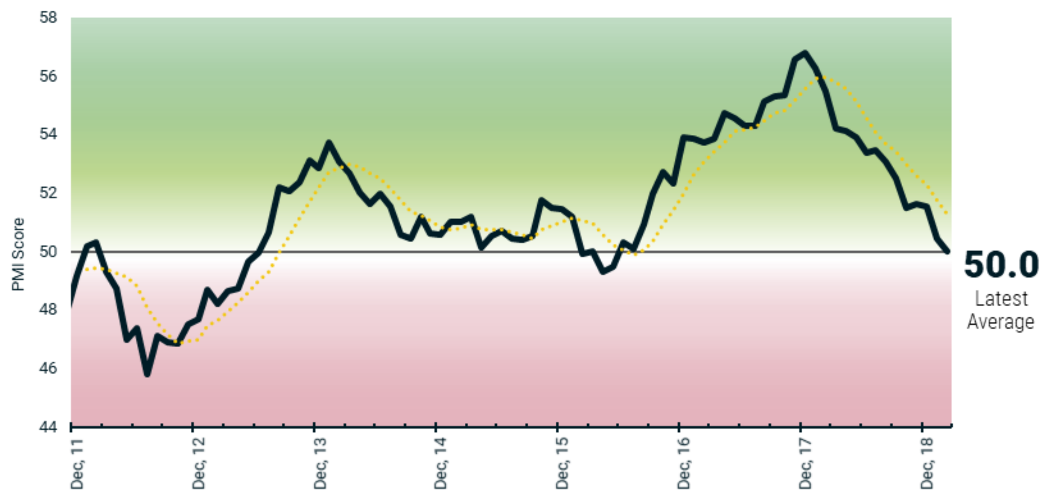
What's it Mean for Investors?

In a late-stage, aging expansion it is important to recognize the changing risk profile of economies and markets.

As the economic expansion surpasses ten years this summer, it is due time that investors reconsider their risk profile and avoid unnecessary risk.

At Harman Wealth Management, we've implemented processes to lessen portfolio risk in the Harman Wealth managed portfolios. This includes general moves like reducing overweights to equities, steering away from historically risky asset classes, and building allocations in safe haven assets like government treasury bonds.

Economic risk isn't the same over all periods of time. There is a strong case for investing differently in a late-cycle economy as compared to an early recovery. As the economic expansion surpasses ten years this summer, it is due time that investors reconsider their risk profile and avoid unnecessary risk.



*Averages the PMI scores of next five largest economies of the world after the U.S.: includes China, Japan, German, U.K. and France

Source: Markit Economics

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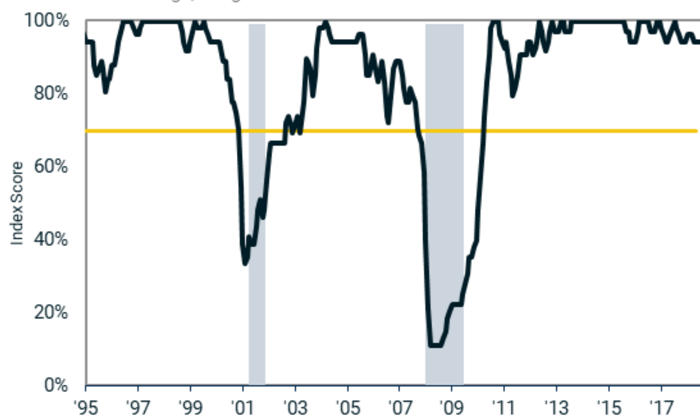
Economic fundamentals are consistent with further growth ahead. While many metrics from manufacturing, retail, and capital investment are slowing, they are still at a position of strength.

Business Cycle Risk Profile

- Economic fundamentals are consistent with further growth ahead. While many metrics from manufacturing, retail, and capital investment are slowing, they are still at a position of strength.
- The recent surge in job growth is an important sign of the expansion extending further. The economy is at full employment with the unemployment rate at 4.0%.
- After years of rising interest rates, housing appears to be set for slowing. Existing home sales is down -8.5% and banks are reporting lower demand for mortgages.
- While the U.S. economy remains strong, global growth is reaching concerning levels. China, Japan and several European countries have already crossed critical thresholds. As global demand weakens the effects of slower global growth will begin to make its way into the U.S.
- 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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Investing involves risk including the potential loss of principal. No investment strategy can guarantee a profit or protect against loss in periods of declining values. Past performance is no guarantee of future results. There is no guarantee that a diversified portfolio will outperform a non-diversified portfolio in any given market environment.

Please note that individual situations can vary. Therefore, the information presented here should only be relied upon when coordinated with individual professional advice.

The Standard and Poor's 500 is an unmanaged index generally representative of the U.S. stock market and cannot be invested in directly.

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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