The Quarterly Perspective

AUTHOR
Christopher Riggs, JD, CFP®

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 strategies, and always working solely for the best interest of our clients.

Markets Rise While the Economy Slows

Markets show attractive returns in 2019, but economy is slowing.

After markets delivered disappointing returns in 2018, investors are finding relief so far this year. As of June 20th, large caps stocks were re-establishing new all-time highs. At market close, the S&P 500 was up +19% while the NASDAQ composite had surpassed 21% on the year.

While surging stock prices are usually supported by a surging economy, it's cleary not the case this time around. Since the fourth quarter of 2018, economic growth has weakened, causing enough concern at the Federal Reserve to support a complete reversal in their policy stance.

The Slowing Trend Is In.

On a number of economic fronts, the metrics have clearly turned toward a softening. Critical areas of the economy, like construction spending, industrial production, and manufacturing, are all seeing growth numbers near cyclical lows. Surveys from the Fed reveal shrinking loan demand from both businesses and consumers. Additionally, employment, which had a been a strong factor for the economy, is now beginning to show signs of fading.

Compounding worries are the increasing tensions on the U.S.-China trade front. In May, after a breakdown in lengthy negotiations, an escalated 25% tariff was enforced upon $200 billion worth of Chinese imports. It is likely the elevated tariff will be extended to the remaining $300 billion of imports by the end of the year.

What Does it Mean for Investors?

While it is tempting to get drawn in by market momentum, it's moments like this where investors should be reminded of the big picture. So, here it is. As of July, the U.S. economic expansion will have reached the longest stretch of growth without a recession in history. Likewise, classic characteristics of a late-cycle economy are plentiful.

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While markets have risen in 2019, key economic factors are showing signs of slowing.

S&P 500 Total Return

19.1%

Year to Date through June 20th.

Total Construction

-1.2%

Growth Since Last Year.

Existing Home Sales

-4.4%

Growth Since Last Year.

Industrial Production: Durable Goods

-2.6%

Growth Since Last Year.

Source: All data as of April 2019 Stockcharts, Federal Reserve Bank of St. Louis.

CONTACT US

HARMAN
1735 Hughes Landing Boulevard
Suite 1250
The Woodlands, TX 77380
Phone: (281)719-8601

www.harmanwealth.com

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The truth of the matter is that efforts to maintain the economy in perpetual growth will push the economy toward exhaustion. Eventually, the pool of qualified labor will run dry and employment growth will slow. Eventually, credit limits will be reached and consumption spending will decline. And, eventually, in the face of waning growth, corporate profits will fall and workforce cuts will begin.

Time for Defensiveness

Take note, the Federal Reserve is preparing to do whatever it can to avoid the expansion coming to an end. In the June 19th post-meetng press conference, chairman Powell conveyed nine different times their desire to "sustain the expansion." Even if successful in re-directing the slowing trend back to reaccelerating growth, it is still only a matter of time before the economy will come face-to-face with the next recession. For this moment, every investor needs a plan.

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At Harman, our managed portfolios have already begun the process of adjusting toward a higher-risk future. In the first half of 2019, we trimmed overweights to equities while allocating to traditional safe haven assets like high quality bonds. Our neutral stance is prepared to manuever even more defensively if the economic metrics warrant such a move.

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U.S. Expansion Reaches Longest on Record. Now What?

Present stretch of growth ties the expansion of the 1990s.

As of June, the U.S. economic expansion reached the longest stretch of uninterrupted growth in history, tying the 10-year duration of the 1990s expansion. It's a moment worth recognizing. After all, the U.S. attained its lowest peacetime unemployment rate since World War II.

In spite of the cause for celebration, investors must not move forward with a naïve assumption that our present state will continue indefinitely.

Instead, we see clear late-stage characteristics developing. Historically, the next major step after the late stage is a recession. But, humbly, we must admit we truly don't know when it will occur.

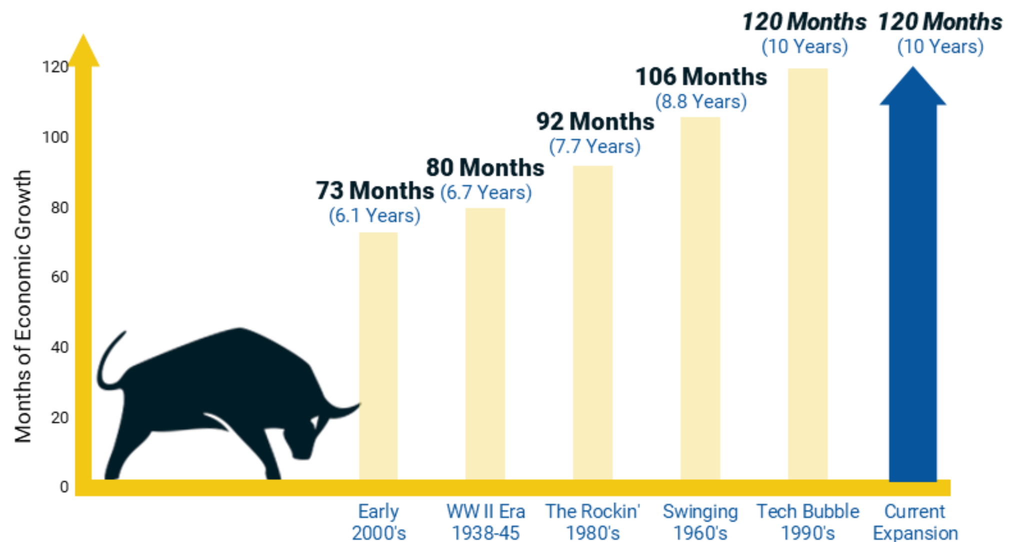
If current slowing trends continue then, of course, a recession may be upon us by early 2020. The reality, though, is that global central banks and policy makers are poised to act with major intervening policies in an attempt to re-stimulate growth and, yes, there is a chance it could be successful.

Nonetheless, here are three sobering truths investors must come to terms with.

1. **The Economy is Ripe with Late-stage Characteristics.**
Low unemployment rates, tight labor markets, loose lending standards, high consumer confidence… they sound wonderful, but historically they have also been classic signs of a maturing, late-stage economy.

2. **These Characteristics Have Been Followed by Recessions.**
Economic stages follow a pattern. From this point, the economy can either find a way to squeak out more growth or move toward exhaustion.

3. **The Timing of the Next Recession is Still Highly Uncertain.**
By no means is the course of the economy pre-determined. Just because the stretch of economic growth is long, doesn't mean it has to come to an end right away.



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A yield curve inversion occurs when longer term interest rates fall below shorter-term rates.

Interest Rates Flash an Important Warning Sign

Yield curve inversion shows for the first time since 2007.

While interest rates don't always make headlines, there is an important development gathering lots of attention as of late. It's called an "inverted yield curve." Most investors probably assume it's too technical for their interest. But, every investor ought to know the facts on what has happened and the record it upholds.

What is a "Yield Curve Inversion?"
It is generally assumed loans given out for longer duration terms should carry higher interest rates versus loans with shorter terms. Because it takes longer for the lender to receive all their money back, the loan is considered riskier. This 'term premium" on longer loans is the incentivizing benefit needed to keep loans flowing from lenders in normal economic growth periods.

A *yield curve inversion* occurs when longer term interest rates fall below shorter-term rates. The consequence is diminished incentives for banks to put money to work. In time, it is believed that inverted yield curves lead to the contraction of new loans needed to fuel economic growth.

...yield curve inversions were seen 8-24 months before each of the last seven recessions since 1970. There have been no false signals.

Why is the inversion getting so much attention?
To an economist, the yield curve inversion has a compelling record as a leading indicator in front of past recessions. In fact, yield curve inversions were seen 8-24 months before each of the last seven recessions since 1970. There have been no false signals.

Could this time be different for the yield curve inversion signal?
There seems to be a lot of commentators who want to believe the recent signal from the yield curve may not be as valid as the signals of the past. As evidence for their stance, they point to the interest rate suppression conducted by major global central banks. They argue interest rates aren't at natural and normal levels due to central banks (including the U.S. Federal Reserve) buying up trillions in government bonds since 2008.

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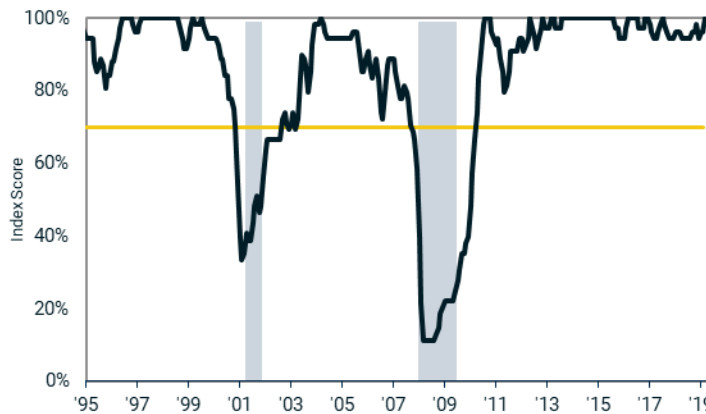
The present economic expansion has tied the longest duration expansion in history and will surpass the expansion of the 1990's as of July.

Business Cycle Risk Profile

- Economic fundamentals have been on a slowing trajectory thus far in 2019. U.S. manufacturing scores have reached their lowest point since 2016. Private residential construction is down -11.4% from last year and existing home sales are down -4.4% from a year ago.
- The present economic expansion has tied the longest duration expansion in history and will surpass the expansion of the 1990's as of July.
- Employment, which has been a source of economic strength, reached the lowest unemployment rate since 1969. However, employment growth is starting to show signs of slowing. The BLS jobs report recorded just 75k new jobs in May, down from 224k in April.
- The Economic Systemic Risk Index is measuring at a 100, with no historical precedence for a recession at the index's current level.
- A thorough review shows certain factors nearing their critical threshold levels. If current economic softening trends continue the profile of the Economic Systemic Risk Index could deteriorate in the coming quarters.



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.

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

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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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