The Quarterly Perspective

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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.

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Prepared for all Paths

Late-Stage Uncertainty Prevails as Federal Reserve Acts to Reverse Slower Growth.

By many standards, the economic players have all followed the script this year.

Late Stage Economy? .... Check.
Economic Slowdown? .... Check.
Federal Reserve Intervention? .... Check.
Economic Recovery and Market Liftoff? .. Well, not so fast.

After reaching its 10th full year of growth, the U.S. economy has indeed reached idealistic proportions.[1] Low unemployment and high productivity sound great, but they are also signs of diminishing capacity for further growth.

Unfortunately, the evidence points to U.S. growth softening significantly since December. Just recently, a measure from the ISM PMI report showed manufacturing new orders falling to the lowest levels since coming out of the last recession.[2]

The Fed Intervenes

As typical of other slowing periods, the Federal Reserve has responded right on cue. Earlier in September, the Fed lowered the base lending rate for the second time in three months. This comes as a complete reversal from expectations set in late 2018, whereby the Fed suggested the year would be on track for two rate hikes instead of two rate cuts.

So, with the Fed's latest easing move, the question now becomes, "what's next?"

It would be easy to buy into the mantra, "don't fight the Fed" and assume a healthy economic recovery will follow. However, history dictates a more cautious outlook. Since 1985, the Fed has embarked upon seven rate cut easing cycles. Four led to near-term economic recoveries, while three preceded recessions.

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What Does it Mean for Investors?

For the optimist, the economy may already be showing signs of a soft recovery. Housing has bounced off early year lows and retail sales have seen a similar pickup. Yet, for the realist, this bounce might be an example of squeezing the last remaining juice from the economic lemon. All expansions come to an end. Even if the economy receives a boost into 2020, it is still only a matter of time before markets stare down the next ensuing recession.

At Harman, we stand committed to following the fundamentals. Should economic growth improve and support markets into 2020, it will mean staying with markets. But, we also stand cautious. Quite simply, a full and complete business cycle includes both growth and contraction phases and a late stage economy is not the time for getting too risky.

Source:
[1] NBER.
[2] Institute of Supply Management. Sept. 3, 2019.

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Digging Deeper on the Inverted Yield Curve

Yes, interest rates can signal a recession, but what else do we need to know.

Since May, one of the most covered topics in the financial press is this interesting twist in interest rates known as a yield curve inversion. In the last Quarterly Perspective, we even shared the compelling record as a forecasting tool for economic recessions.

While the track record warrants attention, there are other notable aspects about the yield curve inversion investors should be aware of. Here are three to consider:

1. An Inversion is Not a Signal for Exiting Stocks.
Although an inversion operates as a reliable indicator for future recessions, it is not necessarily a dependable sign of when to exit stock markets. For instance, when the yield curve inverted prior to the 2008 recession, the S&P 500 total return index returned +22.3% before peaking more than a year later. Likewise, the S&P 500 climbed over +19.5% before topping out in front of the 1990 recession.[1]

2. The InversionTypically Unwinds Before a Recession.
Because the Fed responds to slower growth by lowering short-term rates, it is quite normal for the inverted yield curve to unwind and return to a more normalized shape. In fact, over the last three recessions, the yield curve has "un-inverted" an average of seven months in front of the coming recession.[2]

3. An Inverted Yield Curve is Still a Valid Risk Signal.
Many would assume that when interest rates "un-invert" and normalize prior to a recession, then the threat of recession has been turned off. However, the record doesn't show that's true. Instead, in each of the last three inversions, a recession has reliably followed. The conclusion is that inversions are more than just disconnected signals but potentially causal to the very recession that follows.

The Yield Curve Inversion

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

Historical Record as a Leading Recession Signal:

7 for **7**

With no false signals.
(since 1968)

Range of Lead Times as a Pre-Recession Signal:

8-24 months

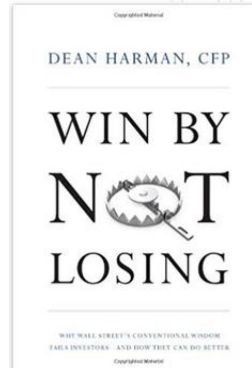
Source:
[1] StockCharts.com
[2] Federal Reserve of St. Louis

Time to Revisit "Win By Not Losing"

Six Years Since the Book's Release, Author Dean Harman Shares His Thoughts.

In 2013, Harman completed *Win By Not Losing*: Why Wall Streets Conventional Wisdom Fails Investors...And How They Can Do Better. Six years later, we pause to ask Dean his thoughts on the ideas expressed in the book.

What compelled you to write *Win by Not Losing*?



Dean Harman: After the carnage of 2008 and the second major drawdown in a decade, many investors were desperately searching for solutions. Unfortunately, the industry's ideas always revolved around adding some new missing asset class. But, these seemed to either painfully lag in bull markets or not offer the much-needed protection during severe pullbacks.

In simple terms, the right answer for some investors is to move out of the way when you identify a risk.

I believed the approach was misguided. Instead, what was needed was a better understanding of risk and how portfolio strategies could adapt to changing economies. In simple terms, the right answer for some investors is to move out of the way when you identify a risk.

How has this been put to work since you wrote the book?
Our team goes through a rigorous process to identify and quantify various risk. We examine things like political risk, currency risk, commodity risk, as well as fundamental growth and interest rate risk. When we detect a specific risk, we trim or avoid asset classes with too much exposure.

You can see this in the way our Harman portfolio strategies have been run. In the last six years, our clients haven't had any dedicated holdings to foreign stocks nor energy stocks through the portfolios. This was due to the inherent currency risk these asset classes possess. As it has turned out, these general asset classes have severely lagged core U.S. stocks.

So, are you against buy and hold investing, altogether?
Absolutely not. As a firm, we try to bring the best of the "buy and hold" approach to our strategies. We choose categories with high conviction, attempt to hold them over years (not months) and aim to weather through market volatility without reacting emotionally.

By methodically adapting the portfolios as the economics change, we aim to avoid the big losers. This alone can offer desirable trade-offs for investors.

But traditional "buy and hold" does have its limitations. Rather than holding everything, we attempt to rotate to investment categories with fundamental support and avoid those that lag. By methodically adapting the portfolios as the economics change, we aim to avoid the big losers. This alone can offer desirable trade-offs for investors.

It's been 10 years without a major pullback like those of 2008 and 2001. Are the ideas in *Win By Not Losing* still relevant?
The simple fact that we have experienced a very long ten-year bull market makes the *Win By Not Losing* approach more relevant than ever. We are facing the prospect that an economic recession could be on the horizon. Furthermore, the average peak-to-trough decline for U.S. large cap stocks over the last seven recessions is -36%. While a recession may not be here yet, many investors should be concerned about having a plan in place when it does finally arrive.

For a free copy of Win By Not Losing or a discussion about how we put it to work, contact us at (281)719-8601 or info@harmanwealth.com

Increasing loan demand, and a lack of distress in lending could mean consumers have more capacity to spend and grow demand. Which in turn provides the precedence of a soft economic recovery going into 2020, but nothing is certain just yet.

Business Cycle Risk Profile

- The U.S. economy is experiencing a slowing growth trend that started in the fourth quarter of 2018. Manufacturing and construction figures are at multi-year lows.
- The Economic Systemic Risk Index recorded an 86 for August. While there is no precedence of a recession at this level, there are reliable metrics revealing the risk of recession is rising.
- The Federal Reserve has started lowering interest rates to re-stimulate growth. There is a real chance of consumer spending picking back up. Already home sales and retail spending have improved since earlier in 2019
- Should consumer activity respond to falling interest rates, the U.S. could see a soft recovery in 2020. If so, the risk of recession for 2020 may be delayed and pushed further into the future.
- The economy is at high productivity and full employment; however, historically this has been sustained for only small lengths of time. Ultimately, a long duration expansion is losing capacity to fuel ongoing growth.

Alphalytics Research Economic Systemic Risk Index

Three Month Average, Weighted Diffusion Index

Shaded areas represent U.S. recessions.
Signal line represents historical mark where economic factors signaled imminent risk of recession.
Source: NBER, Federal Reserve Bank of St. Louis.

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.

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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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Disclosures:

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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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