The Quarterly Perspective

WRITTEN BY:

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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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Maintaining Perspective in a Fed-fueled Market Rally

After three interest rate cuts from the Federal Reserve in 2019, investors turned bullish while the economy stalled toward uncomfortable lows

Following a late year stock market tantrum in 2018, the Federal Reserve changed course by delivering three rate cuts in 2019. Market investors didn't just like it, they appeared to love it.

U.S. large cap stocks (as measured by the S&P 500 Total Return Index) finished the year up +31.5%, the second best calendar year return of the last two decades. In contrast, though, economic categories like manufacturing, consumer goods production, and capital expenditures finished the year at concerning lows.

Considering the big disconnect between market highs and fundamental lows, its time to take inventory with where we stand. So, after such a year, let's pause…take a deep breath….clear your head, and get a reality check on what is taking place.

> *Going forward, risk management will take a more prominent role for investor success than in the strong bull market of the past decade.*

It is Still Late in the Economic Cycle.

A booming year in the stock market feels great, but it doesn't change the certain facts:

- the economy is still in the longest economic expansion on record,
- labor markets are still tight,
- lending capacity only has so much more room left; and lastly,
- long economic cycles do come to an end.

We presume the Fed's actions have extended the expansion out further, but the market surge is not a free pass to lose sight of risk management.

Excesses are Building.

Markets may appear subdued and inflation may be tame, but valuations and leverage are not. As with prior long expansions, meaureable excesses are building within the system.

Market-based P/E ratios are at their second highest level on record. Likewise, the proportion of corporate debt compared to U.S. GDP is also at extremes. Disturbingly, we are back to a time when "no down payment" mortgages are being advertised.

A Recovery Built on Consumer Spending and Debt

So far, the strongest response to rate cuts seem to be on consumer spending. From the lows of last year, the pace of retail spending and home sales have picked up significantly. No doubt, this is an encouraging development for 2020; however, there is an unsettling side of the story. Debt-based spending has limits, and when consumers get "maxed out", there may be little left to fuel a quick recovery in the next expansion.

So, What's it Mean for Investors?

History shows these extremes eventually get corrected. It may not be here yet, but the economic climate warrants a vigilant lookout for when the economy turns.

Going forward, risk management will take a more promiment role for investor success than in the strong bull market of the past decade. At Harman, we continue to prepare for the future changes and having greater risk management tools ready for when when the time demands.

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Checking in on the Business Cycle

The current U.S. expansion has now reached ten and half years and stands as the longest in U.S. history.

- Economic expansions do not operate on set intervals and don't just expire as if on a clock. Instead, expansions end when aggregate conditions deteriorate enough to tip the economy into a negative reinforcing loop.
- Even though the current expansion is the longest, it does not have to end soon. Under the right conditions, economic activity could carry it for more years ahead.
- The Federal Reserve is committed to sustaining the expansion. They appear willing to lower rates even further in 2020 if the fundamentals don't improve soon.
- Prior to 1960, the average length of economic expansion was just over three years. Since 1980, though, the average length of expansions has lasted nearly eight years.

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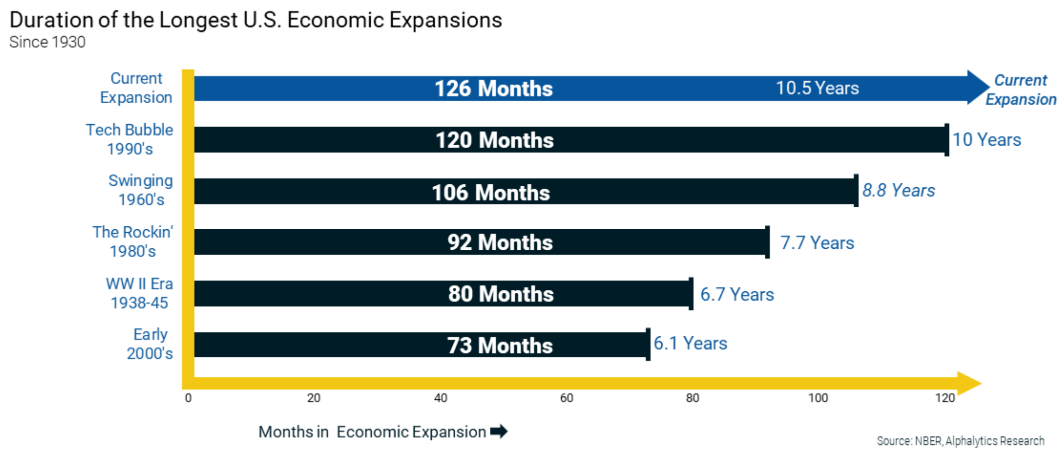
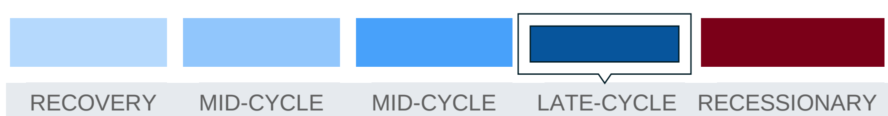
Chart 1



Staging the Cycle

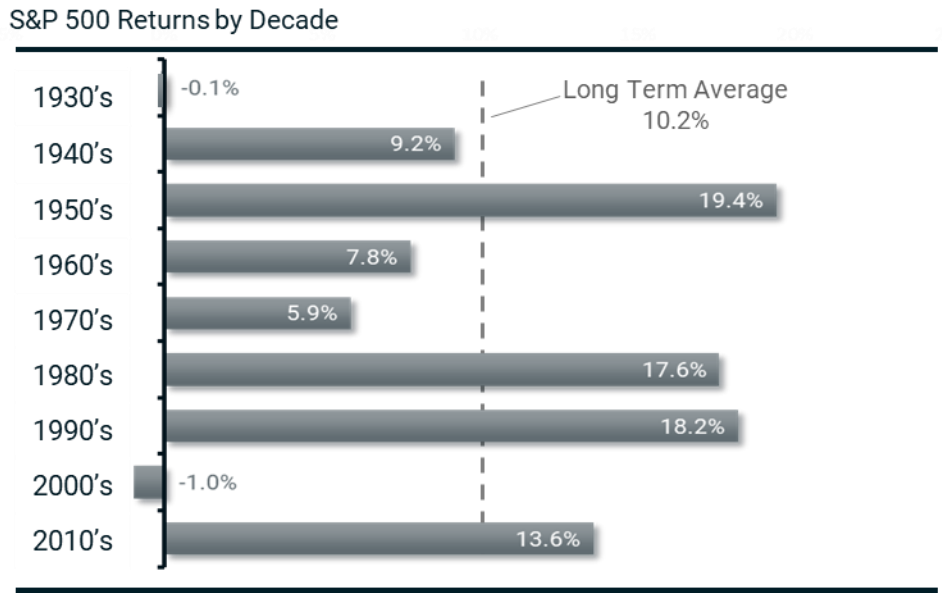


Historically, this was the fourth best performing decade for large cap stocks when compared with the last nine decades.

The 2010's: A Decade of U.S. Large Cap Leadership

The ending surge of 2019 not only closed out a terrific year for U.S. stocks, it also closed out a very strong decade. All in all, the S&P 500 index finished the teens with an attractive return of 13.6% per year. Historically, this was the fourth best performing decade for large cap stocks when compared with the last nine decades (see Chart 2 below).

Chart 2



Source: Global Financial Data

In spite of an assumption that riskier stocks regularly produce more return, the S&P 500 beat out U.S. small caps, foreign developed stocks, and emerging market stocks for the decade.

Outpacing Its Peers

Not only did domestic large cap stocks produce a strong decade, it actually outperformed many of its riskier peers. In spite of an assumption that riskier stocks regularly produce more return, the S&P 500 beat out U.S. small caps, foreign developed stocks, and emerging market stocks for the decade.

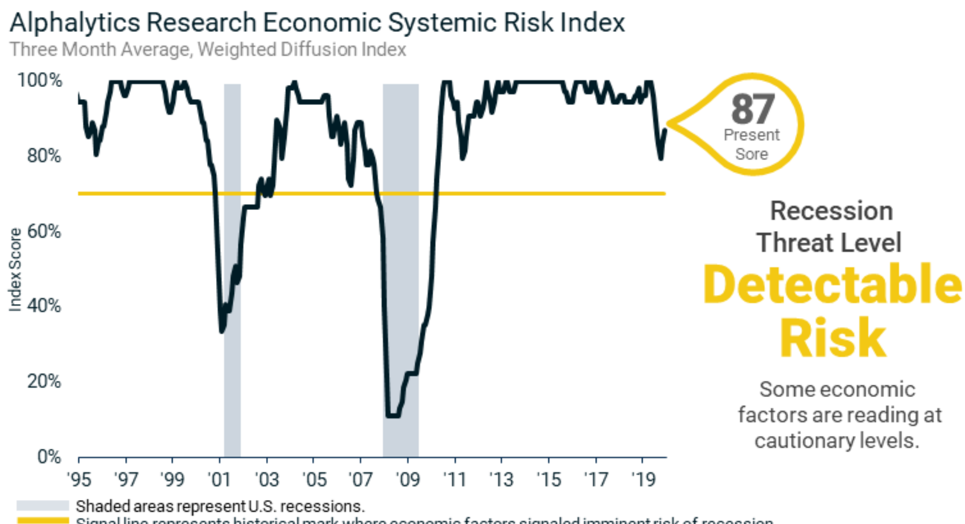
Chart 3

Sources: S&P Dow Jones Indices, FTSE Russell, MSCI

The U.S. economy continues to see a slowing growth trend that started in the fourth quarter of 2018. Core manufacturing remains the highest concern with current levels are at their lowest since recovering from the last recession.

Business Cycle Risk Profile

- Even though the score at 87 is lower than in previous years, it is still consistent with persistent economic growth. At its current level, the index value reflects no historical precedence for a recession.
- The U.S. economy continues to see a slowing growth trend that started in the fourth quarter of 2018. Core manufacturing remains the highest concern with current levels are at their lowest since recovering from the last recession.
- As expected, the fourth quarter of 2019 saw both a decline and rebound in the score. The auto workers strike led to a temporary interuption of industrial production in October.
- Late-cycle choppiness can be normal in the ESRI score. Concerning economic signals can be met with countervailing policy measures from the Federal Reserve.
- Resurgent numbers in housing and retail provide reason for optimism. While the rate cuts may have an overall lagging effect, activity in consumer spending is picking up.



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.

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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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