How to Handle a More Volatile Market?

"Everyone Has a Plan Until They Get Punched in the Mouth" – ***Mike Tyson***

We often hear that bull markets do not die of old age, but there is 100% certainty that this one too will end at some point. The current bull market is one of the longest on record, in terms of total return and duration (*see chart on the right)*. Now is a great time for all of us to think about risk and how we will handle a more volatile market. It is natural for all investors to reach for a little more in good markets and be a little too conservative once values have already fallen. Importantly, the economy is doing quite well, and corporations are increasing their revenues and profits significantly. The tax cuts implemented by Congress have been extraordinary to both public and private companies clearing the way for a booming economy. Typically the final phase of a bull market has very strong returns in a short period of time, which we are still expecting over the next 12-18 months. **To be clear, we are not forecasting another financial crisis and to the contrary, we are still positive in the short term.** While we are bullish in the short term, we remain cognizant of where we are in the cycle and are preparing for what a bear market may bring. Having a plan in place beforehand helps control emotions and we believe ultimately leads to better investment decisions.

Bull markets		
Bull begin date	Bull return	Duration (months)
Jul 1926	152%	37
Mar 1935	129%	23
Apr 1942	158%	49
Oct 1960	39%	13
Oct 1962	103%	73
May 1970	74%	31
Mar 1978	62%	32
Aug 1982	229%	60
Oct 1990	417%	113
Oct 2002	101%	60
Mar 2009	302%	111
-	160%	55

A Look Back

The 2nd quarter showed a nice rebound in both US stocks (+3.43%) and international stocks (+3.47%). However, bonds remained flat and Emerging Markets continued to decline (-3.51%) on tariff fears. The market has been dominated by the performance of a handful of stocks, including Amazon (+45%) and Netflix (+104%). If you take Amazon out of the performance, the S&P 500 would have been negative for the first half of the year. This year has a lot of similarities to 2015, when the FAANG stocks (Facebook, Amazon, Apple, Netflix & Google) provided nearly all of the gains in the market.

Tariffs

No one really knows what the ultimate result of the recent trade war will be, but one thing is for sure, policy uncertainty is at an all-time high and the effects of the uncertainty are already being felt. The industrial sector, which was one of the strongest performing sectors post Trump election, has retraced more than 100% of its gains. This was due in large part to the increase in the price of steel, up over 40% for the year. Each week earnings calls are filled with companies outlining the impact of tariffs on profit forecasts, their business, and the consumer:

- GM: Could be forced to cut US jobs if tariffs are applied to imported vehicles and auto parts
- Volvo: Cars will cost more as trade war escalates
- Tyson Foods: We will face to day to day uncertainty in delivering products and services

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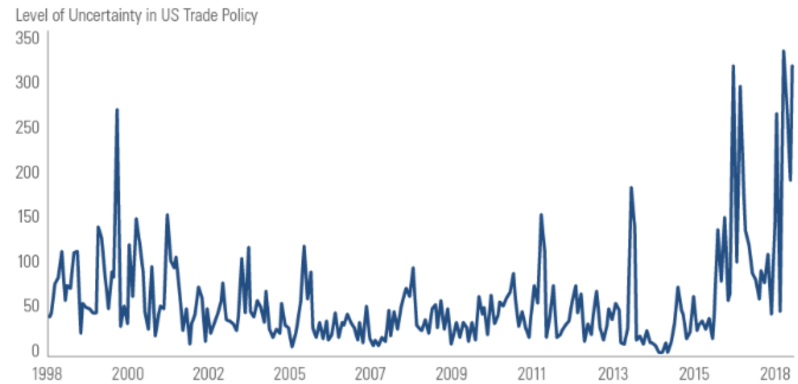
- Harley-Davidson: Moving production overseas, sees EU tariff costing $100 million annually
- Brown-Forman: Raising Jack Daniels prices

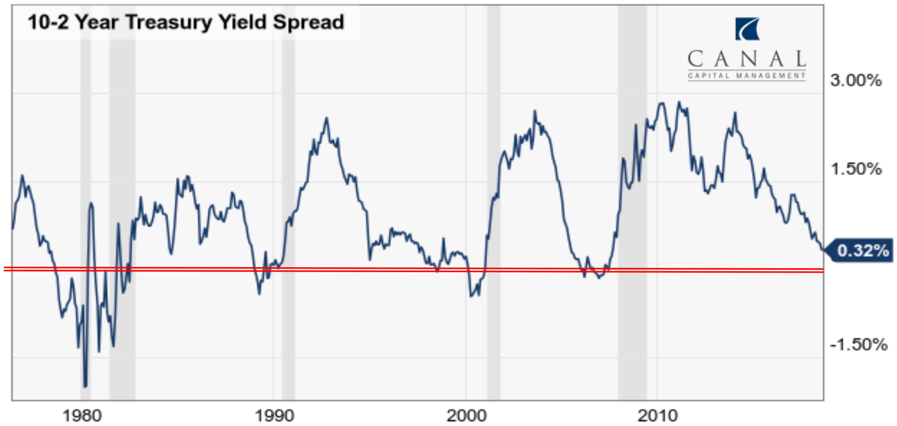
Regardless if you believe this trade war is warranted, it is no doubt influencing the markets in the short term. In the recent Bank of America Merrill Lynch Global Fund Manager Survey, a Trade War was listed as the biggest risk to the market with over 60% of the respondents. That's up from just over 30% a month ago. Without any sort of resolution in site, expect the uncertainty to stay, companies to continually outline the potentially negative impacts to their top and bottom lines on earnings calls, and the markets to respond erratically.



Source: PolicyUncertainty.com and GSAM. As of July 18, 2018.

The Most Important Chart?

Investors are always in search of the perfect signal for market tops and recessions. Nothing is perfect, but there is one indicator that has called every significant market top over the past 40 years. This indicator is the difference in long term interest rates (10 years) and short term interest rates (2 years). Each time the difference in the 10Yr & 2Yr, or the "spread", goes below zero ("negative") there has been a recession following at some point in the next 6-18 months. Intuitively, this makes sense, the Federal Reserve controls short term rates but the market controls longer term rates. This is telling us the Fed is seeing too much strength, but the longer-term prospects might not be so rosy. Today, the spread is 0.32% and steadily approaching zero, the lowest it has been since before the Financial Crisis. Again, no indicator is perfect, but this is certainly one worth watching closely.



Recessions Indicated in Dark Gray. Red Line is Zero Line or Inverted Spread.

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First and foremost, we want to point out that no one can predict future performance. What we do know is that there are both business cycles and market cycles and nothing moves in a straight line forever. Below are some of the ways to reduce volatility and protect assets.

- *Diversify* – There is only one free lunch in investing and that is diversification. This is our number one goal. However, there is a such thing as too much diversification, so we are careful to diversify, but not to "de-worsify".
- *Reduce Risk* – The federal reserve has now increased its target rate 7 times since the end of 2015. The current rate stands at 2%. Although this means higher borrowing costs for consumers, it is great news for investors. There are now more attractive investment choices for investors outside of stocks, which include certain bonds and bank loans.
- *Hedge* – There are a number of ways to hedge risk in a portfolio. We are exploring a number of alternatives with a focus on cost and timing.
- *Don't Panic!* – Most importantly, do not panic. We have been through large drops twice over the past 20 years and although not always enjoyable, market dislocations present many opportunities to make money over the longer term.

Thanks for reading and as always, please don't hesitate to contact us with any changes to your personal situation.

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