Palmetto Wealth Management

Feelin’ Groovy

John M. Gustafson – 31 March 2019

Slowdown, you move too fast
You got to make the morning last
Just kicking down the cobblestones
Looking for fun and feelin’ groovy

What a difference a couple of months can make. As the great Simon & Garfunkel sang, the first quarter of 2019 couldn’t be more positive and uplifting compared to the end of 2018. (At least in terms of the US stock market.)

China and potentially significant tariffs still linger overhead as a drag on the global economy, but Trump needs a clear "win” and seems willing to slightly moderate his rhetoric near term. Something unlikely to continue if negotiations drag on, but for right now everyone seems to be playing nice.

The tariffs have weighed on the global economy, moving the Federal Reserve from a tightening posture into wait & see mode. However, all the kvetching about a looming recession – at least in America – is wildly premature.

There’s pretty much no chance of seeing GDP growth near its peak last summer, but positive growth, even if it’s significantly slower, isn’t “recession.” There will come a time when things get tough again – it’s just not staring us in the eye at the moment.

Also, point of order… This isn't "the oldest bull market" that many in the media continue to rail about. The old guard requires a "close" at down 20% to finish it off. (We reached just shy of 19% on a closing basis.) However, the AI machines clearly disagree.

All you need to do is look back at the spectacularly horrible Christmas Eve trading day and what occurred only a few days later. The US markets hit the 20% “bear market” level on an intraday basis from the peak reached at the beginning of October and almost immediately reversed course violently. That episode clearly satisfied the algorithms driving so much of the volatility and daily trading volume. (roughly 70%)

Our rebalancing that put a chunk of cash on the sidelines in early October made sense then and does now. Even though our economy remains on solid footing, the near-term risks now are really no different than they were back then. And the fact that we can still earn a decently positive return on very short term / cash assets is a good stabilizer for the portfolios. Especially as the yield curve remains flat.

Going forward, the trade war with China remains the most significant risk in the short and longer term. The potential for explosive rhetoric coming from Washington remains completely unpredictable. It is likely that things get solved within the next quarter but it is equally plausible that the solution isn't agreed-upon before another Twitter tantrum sends the markets reeling.

One thing I'm willing to bet on is that President Xi isn't going to come to America for a flashy signing ceremony unless the actual agreement is already set in stone with full detail agreed upon. The way the summit with North Korea was abruptly cut short in an embarrassing fashion didn't go unnoticed in Beijing.

The general dysfunction inside the Beltway is also something that will continue to cause problems for American businesses. With the Fed on hold at what are still historically low rates and very favorable tax policies in place, it's still difficult to plan long-term while both sides of the political aisle give speeches making it sound as if they live in two different countries.

Combine that with the fact the Democrats are climbing into the presidential clown car the same way the Republicans did back in 2015, there isn't much chance anything reasonable is passed into law. Including things that both sides probably agree on more than disagree, such as prescription drug pricing, the new NAFTA deal, and infrastructure spending – which is always a favorite way to shovel locally popular pork into political districts. (And truly something America's bridges and highways could use.)

We remain, as I wrote about several years ago, a country whose representatives in government believe that a 65% win is politically a 100% loss. It's something that's been growing for the past decade - thus making predictions of government activity (in our case as they relate to the economy and markets) almost impossible. Reason has left the process…

In that vein and because of all the incredible volatility we've experienced in the past few months, we are currently running a model update to look at our core allocation and where the current risk may lie. Risk as it relates to investments is fine as long as the potential reward matches up properly. That is the type of analysis we're doing right now – just to make sure our current core portfolio is in line with our worldview / expectations and can help mitigate the incredible volatility that, in our belief, will only continue.

The big economic headline that has caught everyone's attention in the past couple of weeks is the aforementioned flattening yield curve. This, similar to what constitutes a bear market, can be somewhat open to interpretation. Some economists say it's a three-month T-bill versus a 10 year bond, yet others say it's a two-year bond versus the 10 year bond – in either case currently it is very flat but not yet inverted. Meaning there is little rate increase as you add years to your maturity.

Inversion of the yield curve is relied on by some as an absolute predictor of a coming recession. In reality the statistics seem to say this indicator reveals an increased chance of recession in the next two years – not the next quarter. This isn't to say it's not something to keep an eye on; it is definitely a blinking caution light. However, it's not a reason to immediately alter portfolios and completely change one's economic outlook. Merely another statistic or indicator we stir into our bubbling stew.

With our current wall of worry solidly built let's focus a minute on what is working. Even with a global slowdown caused by political and trade related factors, America remains the shining economic star of the world.

The tax cuts repatriated billions in corporate dollars and even though those are not being spent currently on long-term planning and projects, they are still dribbling out to investors via dividends and share buybacks. Not as stimulative as "shovel ready" projects and something that concentrates wealth more into the hands of the currently wealthy, it does put the money into our economy rather than a foreign one.

Even with all our political dysfunction the British are trying their best to ruin their economy via the incredibly sloppy Brexit process. One more factor removing the UK from the list of potential "safe havens" and keeping us at the top.

All this has been a long way of saying that volatility is probably here to stay and will continue to be politically driven in the short term. A China deal will get done with great pomp and circumstance from the White House but just as with the "new NAFTA" I don't expect there to be significant difference in terms of how things functioned prior to this fight. And barring any significant terrorism or other violent global shocks the US economy should continue to plod along on a positive course, no differently than it has for the past 8 to 10 years.

Thank you as always for your business. Reach out with any questions or needs.

Cheers!