NEWSLETTER - FALL 2018

Current Environment – beginning October

By the beginning of October some clients were lulled to sleep feeling more comfortable about the economic and investment landscape. This is understandable since we are well into the into the second longest bull market in history, and recovery from the bottom of the financial crisis in March of 2009. Surprisingly, last year marked 10 years since Lehman Bros filed the largest bankruptcy in U.S. history. Since that time, the continued bull market along with never-ending distractions in Washington D.C., have shielded investors from paying attention to underlying economic and investment risk. This newsletter will touch on these risks.

Although it is not uncommon to be put to sleep by the economic side of things (prior to the past few weeks), **history suggests that it is not time to chase investment returns.** Now may be a time to become more cautious with an eye on quality. As referenced before, it is more important to manage downside risk than remain foolishly optimistic on the upside from an investment perspective, even if this means lagging some of the major indices such as the S&P at times. Rather than delve into the numbers, please click here to read an article from First Eagle which provides a wider viewpoint than just the past 9 years. The average client will live for 25 years in retirement and this is a sound reminder that investors must have a much larger time horizon than just recent “bull market memory.” Put simply, long term means lifetime.

Mid-October

(By the time this newsletter was finalized, investors awoke from the lull as the market took a nosedive on multiple occasions in October.)

Part 1 – What are the Problems on the Horizon?

The mentality remains consistent in Washington D.C., “Kick the can down the road.” The tax relief is projected to add $1.4 trillion to the federal deficit over the next four years. While the reform has fueled the economy, it leaves us scratching our heads as to what the future holds. Over and over again, fiscal irresponsibility continues to be commonplace in all branches of the government, and on both sides. Our main concern is the national debt that has grown from $8 trillion in 2007 to $21 trillion today. 1 The reality is that we “bought our way” out the financial crisis only to be left with a mountain of debt which is the real elephant in the room economically long-term. It continues to defy logic that it is not being addressed. As noted in the last newsletter, Europe Japan and China are swimming in a similar swamp of government debt, leaving a dark mess of political uncertainty and increased populism and divide. No one knows how this will ultimately play out, but it is clear that it must become a catastrophic emergency before it will be addressed from a fiscal perspective. Regardless, whether by financial crisis, higher interest rates, or severed spending on public investment, this massive pile of debt will be a drag on economic growth at some point. *We just don’t know when.*

Interest rates have gone up. This leads to a myriad of concerns. Think of the homebuyer seeking a mortgage, students borrowing at higher rates (compounding the existing problem), anyone looking for a personal loan, credit card defaults etc. For 18 months we at SF have been more cautious (perhaps too cautious). Although the math doesn’t add up, the continued emotional investment exuberance (prior to

October) could just be beginning. It is very, very difficult to know ***"when this tide will flow out only to discover who is truly swimming naked,"*** as Warren Buffett likes to say. This recent pullback could even be a precursor to an even greater increase in the US Stock market. No one knows. That was not a typo. I was reminded recently that the largest run ups in market manias typically happen…at the very end of their run ups. The Pre-Great Depression bull market, the Japanese market in late 80s, and the tech bubble of the late 90s all saw a tripling or quadrupling of value in the very late stages over just a few years.

But I mention this because similarly, the downside (possibly what is beginning to occur right now) is normally more ferocious on the back end of that same euphoria. The impact is sometimes insurmountable as seen in these cases:

- Great Depression - it took 26 years to get back to pre-depression highs
- NASDAQ / Tech bubble - it took 14 years to get back to the pre-Tech bubble high
- In the case of Japan…well…they are still 40% below the high they reached back in December of 1989. To put that into perspective Urkel was starring on ABC and the Detroit Pistons "Bad-Boys" were winning NBA championships. We were actually dismantling nuclear weapons and promoting democracy. The Berlin Wall was falling and there was no talk of putting up walls. I digress. The bottom line is that was a long, long time ago and only a small percentage of you were retired at that stage.2

Part 2 – Late October

The market became extremely unstable in October and not since 2015 have we seen this kind of volatility. Since you are likely to get this in conjunction with your monthly statements you will likely see large losses for October:(3)

- S&P 500 -7%
- Dow Jones -5.1%
- Nasdaq -9.2%
  (Mstar)

In terms of a potential bear market, two indicators that could forecast whether this recent pullback is a sign of true bear, or just a normal correction: ***earnings*** and ***inflation***. Company earnings *have* been phenomenal, but this is due in large part to the corporate tax reform. Moving forward could be a very different story and if future earnings are at or below expectations, look out! There has been virtually no inflation until recently. If the tariffs do go through and US companies are allowed more pricing power, a swing upward in costs could occur domestically. (4)

Either way, the direction of the market is unknown. In the case of your portfolios ***we do know one crucial element***. We know that they are built for the long haul, and times like these. During euphoric periods, ours may even lag a bit. That is ok, as long as they are keeping up with the benchmarks relative to risk. It comes down to being the tortoise versus the hare because it is ultimately a lifetime marathon.

Midterm Elections

Most of us are experts on politics. Just kidding. However, from an economic perspective there is ZERO math to support a political stance left or right. That's right. None. Nada. But the stock market, much like Clark Griswold, does not like surprises. So, if **both** the House and Senate flip Democratic, then you could see a negative reaction in the market today. If just the House flips, you could see a short-term positive reaction, as expected.

Closing Comment

An interesting statistic from a recent conference coincides with the snippet about Japan in Part 1. Japan's major economic struggle is an extremely aging population and low fertility rate, which the U.S. is starting to deal with as well. One secret to the American economy over the course of history is "having babies." The average American woman now gives birth to 1.7 children over her lifetime which has decreased to the lowest level in 30 years. The number historically needs to be more than 2 kids in order to sustain our current GDP and economic growth moving forward. Much of that extra productivity gained over the years in addition to babies, came from *immigration.*

Similarly, in closing, I highly recommend a fascinating Wall Street Journal article entitled "Building Bridges Across the Generational Divide." It touches on the quality of life of the elderly and the importance and for the elderly to feel needed by the next generation, as well as their desire to educate and nurture them. At the same time, the younger generation desires to be nurtured. Studies show that they are good for each other and that listening and learning is exponentially rewarding to both sides. (5)

"Of all the things that divide us, the gap between young and old is arguably the most bridgeable. Connecting across generations is not only pragmatic, it's an essential part of the human experience and a key to the cycle of life."

Thank you for trusting in us and making our job uniquely special. Happy Early Thanksgiving.

Back to work…

Corey and Dan

P.S.) Dan will be out most of November on a trip with his wife, Pam. It is business as usual here although we are understandably getting some phone calls about the market. Always ask a question if you have one. We are here to listen…

SOURCES:

1 USdebtclock.org
2 Morningstar Office
3 Bloomberg Robert Shiller September 30, 2018
4 Goldman Sachs
5 WSJ November 1, 2018, "Building Bridges Across the Generational Divide"

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