BERKSHIRE MONEY MANAGEMENT

*The Knowledge and Experience to Build Your Wealth*

Monday, June 19, 2018

# BERKSHIRE MONEY MANAGEMENT

**2018 Mid-Year Outlook**

In our 2018 Outlook, we made the case for gains and growth, but highlighted our concern for what we expected to be the biggest correction we had seen in a couple of years. We weren't afraid of deteriorating fundamentals, but the contrarians in us were not comfortable with extremely high levels of optimism built on the back of the longest rally on record without a 3% correction. Those overbought conditions have been relieved somewhat, though not enough for us to ignore other concerns.

Since we came out of the financial crisis investor optimism has climbed higher from unimaginable depths. Investors were left so shaken that even small drops in the stock market were accompanied by large drops in optimism and fear was renewed. But ***by early 2018 investors had come to know euphoria again and fear had all but faded from memory. Then a quick ten percent drop in stock prices pushed investors, briefly, into an extreme pessimistic zone. While pessimism was high enough, it wasn't high enough long enough to flash an all clear signal.***

***Not only did we not get pessimistic enough long enough, but the breadth thrusts typical from the bottom of a correction did not materialize.*** Not that breath is all bad, not at all. But there are mixed messages to be received from stock price action. The negative side of that mixed message is the absence of what we call 9-to-1 Up Days, where 90% of the volume and 90% of the price movement are to the upside. ***To be sure, those types of breadth thrusts aren't prerequisites to a new rally. After 10% corrections within bull markets, only half of the subsequent rallies have had similar breadth thrusts. However, the gains have been shorter and weaker when breadth thrusts have not occurred. So until we get a breadth thrust, the market remains vulnerable to additional retests of the February lows. That price pattern would happen to fit nicely into mid-term seasonality.***

Let's review some of the predictions we made in the 2018 Outlook.

We had predicted US GDP would approach 3% in 2018. Last quarter it hit 2.3%. We'll have the advance estimate on this, the second quarter, on July 27th from the Bureau of Economic Analysis. But right now both the Atlanta and St. Louis Federal Reserve banks are predicting 4.8%. The Federal Reserve Bank of NY predicts 3%. Our prediction for 2018 remains the same since we took the cowards' way out and put in the caveat "approach" 3% - we see annualized growth very good for 2018, but not over 3%.

We had predicted that inflation would creep up to 2.4%. The US Consumer Price Index, or CPI, has been about 2.4% year-over-year in 2018 (a low of 2.1% and a more recent high of 2.7%). (I tend to use CPI for purposes of discussion because it's mostly what everyone is familiar with. The more important measure, and the one I use for investment consideration is the Federal Reserve Bank's preferred measure of inflation, which is the core personal consumption expenditures, or PCE, which is running below the Fed's 2% target – which means the Fed can still take it's time in raising rates, if it wanted to).

We had predicted that unemployment would go below 4%.  Its current rate is at 3.8%.

We predicted that the stock market would be up about 4.7% in 2018, with the clarification that "give or take a half dozen months of starting and finishing dates…"  That's not a cop-out, just an admission that it's folly to try and match a precise number and a precise date.  For 2018, the S&P 500 is already at 4%. The Dow Industrials is at 1.5%.

***We had predicted the market would correct by 7% in the first quarter. It corrected by 10% (close enough).  We predicted that the market then would rally 20% from that low. And that's really what we're writing about today.*** Everything else seemed to work out fine in our predictions. Are we still predicting a 20% rise?  So far the S&P 500 has only rallied about 8% from the correction bottom.  ***Can it rally another 12% before we see any big trouble***?  ***I'm thinking yes***.  By "big trouble" I mean anything other than the ordinary garden-variety correction.  And by "I think" I mean I stacked up a list of pros and cons for the expectation of a continued rally and the weight of the evidence determined statistical confidence in an affirmative answer.

I don't like saying that.  Being positive is so…consensus.  I like warning you when corrections are coming. Not that I'm a doomsdayer, but it's easy to say that the market will go up. Everybody says that. And when they're wrong they can have some convenient reason why it didn't go that way, like "it happens". Yeah, it does happen. But I like to try and figure out when it will happen so that 1) I can figure out at what pace and when to get deposited cash to work (or not), and 2) to help you get mentally and emotionally ready for it (well, let's be honest about it, to get myself ready, too).

On that 2nd reason, I was elated that at the depths of correction earlier this year clients were wiring in money to get invested right away. Instead of freaking out our clients were jumping in. If your friends and neighbors say they were doing the same thing, tell them to go Google the term "retroactive prescience", because there is no way they are smarter than you. That's not pandering to you.  That would be cheap.  I do think it is good teamwork where we help our clients understand risks and rewards, even those of a short-term nature, so that we can focus on your financial plan.

But I digress.

Yes, ***the market is going to keep on rallying***.  I'll tell you why.  ***I'll tell you the positive forces that tilt the odds solidly in that favor***. I'll also tell you about the things that are negatives.  Big negatives. Big enough where I'll keep watching them for you to determine if we need to change our minds.

And minds can be changed quickly. For example, just last week the Federal Open Market Committee raised the federal funds rate, as expected, by 25 basis points.  Their press conference afterwards pointed to stronger than expected growth in the US economy.  The consensus for 2018 was three rate hikes. I had thought there was a good chance of the consensus being wrong and only getting two hikes. The odds are such now that I am confident I will be wrong and we could actually see four. That means a stronger US dollar.  The very next day, after the US granted concessions to the Chinese company ZTE and had diplomatic discussions with North Korea, the tariff conversation was advanced further.  Both a stronger US dollar and protectionism are great for some parts of your portfolio, but it also means that we don't want an overweight position in, say, emerging markets.  (An important note to consider, from the discussed tariffs we don't expect any substantial impact on aggregate measures of consumer prices and will likely shave 0.1 percentage points off of US GDP. But it does deter flow of cash to investments and that lack of buying suppresses prices.)

The point is that it's never all clear. We are going to invest your portfolio as if we are going to get through this correction. And, by the way, ***we are still in a correction. The rally has not yet resumed; we are merely expecting it to.***

**The positives**

So without much further ado, here's why I'm getting bullish:

- Long-term uptrend channels never broke down. For more than a bullet point synopsis on this, check out the May 18th article Resolution on the Horizon. https://berkshiremm.com/resolution-on-the-horizon/
- Small-caps, often seen as a leading indicator, have made a new high.
- Underlying breadth (the amount of stocks participating in an indices' rally) has been solid. Advance-Decline lines for the NYSE, NASDAQ, and smaller capitalization indices suggest price gains are being supported by a continued expansion of market breadth.
- Earnings growth has been stupendous. Tax cuts and solid economic growth have prolonged the earnings recovery that began in early 2016. From 12/31/2017 to 3/15/2018 consensus estimates for 2018 earnings for S&P 500 companies jumped from 145.36 to $156.45. Since then, it has gone up to $157.30***. Valuations for the S&P 500 are now roughly back to where they were prior to the 2016 Presidential election, from whence the index embarked on an incredible, invulnerable rally.***
- Domestic economic growth continues to look good, including employment growth. And there are ***no signs of recession***. Much of my job is figuring out when the next recession is coming. ***Right now I am expecting a recession sometime between 2020 and 2022.***
- Housing is ok. That's not a raging endorsement, I know. It depends on what segment (selling or building) and what region you're talking about. But on a whole, things look good. In the Northeast, for example, sales are gangbusters up to $500,000, but building only picks up at about the seven figure range. That's something we're watching closely as I am concerned about when rising mortgage rates will hurt housing.
- Inflation, at least inflation as measured by the Fed's preferred metric, the PCE, is under control. If you're at the grocery store you might not care about the PCE when you're buying beef, eggs, or avocados. But when it comes to the Fed's decision to raise the federal funds rate and affect mortgage and other lending rates, it will matter to you.
- Inflation isn't completely under control. You read that right. Well, it's a poor use of quasi-hyperbole, but I wanted to show some contrast to the last bullet point. Inflation needs to stay low enough to not poke the proverbial Fed bear. But it has to rise at a rate that allows pricing power by sellers (good for corporate profits) as well as nudges consumers to buy now as opposed to later. We're about at that sweet spot right now.
- Small business sentiment is through the roof. We survey 4,000 local business owners quarterly for our Berkshire Business Confidence Index https://berkshiremm.com/berkshire-business-confidence-index-issue-5/ and the local confidence numbers have matched other regional and national surveys. Small businesses are largely past the concerns of red tape and taxes and onto higher-class problems such as competition and not being able to find enough workers for their

thriving businesses. The answer to those high-class problems has been increased capital expenditures.

- ***Stocks are unfazed by interest rate hikes.*** By now you can tell that I'm concerned about interest rates. I think they'll play a big role in that recession we're expecting between 2020 and 2022. From a historical perspective, I probably should relax. The ten year treasury is under 3% as I write this. In the past the 10-year Treasury yield had to get to 5-6% to become a problem for the stock market. But I'm worried because the 10-year Treasury has been so far below 5% for so long (eleven years) that, quite possibly, 4% will be the new 5%. I cannot find mathematical data to support my emotional concern. But it doesn't hurt to keep a close eye on this. For now, ***we're focused on the pace of any interest rate increases more than the level of interest rates. When yields have risen quickly, the stock market has struggled, but the Fed has proven to be patient enough for the stock market.*** I am probably overly concerned about 4% being the new 5%, but it costs me nothing to worry and to watch. Those less concerned than me remind us that from the late 1960s to the early 1990s, stock prices and bond yields were inversely correlated as higher rates implied higher inflation and monetary tightening to the detriment of stocks. However, since the late 1990s, stock prices and bond yields have been positively correlated as deflation has been a bigger concern, so higher interest rates have been considered a bullish sign of stronger economic growth.
- For all the talk of an inverted yield curve, it doesn't (yet) exist. A yield curve is inverted when long-term rates are lower than short-term rates and is widely seen as a strong predictor of a recession as it suggests the long-term outlook is poor. ***However, the current level of the curve (between 50 and 100 basis points) has actually seen the S&P 500 have a positive occurrence over the next 12-months 89.2% of the time. The average return has been 11.1%*** (pretty close to that additional 12% return we need to get my 20% rally).
- Investor sentiment has dipped from nearly euphoric at the beginning of the year to something more sober (contrarians like myself prefer blood in the streets, so to speak, but we'll take optimism over euphoria).

**The Negatives**

I have often said that a smart person can argue either side of an argument. If I wanted to I could paint a picture about how the world, and your portfolio, is going to fall apart. Actually, I construct those scenarios on a regular basis. It's my job to whip garbage up against your portfolio and see if garbage attracts garbage, or if your portfolio is made of Teflon. I don't like that part of my job. It's not very human of anybody to try to upset their own narrative, to pick apart their own hypothesis. I don't like it, because I'm good at it. I build your portfolio to withstand a bomb blast. But it can't. It just can't. If that bomb comes, in the form of a recession or a financial crisis or whatever, then our portfolios are going to get bruised up. So instead I have to build them as bomb proof as possible (diversification, tax efficiency, liquidity, low-cost, etc.) and play a Ronald Reaganesque-style Star Wars game and watch for those incoming ballistic missiles. Following is a list of those missiles we're watching for.

- We're still in a stock market correction. I'm looking ahead, identifying the odds of success of a rally that breaks us out of this correction. But the S&P 500 is still about 5% from breaking out of this current correction. And then we have to stay out.
- ***The June-September period has historically been the worst time of the year for stocks from a seasonal perspective, and this seasonal weakness is even more amplified during mid-term***

***election years. This may delay a breakout to get us out of the correction, which makes stock prices vulnerable***.

- Small capitalization stocks. BMM made a lot of money in them in our first few years of business. But it hasn't been until the last few years that we've gotten back into them. And they're getting expensive. Debt is cheap, but for these companies it's still high versus operating earnings.
- Reversion to the mean. Fortunately we've tilted heavier than market-weight in technology stocks and that has paid off. We've, unfortunately, only been neutral-weight on Consumer Discretionary stocks, which have also performed very well. Both sectors have lifted the markets higher. There are no indicators of a slowdown in either sector, but at some point mean reversion comes into play and that will flatten, if not falter, broader stock market returns. The Technology sector's weighting in the S&P 500 is approaching that of the tech bubble of the late 1990s (valuations are much improved, of course), and the Consumer Discretionary sector's weighting is at its highest in sixteen years.
- Financial stocks are well valued, are performing very well from an operational and earnings standpoint, and have the tailwind of reduced regulation. However, they have been flat this year. We're overweight Financials so that's not exciting. But the bigger concern is that it's the 2nd biggest sector of the S&P so you do need participation from this sector for the market as a whole to rally strongly.
- The Fed is raising rates and long-term yields are rising (See above in "Stocks are unfazed by interest rate hikes").
- TINA to TINAA. For close to a decade post-crisis, interest rates were so low that investors took cash out of money market funds because they paid virtually nothing and put it into bonds and stocks (at least the broader market was paying a couple percent in dividends). The acronym to explain that shift was TINA, There Is No Alternative (i.e. if an investor wanted returns they had to move from cash to equities or bonds). Now, its' TINAA, There Is Now An Alternative. For example, there is money market fund we use through Charles Schwab that as of 6/16/18 had a 7-day yield of 1.96%.
- You get knocked out by the punch you don't see. Now that I've listed my concerns, who cares? It's never the known that surprises you, it's the unknown. If our investments are going to be truly hurt to the point where it affects your financial plan, it's probably going to be by something we haven't yet added to this list (not that this is the complete list). (See the paragraph directly under "The Negatives" to read more about how we test for this.)

<u>**Bottom Line**</u>: We got the correction we had expected and now we're looking for evidence of a 20% rally from the bottom of that correction, bringing the S&P 500 to about 3,100 points, or a 12% advance from here.

There are lots of reasons to expect failure, such as rising interest rates, seasonal resistance, and the fact that we're still in a stock market correction are primary reasons. But the weight of the evidence tilts toward more upside. That evidence includes working off investor optimism (good for contrarians), strong earnings have made stock prices more fairly valued, and increased competition among small businesses spurring capital expenditures.

We expect stock market to challenge the May 3rd lows with weakness from today through September with a pullback from current levels of 2.5% to 5.5%, likely challenging investor confidence at times, but with the outcome being a rally at the end of 2018 and into 2019.

Let's not play the game of guessing where the stock market will be on some precise, arbitrary day (ex. December 31). But the evidence makes me comfortable in expecting a 12% return in the next 15-months. That's a monthly gain of 0.8%, which exceeds the historical average of less than 0.6%. I'll take it.

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