BERKSHIRE MONEY MANAGEMENT
The Knowledge and Experience to Build Your Wealth

December 19, 2018

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2019 Outlook

What You Need to Know in Sixty Seconds

- A recession is coming, but it won't start any sooner than 2020.
- US GDP should increase solidly over 2% in 2019 as we continue to benefit from fiscal stimulus.
- The weakness of the equity markets in Q4 2018 will continue into 1H of 2019.
- The S&P 500 will return double-digits in 2019, challenging the highs of 2018.
- The 10-year Treasury will move above 2018 highs, to about 3.3%.
- The Fed will hike the federal funds rate twice in 2019.
- Inflation, as measure be the CPI, will rise from its current 12-month change of 2.2% by about a half-percentage point.

Economics

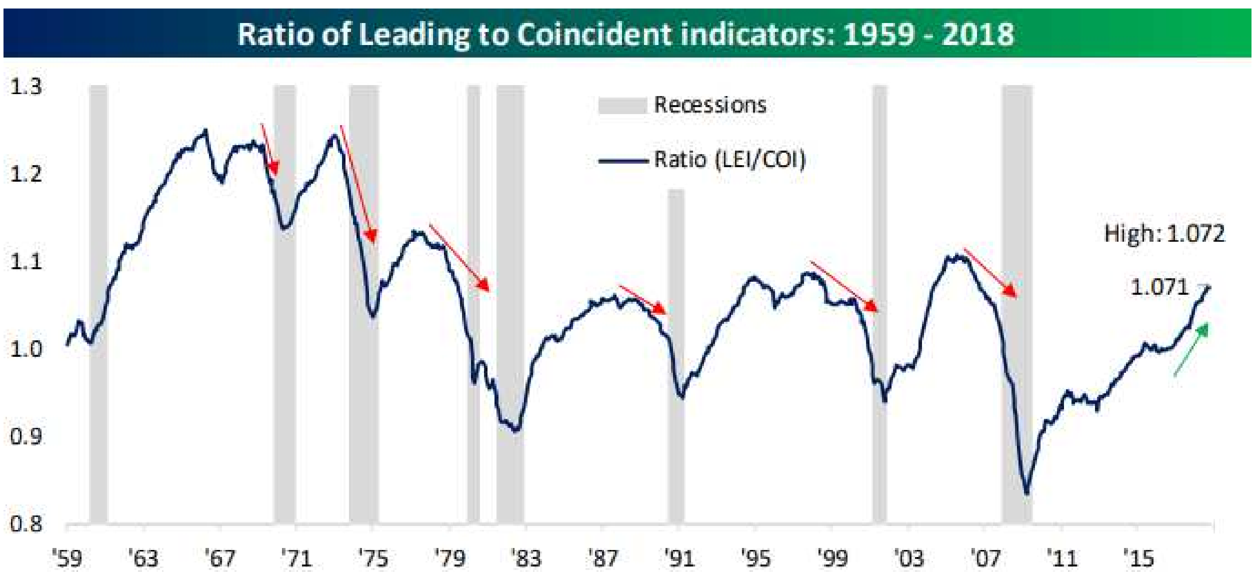
"There are no signs of recession" is a common refrain used by money managers nowadays.

That's just wrong. There are always some signs of something (a recession is coming, a rest area is ahead on the highway, your favorite character on Game of Thrones is going to die, whatever). I won't argue too strongly that it's wrong to say "there are no signs of recession," because that would just be placing far too much emphasis on the word "no" when, in fact, the word that should be used is "few".

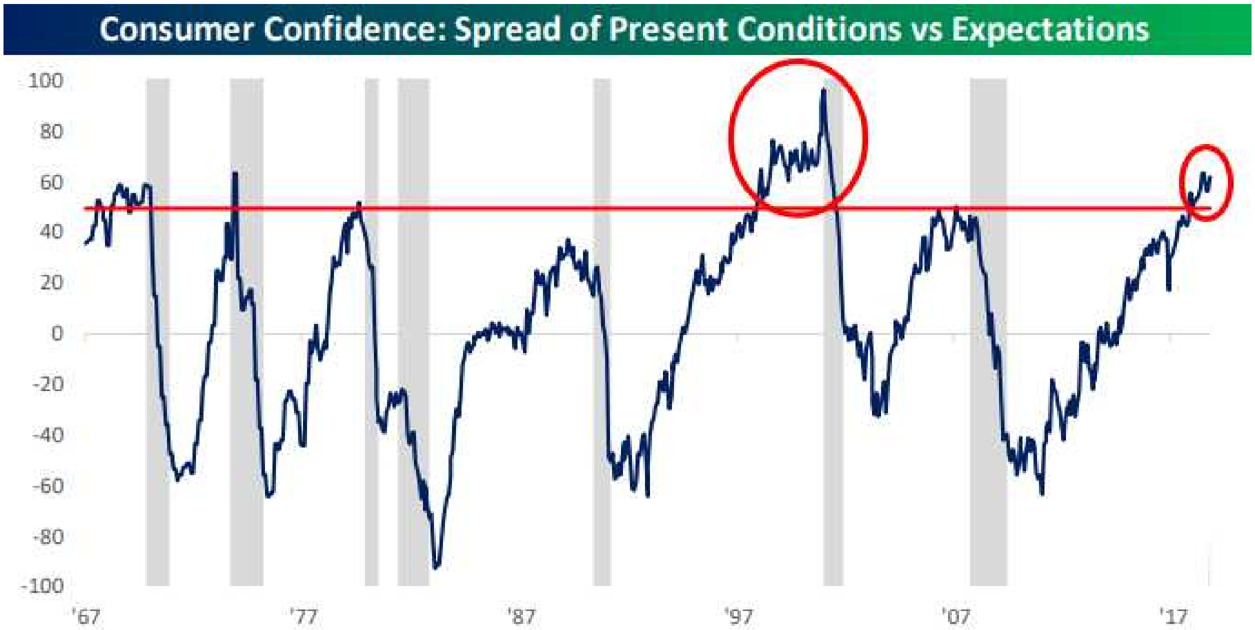
Here's the problem and why so many people say there are "no" signs of a recession: Most indicators of economic activity are backward looking. So, yeah. I totally agree. There are no (or very few) signs of recession on a backward looking basis. However, let us not forget that things always look best right before a downturn. It is called a peak, after all, for a reason. We expect GDP to slow from the 3%-plus to 2%-plus. Growth with a 2-handle is good, it's no recession. Consumers are going to be the champions for the US economy. Wages are increasing, employment is robust, and the household financial obligations ratio it near its lowest level since the 1980s. This leaves room for consumer spending. In fact, I was looking at holiday shopping metrics on the morning of December 18th and they're impressive.

That's not to downplay the consumer headwinds, such as the negative wealth effect from lower equity or home values, or higher interest rates increasing financing costs. We don't want to focus on just the positive. For about a half-decade I've been targeting 2020-2022 as the most likely timeframe for a recession. Admittedly, picking that rather wide time frame wasn't very brave of me, but now that we're getting closer to it, we need to start considering if it's a realistic scenario, or if we should have a more optimistic tone. I mentioned that most economic indicators of economic activity are backward looking. But there is a list of ten indicators, tracked aggregately, that are referred to as Leading Economic Index. Similarly, there are other indicators, also tracked aggregately, called the Coincident Economic Index. What we've found is that measuring the two indices together is a better tool than just measuring the leading indicators. And ***right now, the ratio of the Leading Index to the Coincident Index is a positive***.

This ratio actually does a good job signaling recessions. When the ratio turns down there has always been a recession, with the peak coming about a year prior. Right now the ratio is 1.071, just a tad below the prior month measure of 1.072. Theoretically, that could be the beginning of a downturn but one month does not a trend make. Besides, at 1.071 it's pretty low relative to previous highs and still could have a lot of room to go. Only one recession since 1959 started when the peak was lower.



So, yes, looking at all of these leading and coincident indicators one might have to agree that there are no signs of recession. But I like obscure stuff. I mean, comparing indicators on a ratio basis isn't going to ever grab the front page of your favorite business newspaper. That's pretty obscure, too, I get that. But let's get a little more weird and look at the spread in Consumer Confidence by looking at the difference between Present Conditions and Expectations. Since early 2015, sentiment towards Present Conditions have been surging while Expectations have been slower to keep up, and recently stalling. As you can see in the chart below, ***in nearly every instance where the spread hit 50 a recession was quick to follow.*** The exception was the dot-com bubble era of the late '90s. A recession eventually came, but it took three years. This time around it's been a year since the spread hit 50 and economic numbers are still coming in strong. That three-year run of growth after the spread hit 50 in the '90s gives me hope, but once it starts turning down I'll grow concerned.



Here is something I bet most people didn't know. The average performance of the S&P 500 in the 12-months leading up to recession post-WWII has been just a 4% loss.

While that data point is true, it's also deceiving. The average drawdown in that particular 12-months is -13.89%, so the market goes down then swings back up by the actual start of the recession (which, by the way, typically takes about a year to get official data on that; it's not easy to measure a $17 trillion economy). And, of course, the peak-to-trough decline (perhaps more emotionally important than the twelve months prior to the official start of a recession) could wipe out much more of the value of a portfolio. Since 1970, the average peak-to-trough decline during recessionary times has been -26.2% for the S&P 500. Also, the S&P 500 reaches its low, on average, 62% of the way into the contraction (which is interesting, but not terribly useful given how long it takes to officially get those numbers and actually know if a recession is happening, much less how much of it has already progressed and how much longer it will go).

But we're not in full worry mode. Yet. The Pollyanna-ish comment that "there are no signs of a recession" bothers me because it makes me feel as if the person saying it isn't looking hard enough, and/or has a bias they wish to affirm. Not that I'm looking for trouble, but I need to be aware of it. Still, though, I have to admit that there are few signs of a recession starting in 2019.

Still, having few signs of recession doesn't stop people from trying to force non-confirming data into the conversation. Again, don't forget, I'm the guy who has been saying for a long time that we expect a recession sometime in 2020-2022. My baseline scenario is a recession sometime in the next year or three. So I'm most certainly not trying to convince you that everything is going to be alright, because if you define "alright" by not gonna have a recession, then it ain't gonna be alright. But it's my job to look at this from different angles, including trying to prove myself wrong.

That's a long winded-introduction to discussing an inversion of the yield curve. Honestly, I'd rather leave that subject alone because it's been played out in the financial media for so long now that it only feels like I am addressing it out of obligation. Those who are calling for a recession in 2019 are suggesting that the inverted yield curve is a reason why. It's important that we look at it objectively and not be persuaded to modify investment allocations out of incorrect yield curve analysis.

A yield curve is inverted when shorter-term interest rates yield more than longer-term interest rates. It's a sign of eroding economic confidence as investors are more fearful to tie up their funds in longer-dated maturities. A yield curve inversion is an excellent predictor, but only if you're comparing the 10-year Treasury rate to the 3-month note (the 3-year and the 5-year have inverted but there is no real predictive power there). As excellent a predictor as it may be, while every recession since 1962 has been preceded by an inverted yield curve of the 3-month/10-year variety, not every inversion is followed by a recession (so there are false positives).

Complicating the matter is that inversions, while excellent leading indicators, have a lead time of 18-24 months. So if the 3-month/10-year inverted by May 2019 (my radically crazy best guess at precisely timing an inversion, if there is one), that means a recession would likely start around November 2020. Also, from the investor's perspective, the correlation between the curves at any spread and forward returns for stock prices is near-zero (stock market returns have traditionally been rather good as the yield curve flattens). We don't look at the yield curve to create asset class exposure strategies. We look at the yield curve to assess recession probabilities. Then we angst over the timing of said recession and the beginning of a bear market.

I should point out, while I am much more pessimistic than most money managers, I am more positive than most business managers. For example, The Duke University/CFO Magazine Business Outlook Survey recently (December 12th) showed declining optimism in economic growth as it declined in to its lowest level in over a year. This is due to waning fiscal stimulus, growth-threating tariffs, and weaker global growth. **Nearly half of CFOs expect a recession by the end of 2019 and 82% forecast one by the end of 2020.**

The Stock Market

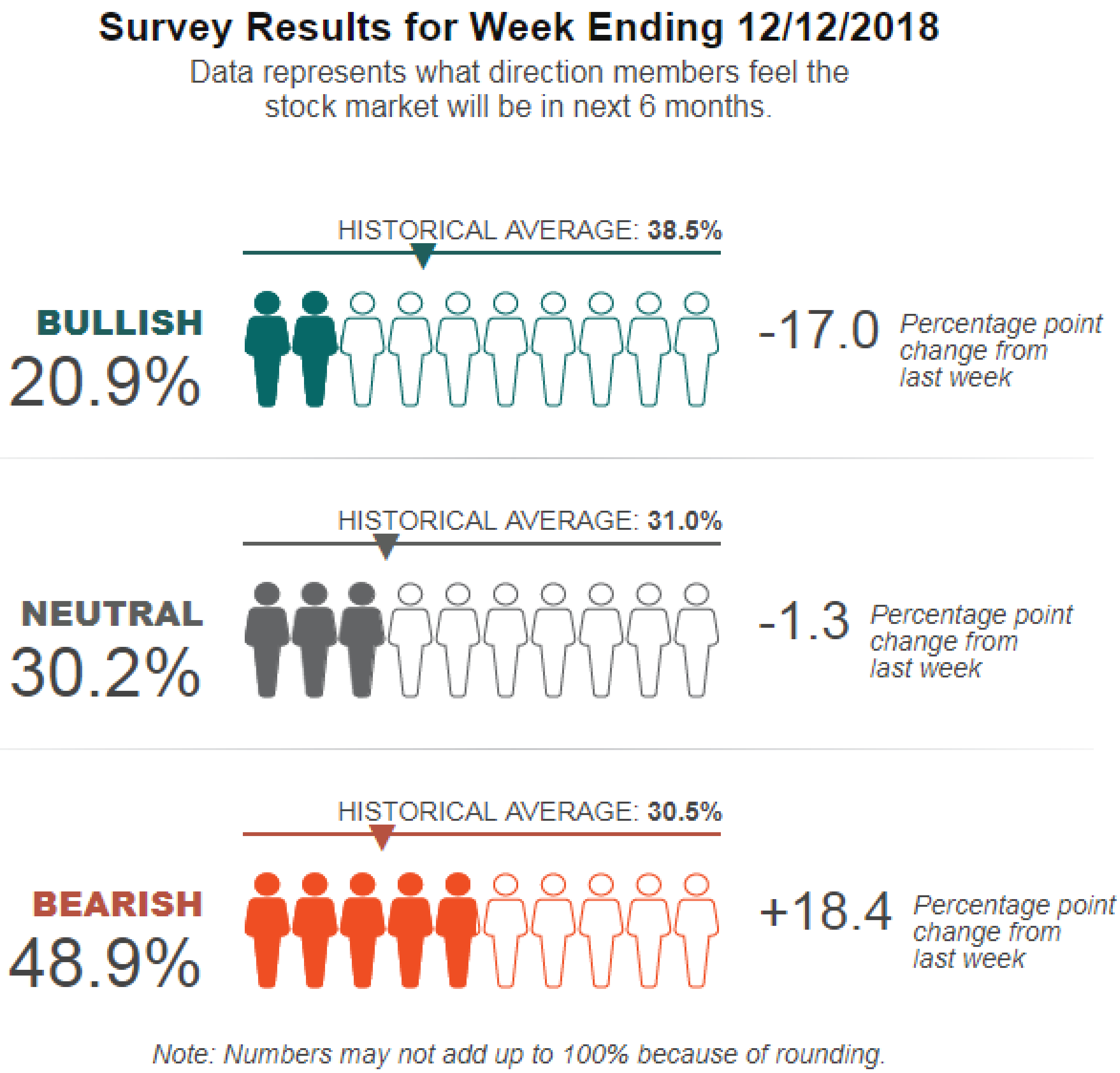
The bad news is that the stock market weakness of 2018 will most likely continue into Q1, maybe even H1 of 2019. The good news is that when we do reach that bottom, with ***a very real possibility of a peak-to-trough decline of 20% (levels last seen in 2017), the market rallies back to challenge new highs (that's double-digit returns from today's levels).***

The secular (long-term) bull stock market remains intact. However, ***the cyclical (short-term) bear market is about three months old and is expected to age another 3-4 month before reaching stock price levels low enough to warrant a transition from investors buying defensive sectors to buying cyclical sectors.***

I want to be more hopeful about the beginning of the year and, quite frankly, I hope I am wrong. ***We have reduced beta in portfolios and feel comfortable doing so even more if need be,*** but we're far from past situations where we're holding large amounts of cash in even our more aggressive portfolios. So if we're right, we'll have some protection. And if we're wrong, well, it'll be embarrassing that we make less money than the market, but we'll still make money. I can get past that embarrassment. I can't get past not doing my job to try and protect you. ***The key to making money in the stock market in the long-term is to manage risk and keep mistakes relatively small***. There are a lot of concerns out there, so we've paid attention to those added alerts and have been scaling back risk.

There is a high probability that I am wrong and we've seen the bottom. We tend to be contrarians, so when investors are gloomy that's often a signal to us that we should be net buyers of investments. And right now, according to the American Association of Individual

Investors Sentiment Survey, the amount of bulls are only about half of the average, and the amount of bears are about 60% higher than the average. It's a pretty good sign that we're being too conservative. But as daddy used to tell me, you don't go broke taking a profit.



Sentiment is a contrarian measure, and generally speaking, when investors turn bearish, it's a positive for the equity market. Bullish sentiment, as measured by the AAII, is at its lowest level in a year, at 20.9%. Over the intermediate-to-longer term, this sets the stage for above average returns. After AAII bullish sentiment has dropped below 25%, when not having done so in the prior six months, six months later the S&P 500 saw positive returns 81.25% of the time with average gains of 4.51%.

S&P 500 Performance After Bullish Sentiment Dips Below 25%										
	AAII			WoW % Change		S&P 500 Performance (%)				
Date	Bull	Bear	Neutral	Bull	Bear	1-Week	1-Month	3-Months	6-Months	1-Year
12/5/91	23.00	45.00	32.00	-10.00	5.00	1.10	10.75	9.40	9.50	13.92
7/2/92	21.00	35.00	44.00	-18.00	8.00	0.69	3.02	1.18	6.57	9.05
3/17/94	24.00	35.00	41.00	-5.00	-2.00	-1.39	-5.25	-1.81	0.83	5.23
6/4/98	25.00	31.00	44.00	-9.00	5.00	-0.02	4.71	-6.18	7.35	21.27
9/26/02	24.51	47.06	28.43	-9.27	3.82	-4.21	3.22	4.77	1.59	16.60
3/24/05	23.23	41.94	34.84	-9.24	9.47	0.13	-1.65	3.81	3.31	11.23
7/20/06	23.85	57.80	18.35	-12.65	18.38	1.13	3.87	9.33	14.52	23.41
1/10/08	19.63	58.88	21.50	-6.08	3.64	-6.13	-6.27	-3.86	-11.75	-37.31
11/5/09	22.22	55.56	22.22	-11.43	13.25	1.93	3.69	2.87	4.15	14.93
7/1/10	24.68	41.99	33.33	-9.78	9.56	4.92	7.23	11.17	22.62	28.55
6/9/11	24.42	47.67	27.91	-5.76	14.24	-1.66	4.25	-8.92	-2.37	2.84
5/17/12	23.58	45.97	30.45	-1.82	3.91	1.21	2.91	7.61	3.71	27.92
4/11/13	19.31	54.48	26.21	-16.18	26.31	-3.25	2.09	2.96	3.90	15.04
6/11/15	20.04	32.58	47.38	-7.30	7.95	0.59	-1.53	-8.90	-2.15	-0.61
12/17/15	23.87	39.38	36.75	-4.64	9.49	0.94	-7.86	-0.72	1.44	10.59
5/18/17	23.85	34.25	41.90	-8.88	4.03	2.09	2.85	4.23	9.01	14.68
12/13/18	20.90	48.87	30.23	-17.04	18.37	?	?	?	?	?
					Average	-0.12	1.63	1.68	4.51	11.08
					Median	0.64	2.97	2.91	3.81	14.30
					% Positve	62.50	68.75	62.50	81.25	87.50

So, why am I not that hopeful about a strong start to the new year? While growth is still good, the growth rate is still decelerating. And ***the market doesn't only look at "good and bad" it also reacts to "from good to less good"***. And a shift from GDP with a 3-handle to GDP with a 2-handle is less good. Also, I have concerns over monetary policy. Fiscal policy (i.e. lower taxes) is certainly a tailwind. But it's contending with tighter monetary policy from the Fed both stopping quantitate easing (i.e. no longer buying bonds) as well as raising the federal funds rate from accommodative to neutral. But ***our biggest concern is rapidly slowing earnings growth.***

When earnings growth slows rapidly, the stock market struggles. Currently the consensus estimates of earnings growth for the S&P 500 is about ten percent. I hate to get laden down in this report with too much financial jargon, but that's just nuts (it's a technical term). In 2018 corporate earnings skyrocketed on the back of great GDP growth and tax cuts. In 2019 businesses will face those aforementioned headwinds, which will be a hurdle for earnings growth. Additionally, higher wages and interest expenses will affect profit margins. Sure, buybacks should add about a percentage point to earnings growth. But the tighter margins will subtract a point and a half. Without getting into the math I did on the back of my envelope, I am expecting earnings growth to be closer to 5-7 percent (depending on the timing and success of any trade conversations). So instead of $174 per S&P 500 share, I'd expect something closer to $165. And that's why in 2019 I think we get back to the old highs of 2,940 instead of cleanly taking out those highs and going higher.

I really want to be positive regarding the start of 2019, but I think the market needs to stay lower for longer before we go higher.

Stock market selection

Given that we expect a slowing of growth (not a contraction, but a slowing of growth) in sales and profits for corporations in aggregate, we want to consider for equity-oriented portfolios sectors that can more readily withstand those headwinds. Sectors that can maintain growth rates in the face of the rest of the world slowing down will deserve a stock price premium. That doesn't mean we may need direct asset class exposure via sector ETFs, but we do want to switch overall allocation to the likes of Consumer Staples, Utilities, Health Care, and REITs. (REITs admittedly have a cyclical aspect to them that makes them more vulnerable to GDP slowdown concerns, but we're comfortable that 2019 will be an economic slowdown and that a recession will start in some later year). These sort of low-beta plays have held up well in the market's corrective phase and we expect that to continue.

Those may not be long-term investments (we hope not). After a corrective phase that brings the markets to an oversold position, we'd expect a change of leadership by the most oversold positions – sectors like Industrials, Materials, and Technology. Sectors with stronger earnings growth rates and attractive valuations will resume leadership.

Interest Rates

The consensus is that the Fed will raise rates three times in 2019. I think two is the maximum, and just one isn't out of the question at all. Currently, it stands at a range of 2.00-2.25%. A hike in December then two more will bring the federal funds rate range to 2.75% to 3%. Given all the concerned talk about the possibility of a yield curve inversion (especially the possibility of the 3-month rate being higher than the 10-year rate), it's important to consider where the 10-year rate will be. We expect it to move to 3.3%. The Fed will continue to normalize its balance sheet by winding down its quantitative easing, meaning they'll no longer be buying bonds in the open market. That additional supply pushes down bond prices, and keeps rates higher. We expect an inversion at some point, when a recession is a bit more imminent. If we're wrong about the timing of a recession, and it's going to come in 2019, earlier than our 2020-2022 expectation, it'll show up in the yield curve.

Between October 2016 and November 2018 there has been a 1.5 percentage point rise in mortgage interest rates. This has weakened the housing sector, which has an outsized impact on recessions and recoveries. New home building has stalled out as the inventory of homes available for sale has risen, because this sector is much more sensitive to interest rates than others.

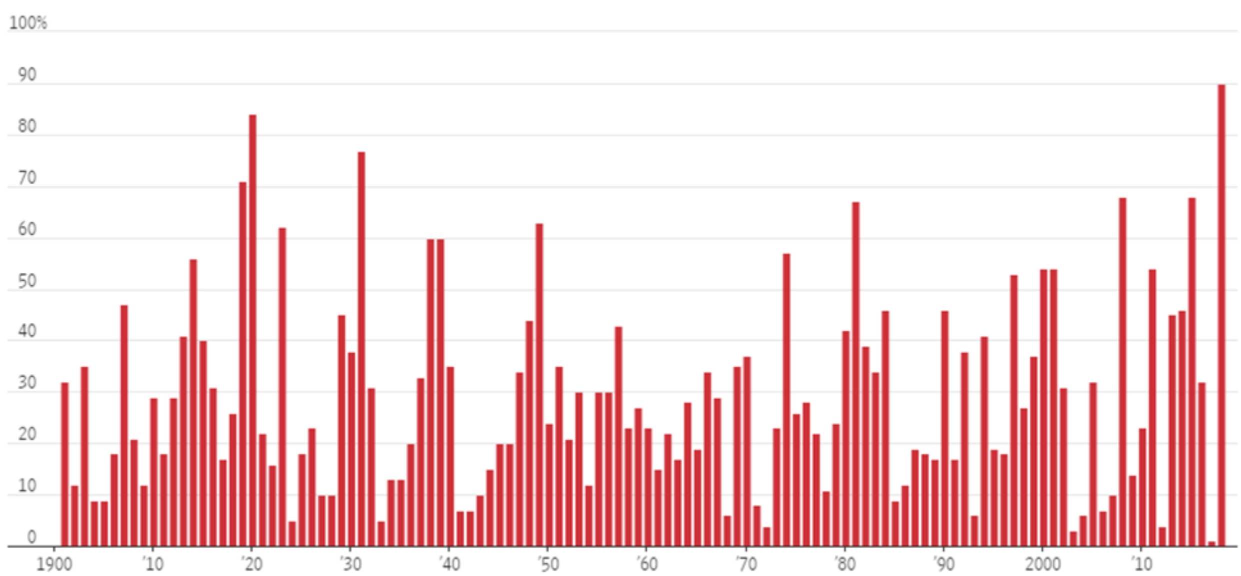
Not too long ago, cash was directed to risky assets because interest rates were too low. The phenomenon was referred to as TINA - there is no alternative. The term explained the allocation of stocks well above historical norms as interest rates were too low to compel investors to buy low-yielding bonds or hold near-zero yielding cash. Now, there is an alternative, modest as it may be. The result is that equity will have to compete even harder in the form of corporate earnings to gain capital flows. And as we discussed, earnings growth will decelerate measurably next year.

Bottom Line: This year sucked. And it'll likely get tougher before it gets better.

Some data from the Wall Street Journal summed up how hard it was in 2018 to manage money. "All told, 90% of the 70 asset classes tracked by Deutsche Bank are posting negative total returns in dollar terms for the year through mid-November. The previous high was in 1920, when 84% of 37 asset classes were negative."

Under Pressure

A record share of asset classes have posted negative total returns this year, according to Deutsche Bank data going back to 1901.



Note: Returns are in U.S. dollars. Data for 2018 are as of mid-November.
Sources: Deutsche Bank; Bloomberg Finance LP; GFD

The key to making money in the stock market in the long-term is to manage risk and keep mistakes relatively small. Given that 2018 was riddled with stock and asset classes and indices that ripped the heads off of investors, our biggest win was focusing on capital preservation over taking unncessary risks.

Given the average duration of stock market corrections, we can expect another 3-4 more months of weak market action. If you have a question about how this will affect your long-term needs, wants, and wishes, all you have to do is refer to your financial plan. We don't take more risk than your needs can handle. The next 3-4 months will be no different. Then we're looking to get back to business as usual.

GENERAL DISCLOSURES

Article may include forward-looking statements. All statements other than statements of historical fact are forward-looking statements (including words such as “believe,” “estimate,” “anticipate,” “may,” “will,” “should,” and “expect”). Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct. Various factors could cause actual results or performance to differ materially from those discussed in such forward-looking statements. Historical performance is not indicative of future results. The investment return will fluctuate with market conditions. Performance is not indicative of any specific investment or future results. Views regarding the economy, securities markets or other specialized areas, like all predictors of future events, cannot be guaranteed to be accurate and may result in economic loss to the investor. Investment in securities, including mutual funds, involves the risk of loss. Registration with the SEC should not be construed as an endorsement of Advisor’s investment skill or acumen. Investment process, strategies, philosophies, allocations and other parameters are current as of the date indicated and are subject to change without prior notice. This article is intended to provide general information only and should not be construed as an offer of specifically tailored individualized advice.

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The S&P 500 Index (S&P) has been used as a comparative benchmark because the goal of the above account is to provide equity-like returns. The S&P is one of the world’s most recognized indexes by investors and the investment industry for the equity market. The S&P, however, is not a managed portfolio and is not subject to advisory fees or trading costs. Investors cannot invest directly in the S&P 500 Index. The S&P returns also reflect the reinvestment of dividends. Berkshire Money Management is aware of the benchmark comparison guidelines set forward in the SEC Clover No-Action Letter (1986) and compares clients’ performance results to a benchmark or a combination of benchmarks most closely resembling clients’ actual portfolio holdings. However, investors should be aware that the referenced benchmark funds may have a different composition, volatility, risk, investment philosophy, holding times, and/or other investment-related factors that may affect the benchmark funds’ ultimate performance results. Therefore, an investor’s individual results may vary significantly from the benchmark’s performance. The S&P 500 Index (S&P) has been used as a comparative benchmark because the goal of the above account is to provide equity-like returns. The S&P is one of the world’s most recognized indexes by investors and the investment industry for the equity market. The S&P, however, is not a managed portfolio and is not subject to advisory fees or trading costs. Investors cannot invest directly in the S&P 500 Index. The S&P returns also reflect the reinvestment of dividends.

DOW

The Dow Jones Industrial Average (NYSE: DJI, also called the DJIA, Dow 30, INDP, or informally the Dow Jones or The Dow) is one of several stock market indices, created by nineteenth-century Wall Street Journal editor and Dow Jones & Company cofounder Charles Dow. The Dow average is computed from the stock prices of 30 of the largest and most widely held public companies in the United States. Clients of BMM may have portfolios that differ substantially from the composition of the DOW and therefore, their performance may vary significantly from that of the Dow. The Dow is used for illustrative purposes only, as one indicator of the overall US economy, and its past, present, or future performance should not be viewed as an indicator or comparison point for BMM client performance.