StraightTalk

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Cyclical Bears and Secular Bulls

Cyclical. Secular. The two types of markets we talk about in every meeting together, in most of our discussions, and in more than a few of these newsletters. All of financial journalism focuses on cyclical markets, particular those of the bear variety. All of our discussions about success in your financial plan focus on the secular markets, particularly the bull variety, in which we grow our wealth over time. And folks, December was really, really close to a cyclical bear market inside of this current secular bull. Essentially, we had a "20% off sale" for no particular reason, when the fundamentals had not changed.

Depending on which index you were watching when the dust settled a couple of days after Christmas, the market had contracted around 20% from the high earlier in the year, with most of the damage coming in the fourth quarter. For that quarter, the Dow was down 11.8%, the S&P 13.9%, while the Nasdaq was the worst of the major U.S. indices, declining 17.5%. It was the second worst December ever, better only than the same month back in 1931, which was squarely in the middle of the worst economic and market climate in our nation's long history.

So, what fundamentals changed? What caused the selloff? And what does it mean for your financial plan? My answers are: none, I don't know, and absolutely nothing. I am not trying to be pithy, but any data point you might bring up as an explanation of something "changing" was already known prior to the start of December. The cause of an investor stampede, whether it be buying or selling, is an enigma even to traders with a half of a century experience in daily markets - but unless your financial plan has changed due to life circumstances, remember that we never alter your portfolio just because prices have moved around.

But let's turn back to some of the possible data points to explain the December downdraft. The ones I hear the most frequently range from the very general: this President is crazy, or America has too much debt - to the very specific: the Federal Reserve is going to raise rates and start a recession, or a looming trade war will crimp economic growth and cause a recession. My thoughts on those are they each have kernels of truth, but a macro understanding of our economy renders these either irrelevant in the long term, or unlikely as the cause of a sharp one month drop, or both.

The crazy president "reason" is the easiest to dispel – this President has been crazy since long before winning the election, which was 5,000 Dow points below today's market. His behavior is frequently cringe-worthy, he has a fourth grader's vocabulary, and he tried (as most politicians do) to win by getting dirt on his opponent. None of this was new information in the final month of 2018. Perhaps he was part of a conspiracy with a foreign nation to steal the highest office in the land for personal profit, but I don't think so. More likely, he never thought he would win, and is making this up as he goes. Fortunately for all of us, the brilliant men who concocted this never-before-tried form of government set it up to survive fools, blowhards, and bad policymakers. It is highly unlikely the market dropped just due to his behavior.

Other people ask, "what about the debt?" Part one of that "reason" is the total amount of our sovereign debt, or what America owes to all holders of U.S. Treasury Bonds. It is at an all-time high of $21.9 trillion, which works out to be about $64,000 per citizen. In absolute terms, debt is always a limiting factor on growth. However, there is one often omitted critical fact about the national debt that must be brought out into the daylight. That fact is the *rate of growth* of the debt, which usually gets excluded by whichever political team is trying to score points in any particular environment. Setting political points aside, the fact is, that under President Obama the

national debt essentially doubled from $10 trillion to $19.5 trillion. We won't be discussing the economic environment or the policy responses that drove that increase, we will simply focus on the growth rate, which was 95% over eight years, for an average rate of debt growth of 12% per year. Under the last two years of President Trump, that debt number has grown from $19.5 trillion to $21.9 trillion, an increase of 12%. Dividing that number by two years gives us an average rate of debt growth of 6% per year. Neither number is good, but debt growing at half of the previous rate is not a likely cause for markets to plunge in the course of one month.

The second debt fret is the supposedly over leveraged U.S. consumer. Household debt now stands at $15.9 trillion, which is above the amount just before the financial crisis in 2008. The implied connection here is that another 2008 is lurking around the corner because of all of our debt. Again, too much debt is a bad thing, but the doomsday crowd omits the context needed for a full understanding. What is missing is the other side of the balance sheet, our household assets. Back then, consumer debt was 19% of our collective assets, but today it is just 12.7% of assets. Yes, we owe more, but we are worth even more. The rate of growth in debt has been less than the rate of growth in our assets, which improves that fiscal health picture meaningfully. And, these numbers have not changed on a relative basis in the last few months, so they are not likely the cause of December's rapid repricing.

Which brings us to the specific "reasons" of the Fed and trade. These may be a more likely partial cause of the market's dyspepsia in the fourth quarter, but I believe the fears around them are overblown. Yes, the Fed was embarking on a clear path to raise interest rates, but not because the economy was overheating. The main driver behind moving rates up is to have enough "dry powder" for the next economic downturn, or recession. Excluding the Great Recession of 2008, the average recessionary interest rate cut by the Federal Reserve over the last forty years has been 3%. Well…basic math tells you that if your starting interest rate is below 3%, you can't cut 3%, hence their focus on raising rates while the economy is healthy. Nervousness that the Fed was not heeding the market's signals of slowing earning's growth may have been a part of the December swoon, just as hearing the early January message of a more cautious Fed may have been a part of the recovery from the swoon.

The other popular possible reason for the December Drop is trade, specifically the fears of a trade war. Despite some recent shockingly tone-deaf television appearances by Secretary of Commerce Ross, things are trending towards better outcomes for the U.S. with our major trading partners. In recent trade negotiations, Europe, Mexico, and Canada each blinked, and China now appears poised to do so. I believe this has less to do with our Negotiator-in-Chief than it does with the relative strength of our economy compared to theirs. If we are able to extract some better terms from China, the market will respond positively, but I don't think fears of China besting us on trade talks was the sole reason for what happened to the market in December, any more than I think we will be in a global trade war next year.

Simply stated, many more people sold than bought during the month of December and no one really knows why. However, as I write this in late January, that trend seems to have reversed, at least in part. The facts remain that our economy is growing, interest rates are still quite low, unemployment is unbelievably low, and inflation is not a problem. There will be a recession at some point in the next couple of years, but I don't believe that is in the cards for 2019.

If none of this has soothed your raw nerves, here are two closing thoughts. Research from Standard & Poor's shows that since 1928, the U.S. stock market has never had two down years in a row without a recession or global war. If you think those are unlikely in 2019, then history is on your side for this year. Even more powerful, the investment firm, American Funds, states it even more unequivocally; "since 1950, U.S. stocks have always generated positive returns in the year following a midterm election." Of course, past history does not guarantee the future, but perhaps knowing the positive trends of the last 70 and 90 years will help you tune out the short-term *cyclical noise*, and stay focused on our long-term *secular plan*.

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