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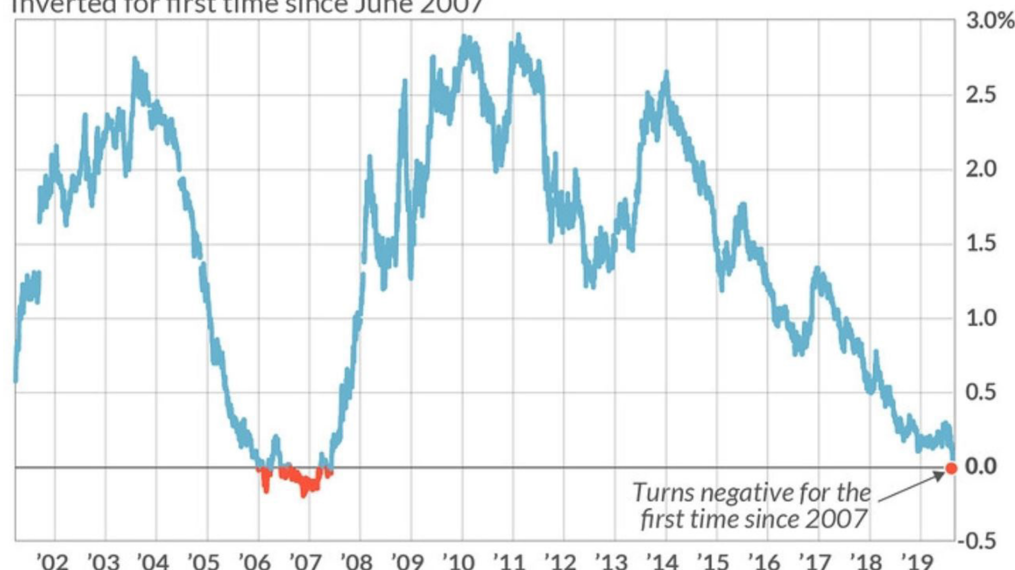
The Market Climbs Its Wall Of Worry

As investors return from their summer travels and re-assess their portfolios, they will find the equity valuation levels at odds with the discord in Washington and abroad. This is due to two powerful tailwinds at the back of the equity markets, the recent return of fed easing, and continued US consumer spending. Each day of trade posturing and geopolitical instability seems to precipitate a market decline which is immediately followed by a subsequent rally, as investors realize that these theatrics are part of a new investment regime. Thus far, the markets have generally looked past these political gyrations.

While investors fear this instability could translate negatively, the market has continued to climb the wall of worry to new highs. That's because the US consumer remains strong and lower interest rates help enhance the growing streams of cash flows by reducing the discount rate. The result has been stretched valuations as investors are willing to pay newly minted multiples in the equity markets because bonds remain at historically low yields. Although pockets of value exist in equities, they're becoming harder to find. As valuations run away, the more difficult it becomes to justify the extent of this bull market rally.

There's no telling when the end of the positive trend will arrive, but rough estimates based on how past cycles have played out can give us clues. Currently, the yield curve is telling us that we are likely closer to the end than we are to the beginning. Bond markets are often better at sniffing out economic weakness than their equity counterparts. Yield curve inversions have predicted each of the past 7 recessions. 1 This is because bond investors operate with low to mid, single digit returns, and develop the majority of their long-term benefit by avoiding catastrophes.



Source: Federal Reserve Bank of St. Louis

While a rolling bear market could return from its late 2018 debut, we have our doubts that it will hit every segment of the stock market at once. Although a persistent trade conflict creates a real chance that geopolitics could cause supply chain disruptions and shock an otherwise healthy US economy at both the corporate and consumer level, the risks for systemic failure appear mitigated – as banks are stronger than ever due to the regulations put into place after the global financial crisis engendered in 2008.

While there have been many inflection points in history in which revolutionary technologies should have made meaningful human work irrelevant, we continue to see the lowest unemployment rate in over 40 years. It remains the case that there are about 1 million more open jobs currently, than there are candidates to fill them.2 That's not a recipe for dire markets. We find it more likely that innovation will find a way to harness the enormous potential of artificial intelligence, robotics, and clean energy to create more 21st century jobs, which will bring about positive disruption.

All of this is to say that we are much more inclined to view any temporary market volatility as an attractive entry point for those who are bullish on a repeat of a 300 plus year history of the successful implementation of capitalism.

Because these data points are divergent, they favor our strategic asset allocation that reflects our conservative DNA. Dividend-paying blue-chip stocks are in vogue given historically low interest rates. Increasingly, the desire of investors to dampen volatility through exposure to balanced companies with strong cash flow and growing earnings, also plays into our investment thesis. This implies that we maintain an important strategic allocation towards US growth companies, with the important caveat that these companies demonstrate a history of strong free cash flows, growing economic moats, and the ability to weather a market downturn.

We believe that it is only through thoughtful and balanced allocation that we will be responsible stewards of our clients' capital throughout all market regimes.

Source https://www.marketwatch.com/story/5-things-investors-need-to-know-about-an-inverted-yield-curve-2019-08-14

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