

## THE CHECK ENGINE LIGHT IS ON

The Secular Bull Market just turned 10. It was a decade ago that the US Stock Market reached a bottom and the Financial Crisis ended. It was the Spring of 2009. Out of the ashes, the new Bull was born. It's been an impressive 10-year run. It's also been an impressive start to 2019. Especially, considering how 2018 ended.

This has been the best start to a year for stocks since 1998. How things have changed in 3 months time. The violent December crash was followed by a Q1 spike. The volatile price action the last 6 months shook investors to their core. But the 2019 gains seem to have clouded the 2018 losses. Investor sentiment went from a decade low back to enthusiasm in short order. Appetite for growth stocks is reaching levels perhaps not seen since Dot.com days and the surging IPO market reflects it. Global issues present significant risk and uncertainty. The optimism of a trade deal between the US and China hit the news circuit for like the millionth time, but it still lacks clarity on what it is or when it will happen. The fate of Brexit is holding Europe hostage and the can keeps getting kicked down the road. It isn't good. The Market knows it.

### THE MARKET SUPER HIGHWAY



The Market today is like a Super Highway. Continentally connected, it's always open, and there is constant movement. Digitalization has enhanced the speed and efficiency. Investment portfolios are like vehicles on this highway. Some are built for speed. Others are slow and steady. Size varies. Some are very large; others are less large. Ultimate destinations vary too. A destination could be retirement, or college or perhaps buying a home or starting a business. There are accidents from overly aggressive behavior. There are vehicles for oversight. There are vehicles to clean up messes. Machines play an increasing role, but humans still matter most. The journey on the Super Highway is a long one. Some are close to their destination. Others are just beginning.

The check engine light has turned on for many of these portfolio vehicles. It's time for the 100,000-mile checkup. It's all part

of the process of owning a portfolio. Of course, they are monitored daily and adjustments are made for the everchanging conditions. Seasonality plays a role. Age does too. We see the yellow lights flashing now. We are slowing the speed and plan to reposition for what we believe will be a tougher road ahead.

### DASHBOARD SIGNALING CAUTION

There is so much to account for behind the wheel. The dashboard is full of indicators. Global growth is slowing. It's happening both economically as well as with earnings. The Yield-Curve is amongst the most important gauges. It has inverted. The 10-Year Treasury yield undercut the 3-Month yield for the first time since 2007. Historically, that's a sign of recession ahead. This precipitated every recession since 1975. However, every inversion has not led to a recession. There have been some false signals over time. And recession was never imminent.



A yield-curve inversion often signaled a recession 12-18 months in advance. So, there could be more room ahead for stocks. But the check engine light is definitely on. It has our attention and we are checking the engines thoroughly.

Bond yields rise, not fall, when optimism builds around economic growth. The opposite is occurring right now. This is not a bullish sign for the economy in 2019. Interest rates are outright negative in Europe. Financials are getting hit hard in response. Banks get their profitability squeezed with a flat to inverted yield curve. European banks seem to be pricing in a crisis. Europe is the biggest risk in our mind which the Stock Market seems to ignore.



The Bond Market and the Stock Market are telling different stories. We pay close attention to the Bond Market. We always have and always will. The Bond Market is the Smart Market. Right now, it's telling us that growth is slowing faster than expected, and the Fed was slow to act. The Bond Market forced the Fed's hand in January and did it again in March. It is essentially calling the bluff of the Fed by front running them and lowering rates for them. This does not happen often; in fact, the last time this happened was in 2008.

#### EARNINGS & ECONOMIC GROWTH SLOWING

Earnings are the biggest driver of stock prices. But the Fed has been a big driver too; Perhaps bigger at this stage of the cycle. The Fed clearly changed its tune and has signaled its intent to defend the US Economy and the US Stock Market. It did a complete 180-degree turn. Forget more interest rate hikes now. The Fed said they don't plan any more this year. Why are they doing this you might wonder. Well, they have clearly

acknowledged the global slowdown which has finally reached the US. They also acknowledge that inflation remains a non-threat, continuing to stay well below that targeted 2% level. The Market is now pricing in an actual rate cut before the year ends, with a nearly 70% probability. It was next to zero in February. Things have changed.



The Fed's complete reversal on monetary policy, going from hawkish to dovish, sent many signals. It shows its attempt to be supportive amidst the slowing global economy. But it also begs the question, how bad is it? It's pretty bad in Europe, and Brexit seems to be exacerbating the political and economic struggles. It seems pretty bad in China, and the trade war has been compounding the slowdown. The US is definitely in the best shape. But economic data is suggesting a cooling. America has largely been immune and insulated from many of the global issues. For how much longer the question is. We think not much more.



**AS GOOD AS IT GETS?**

Growth accelerated in 2018. Corporate earnings grew over 20% last year. The economic conditions were near perfect, and the tax cuts provided a boost for the US economy and Corporate America. The Fed now estimates 2.1% growth this year and 1.9% the following. This comes on the heels of the 3.1% growth in 2018.

As 2019 approached, the Street was expecting another double-digit increase in corporate earnings ahead. Not anymore. Earnings are now expected to grow just 3% this year. And even that might be too high. Q2 earnings are expected to see the first year-over-year contraction since 2016, which was a defined period of earnings recession. We see similarities to 2015-16 again. That brought a healthy correction. Stocks have gotten expensive. Expectations have too. Disappointment could lead to declines. At this stage, from our perspective, the risk/reward balance is less attractive.



Europe is battling recession and an unprecedented unknown with Brexit exacerbates the problems. The Trade War with China seems to be running its course with economic pressures, while talks continue to gain traction. At least that's how it's being reported. But there is no quick fix here. The problems overseas have no simple solution. And the strength in the US seems to be slipping a bit. Was 2018 as good as it gets? A case can be made. Economic and earnings growth accelerated to multi-year highs. Unemployment fell to multi-year lows. There has been over 100 consecutive months of job growth. That is the longest on record. Those rates are seemingly unsustainable. But money has poured into the US for a decade.

**IPO FEVER**

Investor interest in American assets has kickstarted the IPO bug again. Initial Public Offerings have returned in size, as these young companies, led by venture capitalists, try to tap the capital markets while they're still hot. It should be noted that history has shown there is a relationship with hot IPO's and Market tops. There are some similarities to the late '90s and the Dot.com days. Can the Market absorb all of this new supply at these really high valuations with no profits? This factors into our thinking too.

Since before World War II, no period of economic growth has lasted longer than 10 years. With the last recession having ended in 2009, we're now reaching that period on the economic calendar.

The excitement of the IPO Market seems to be distracting from the various global issues with no clear or easy resolution.

The great unknown of Brexit is atop of that list. Relations with China are a close second. Investors seem to have forgotten December. Appetite for risk has signs of insatiability. This upward trend is unsustainable, and the risks just don't seem to be priced in. With the earnings and economic slowdown, combined with a relatively high valuation for stocks, and the major indexes near resistance, it's hard to see the Stock Market go materially higher from here. We're not sure if that means another significant sell-off, it might be sideways movement, remaining in the defined range, which is currently at the highs. The major geopolitical issues need to have some resolution before things break out or break down meaningfully. We just don't think a breakout is imminent.

**CENTRAL BANK BACKSTOPS**

Central banks have played a major role for the full 10 years of this Bull's life. They coordinated a strong defense to combat the Financial Crisis. It worked. But they kept the aggressive monetary policy for years, and in the case of Europe and Japan, they never stopped. The Fed began tightening a few years ago but have discontinued that approach this year. The aggressive policy has distorted the true health of the global financial system which has complicated risk and risk-taking. With a central bank backstop, risky behavior has been promoted. But at what cost? When is the ultimate price going to be paid? There is a mountain of debt around the globe and it ultimately will need to be paid. The complexity is the fact that central banks have artificially influenced interest rates for 10 years, in response to the Financial Crisis. It is clouding the severity of the situation with the inverted yield curve and outright negative rates overseas. It's impossible to ignore.



Major global stock indexes like the Japanese Nikkei and German DAX are failing at strong resistance in large top formations, while their relative trends are hitting lows. International stocks have not experienced the same success as the US throughout this 10-year run. The weakness abroad remains a top concern of ours. Also catching our attention is the fact that Small Caps and Tech were leaders through February, but have since shown signs of weakness. Recent strength has been found in Utilities, select Consumer Staples and REIT's. These are defensive sectors, not the faster growing areas. This supports what the Bond Market is telling us, yellow lights flashing. Caution is warranted.



Is this time really different? Those are dangerous words that are often used to defend against potential problems. We have been really bullish for 10 years, with pockets of defensive positioning along the way. This time is no different. We are risk managers. We play offense when we see opportunities to grow capital and cash flow. We play defense when we feel the risks are greater than rewards. There are things to like in this Market. We like Bonds and Dividend Stocks, particularly in the Health Care and Consumer spaces. We like Gold. We like Growth Stocks in Tech with unique and innovative business models. We are just sensitive to price. Price matters. We focus on facts and logic. The facts suggest caution at this stage of the journey. The conditions have gotten more challenging. We don't completely trust the optimism. We're studying everything under the hood. Our focus is on safety and we are approaching these conditions with skepticism. It's our job to be skeptical.