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Economic and Market Outlook

September 30, 2019

Putting Time Together

Knowing What Must Be Done
Does Away with Fear.
--Rosa Parks

Section I. Protection—The Equal of Enhancement

The best way to measure your investing success
is not by whether you're beating the market,
but by whether you've put in place a financial plan
and a behavioral discipline that are likely to get you
where you want to go.
--Benjamin Graham

Part-A. Overview

The tenor of this report is guardedly optimistic, in that we believe the Economic Expansion that began at the end of the Great Recession (2007 Dec. to 2009 June) will continue as a direct result of the boost to confidence and, hence, to planning provided by the Federal Reserve's lowering of the Fed-Funds rate in both July and September.

We chose the phrase *guardedly optimistic* because it reflects our deep concern that the President may yet create a Recession out of the trade war.

For our forecast of an extended Economic Expansion to unfold, the weakening trend of the economy apparently must be reversed by Fed action (Monetary Policy) alone, unless there is help from the President and/or Congress (Fiscal Policy).

To sum, our view is that, if the weakness does not immediately stabilize and then begin to reverse, the slowing trend will morph into Recession in the first half of the new year, or even before.

The rest of this report will pursue the following outline:

First—As an aid and reminder, in **Section I—Parts-B, -C, and -D**, we will present a complete description of our decision process in arriving at the point where Recession is declared and action is taken to fully protect portfolios from Bear Markets that typically accompany Recessions.

This clarification of the decision process and point of action is offered to lessen the anxiety connected to the slow process of reporting the developing trends that precede necessary actions.

Fortunately, few such reviews of the process to decision point are required through time. History shows:

(1) The average length of Recession is approximately 11.9 months;
(2) The average length of Expansions is approximately 67.0 months;
(3) The % of time in Recession is approximately 15%;
(4) The % of time in Expansion is approximately 85%.

Second—In **Section II**, we will review the current economic data that support our conclusion that Expansion persists, though growth continues to slow when seen in the aggregate.

For now, we await the expected effects of the Fed's rate reductions.

Part-B. An Advisor's True Utility

The essence of investment management
is the management of risks,
not the management of returns.
--Benjamin Graham

The greatest opportunity for an Investment Advisor to help clients is not found in outperforming the market by some (X) amount, but by preparing clients and helping them to Stay with the Plan.

This key—to Stay with the Plan—does **not** mean to keep insisting that clients should simply Buy-and-Hold the portfolio's chosen assets for the long-term, but, instead, to Buy-and-Hold such assets **only** for as long as the economy remains **expanding**.

The "Why" (i.e., reason for the firm's existence) of Clutinger, Williams & Verhoye, Inc., has always been more than designing, selecting investments, and managing portfolios for the long-term based on both clients' objectives and their risk profile—though those are, indeed, vital functions.

But the overarching "Why" has been an overwhelming <u>need</u> for us to help clients <u>actually achieve their objectives</u>. Such actual **<u>achievement</u>**, not just making <u>plans</u> to reach objectives, requires that <u>**Protection** of Assets Ranks **Equally** with **Enhancement** of Assets.</u>

<u>The actual performance record</u> of investing, seen in the annual Dalbar Study, is typically <u>so bad</u> that an explanation can only be found among behavioral errors, based in the psychology of fear, on the part of both advisors and clients.

In **Section II** of our December 2018 report, we quoted Mark Hulbert, writing for the blog, *Marketwatch* (August 2018), as saying:

> Most who say they believe in a long-term buy-and-hold strategy end up discovering—at or near the bottom of the bear market—that they don't have what it takes. That means they suffer most or all of the bear-market's losses and benefit from only a portion of the market's subsequent rebound.

<u>We would go further, by saying that most investment advisors who advocate what is behaviorally impossible (i.e., simply Buy-and-Hold) contribute directly to the failure of clients to actually attain their goals.</u>

The "so-called proof" of the Buy-and-Hold mantra lies in the <u>undisputed fact</u> that, if a client could actually hold the underlying assets planned for through "thick and thin," the client's performance over time would be that same performance achieved by the assets.

However, the truth of the "simply Buy-and-Hold" mantra gets down-right ugly!

Again, as we previously quoted in our December 2018 report, from a 2018 White Paper entitled, *The Ugly Truth about Buy and Hold*, Don Schreiber, Jr., presented the following:

> Buy and hold theorists suggest that investors cannot successfully time the markets, and by trying to avoid the down days, investors will miss the few powerful up days that provide most of the return. They believe the positive returns generated during bull market uptrends will always be sufficient to allow investors to not only recover lost capital but to generate returns high enough to help them achieve their financial goals. But the devil is in the details, and as it turns out, investors who follow the "Buy-and-Hold" mantra also expose their capital to the markets' biggest losing days, which have an even worse effect on return.
>
> The prevailing conventional investment wisdom suggests you would diminish performance dramatically by attempting to avoid losses, but our analysis of the first Chart [our <u>Figure A</u>] shows that, if you can avoid the worst market declines, you can also miss the best gains and still enhance return. The first Chart also shows that since 1950, $100,000 invested in the Dow Jones Industrial Average (DJIA) Index on a buy and hold basis would have grown to $12,351,581.

However, by missing both the 10 best and worst quarters, the return would have improved to $17,250,082. Of course, missing the 10 worst quarters while capturing the returns from the 10 best quarters would have produced the best result. We believe the important takeaway is that preventing large losses is dramatically more important than chasing returns. [Our emphasis.]

We added:

Clearly, there are great gains to be made by missing the worst quarters. Despite the truth of the above statement, we are not advocating that all such worst quarters can be avoided, but it turns out that 60% of the 10 best quarters occurred in close proximity to the 10 worst. This close occurrence of the best and worst relates to the presence of Bear Markets (i.e., rallies in Bear Markets).

The "experts" cite only that Buy and Hold (1950-2017) $100,000 goes to $12,351,581, and if you miss the 10 best quarters, it only goes to $2,423,052. The fact that, had you missed the 10 worst quarters, the $100,000 would have gone to $87,932,833 is left to silence.

Turning to the actual performance of investors, as seen in the annual Dalbar Study, the following is revealed:

Chart-1A (The Dalbar Study [1-1-1987 to 12-31-2018]: 31 Years of Average Equity and Fixed Investors vs. Indexes) presents the data in the form of average annual rates of return, while Chart-1B presents the same data in dollars.

Observations:

First—over the 31 year-period, Stock investors not only underperformed the S&P 500 Index (i.e., the average Stock investor's $100,000 goes to $332,386 in 31 years vs. $100,000 goes to $2,133,346 for the S&P 500 Index), but the S&P's return was more than six-times greater than that of the average investor.

Second—Fixed-Income investors equally underperformed the annual return of a 1-Year Treasury Note, as measured by the Bank of America, Merrill Lynch 1-Year Treasury Note Index (i.e., the Fixed-Income investor's $100,000 goes to $217,617 in 31 years vs. $100,000 goes to $331,209 in the Index).

Moreover, considering inflation, the Fixed-Income investor actually had a negative annual return on average over the same 31 years. (Note: The Average Inflation Rate (CPI), over the 31 years, was 2.77%, but the average investor's annual return was 2.54%; thus, the investor's real return was a minus 0.23% per year (2.54 - 2.77 = -0.23 real return).

Neither the Mutual Funds nor the Treasury Notes provided such poor results. The problem clearly lies instead with behavioral errors on the part of investors, with or without "expert" advisors.

As it turns out, we can see the behavior of the average investor at work in the data on the turnover rate made available from the Investment Institute as well as a study from Standard & Poor's (March 2017) entitled, *Don't Worry Jack Bogle* (an ironic

reference to the Vanguard Fund's Founder, who long preached the virtues of Buy-and-Hold). According to S&P data, the average holding period for equity funds was 27 months for advisor accounts and 20 months for retail accounts.

Likewise, for Fixed-Income (Bond) funds, the holding time was a mere 26 months for advisor accounts and 19 months for retail.

So much for simply Buy-and-Hold!

The short holding period by both stock and bond investors explains their underperformance.

Is there a better way? We answer "Yes!"

As we explained earlier in this report:

Instead of simply Buy-and-Hold for the long-term, substitute this principle:
Buy-and-Hold **only** for as long as the economy remains **expanding**.

This approach means the following:

1. The direction of the economy primarily determines market performance.
2. Economies advance and contract.
3. Successful investing requires dropping the concept of "simply Buy-and-Hold for the long-term" in favor of "Buy-and-Hold for only as long as the economy is advancing." This means selling as key data indicate an economic contraction has developed.
4. It is imperative to recognize that systematic-risk (i.e., from the economy/market valuation) is equally as important as the specific-risk connected to asset selection and diversification (i.e., the allocations of portfolio construction).

In effect, we must all keep in mind that **selling is of equal concern as buying**, and that, to be comfortable with the sell side, we need to understand that we Buy-and-Hold **only** during economic **expansions**. We will further discuss below how we determine when an expansion has turned to contraction, and vice-versa.

We have confidence that working together as an Advisor/Client Team will lead to Plan-Goals being met.

The key is for the team to rehearse, rehearse, rehearse that protecting assets is an important as enhancing assets. The key to achieving each client's Goals requires mitigating behavioral errors.

Part-C. Can Recessions Be Predicted?

In a research paper by James Conover, David Dubofsky, and Marilyn Wiley (September 2016) entitled, *Does It Pay to Forecast the Business Cycle?* the authors

first point out that there have been seven (7) Recessions since 1970 (note: their study period was 1970 through 2015). The authors also point out that seven (7) of the eight (8) Bear Markets recorded were recorded in connection with those seven (7) Recessions. Only the Bear-Market Crash of 1987 was not attached to a Recession. Therefore, Recessions clearly matter to Bear Markets and, hence, investor performance. Clearly, the few Recessions have been sufficient to destroy investor performance, as we saw above in the annual Dalbar data.

The answer to the question of whether Recessions can be predicted is, "Yes"; thus, an important part of the Bear Markets can be avoided by switching from stocks to bonds and cash during the Recession and reversing the pattern once expansion begins again.

Of course, the trend of the stock market is a leading indicator in the sense it begins declining before Recession and begins advancing before the Recession turns to expansion, yet the trend cannot be used in real time to actually determine when a Recession begins or ends. Why? There simply are too-many signals unrelated to economic health.

Chart-2 (Moderate Pullbacks Happen Frequently) presents the problem of too-many signals to know which one carries the information that a Recession has begun and, therefore, that the decline underway in the market will not stop at a mere Correction (less than 20%), but is likely to fall an average of 35%, with a range out to 58.6% (as in 2007-09).

The authors of the study cited above concluded that, importantly, even investors with only slight forecasting prowess were rewarded with positive performance from forecasting the turning points of the economy using only widely available Business Cycle data. But there was a second, and even more astonishing, result that concluded the following:

> Over the period 1970-2015, investment returns were enhanced by merely knowing concurrently whether the economy was in a state of expansion or contraction, and making the most basic asset allocation decision of whether to be in stocks or bonds. In the United States, an annual excess return of 2.01% was earned by investing in stocks during expansions and in bonds during contractions.

They pointed out that sources of concurrent knowledge are available from "Nowcasting Models"—published by the Federal Reserve Banks of Chicago, Philadelphia, New York, and Atlanta—plus from Aspen Publisher's Blue-Chip Economic Indicators.

The major point the authors found was an excess annualized return above the market's return (i.e., S&P 500's return) of 2.01% over the 45-year period, and it was

achieved even without forecasting but, instead, with knowing only whether the economy was going up or going down.

As an example, the Chicago Fed National Activity Index (CFNA) is constructed from 85 macroeconomic time-series encompassing groups of indicators, such as: production and income; employment, unemployment, and hours; personal consumption and housing; and sales, orders, and inventories.

Their latest version (i.e., the new CFNAI—updated *Economic Perspectives* [Vol. 43, No. 1, 2019]) reports the Index now has a 99% ability to correctly classify U.S. Recessions and Expansions, up from 94.8% in their earlier Index. The Philadelphia Fed's (ADS Index) has been shown to be 98.6% accurate.

Part-D. Armed with "Nowcasting"

Chart-3 (Perfect Recession Timing) suggests great rewards for being perfectly successful (highly unlikely) at forecasting the economy, but does it really matter that much, when you can earn the market's return (i.e., actually 2.01% better than the market's return), by simply knowing, on a concurrent basis, that the economy is expanding or contracting?

Each quarter, we report on the seven (7) tools we watch most closely; our forecasting tools are the first five (5), representing our trend-watching. They help us adjust portfolios relative to increasing or diminishing risk that develops between the allocations of assets within each client's portfolio.

To review, here is the list of the five (5) forecasting tools:

1. Civilian Unemployment Rate (Current vs. 12M [Twelve-Month] Moving Average—and/or 0.3% increase in the 3M [Three-Month] Moving Average from low point);
2. Advance Real Retail and Food Service Sales (Percentage Change from Year Ago);
3. Industrial Production Index (Percentage Change from Year Ago);
4. All Employees: Total Nonfarm Payments/Civilian Labor Force (Percentage Change from Year Ago);
5. 10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity (Inverted Yield Curve?).

The last two (2) of the seven (7) are "Nowcasting" tools, which have a huge advantage, as we believe they permit our clients to reach their goals by mitigating behavioral error (which Dalbar's data sadly shows seemingly cannot be done by average investors).

1. Philadelphia Fed Nowcasting (i.e., called Aruoba-Diebold-Scotti Business Conditions Index (91-Day Moving Average);

2. Chicago Fed National Activity Index (3M [Three-Month] Moving Average).

Overview of Indicators' Use:

We believe that, in fact, there is only a limited need for the use of the first five indicators, called forecasting tools:

Unless—

1. There is a greater-than-average "risk aversion," due to the investor's being near or in retirement or in poor health, or simply due to the presence of a low-risk profile;

Or unless—

2. The investor is seeking to outperform the market as a Goal;

Otherwise—

3. Since all five of the forecasting tools are part of those used to construct the "Nowcasting" tools, the five (5) forecasting tools are actually not needed separately for portfolio actions to protect assets (note: the majority of the five [5] are more than likely to call for a sell on or about the same time frame as the "Nowcasting Indexes").

Decision Point:

In the final analysis, there are two conditions, either of which will signal the economy has **reversed its direction**. In either case, clients will be contacted and portfolios adjusted to maximize Protection (i.e., in the case of reversing to contraction, common stocks will be removed in favor of bonds, cash, or hedging strategies may be deployed.).

Thus, we will act to protect our clients if **either** (1) the majority of the five (5) forecasting tools turn negative *at the same time* as the market shows the current week's closing price to be below the average of the last 40 weeks (i.e., approximately 200 business days); **or** (2) either of the two "Nowcasting Indexes" signals that the economy is contracting (i.e., the Philadelphia Fed's Aruoba-Diebold-Scotti Business Conditions Index = Sell at -0.8; or the Chicago Fed National Activity Index = Sell at -0.7).

Section II. Measuring the State of the Economy and, through the Economy, the Market

Going forward, as always, we will review the state of the economy and the financial markets, as seen through the lens of our five (5) leading and two (2) "Nowcasting" tools.

However, we intend to be somewhat less ponderous (i.e., we will be providing fewer added Charts in support of the five (5) leading indicators, in particular). We

recognize that the drip, drip, drip effect of the many Charts, unfortunately, can add to the anxiety of time (i.e., When is it going to happen?).

Moreover, the effect of such added data can be interpreted as an effort to predict the predictors, a practice that can lead to overemphasis and, occasionally, judgmental error. Of course, this is not what we have ever intended.

We believe that clients should completely understand the background of data that leads us to the advice we provide. To this end, we have typically provided a large number of supporting Charts to transparently show the evidence, and any client is always invited to inquire for further background data, which we will be glad to show and discuss in regard to any actions we recommend and take.

But we now feel that giving large numbers of added Charts, as we have over many years, has served its purpose in helping clients understand the underlying data that show how markets work and the ways we analyze them.

Going forward, it is vital that our clients, and prospective clients, can rest assured that we are doing full diligence in compiling and analyzing all key market data, as we always have.

At the present time, there is a real possibility that the market direction is changing. Accordingly, our emphasis should be seen as <u>action dependent on concurrent evidence</u> (from our forecasting and “Nowcasting” tools) <u>showing when the economy is no longer expanding!</u>

<u>What follows is the current state of the evidence.</u>

We begin with the First of our seven (7) tools, shown in <u>Chart-4</u> (U.S. Unemployment Momentum—U-3 [Civilian] Rate and U-3 12 month Moving Average).
While the <u>absolute level</u> of the monthly Unemployment Rate is a <u>lagging</u> economic indicator, the <u>trend</u> in the Unemployment Rate (i.e., the <u>direction</u> in which it is moving) is a <u>coincident</u> indicator of Recession.

Moreover, specific changes in the <u>trend</u> actually are <u>leading indicators</u> to Recession.

<u>This single indicator has been as near perfection as they come</u> throughout its history. <u>This indicator declares a Recession call when the current month’s level exceeds its 12-month Moving Average level</u> and, importantly, occurs <u>at the same time</u> as the stock market having declined to where the week’s closing price falls below its 40-week, or 200-day, Moving Average.

Moreover, looking at the shorter-term <u>3-month</u> Moving Average of the Unemployment Rate, we find that, for the eleven (11) Recessions since 1945, <u>whenever the 3-month Moving Average has increased by 0.3% or more from any lower level of</u>

this Index, the economy has always ended up in a full-blown Recession, with a lead-time of from eight (8) to zero (0) months.

See Table I ("Turning Higher"). The data come from the New York Fed under William Dudley, offered in a footnote to his speech entitled, "The Outlook for the U.S. Economy in 2018 and Beyond" (January 11, 2018). This Table tells us that the turn higher of the 3-month Moving Average by just 0.3% projects that a Recession is already underway (zero [0] months lead) or, on average, will begin in 3.45 months from the date of the 3-month Moving Average's gain.

Currently, data from either the 12-month or the 3-month Moving Average indicate that all remains well. But, just in case a change is coming soon, we will be keeping acute attention to the Unemployment Rate each month; if the 3-mMA reaches 3.93% from the current low of 3.63%, or if the current rate exceeds the12mMA, it would mean this forecasting tool would be indicating a change in the economy's direction.

But since perfection really doesn't exist, we look for added confirmation of the economy's change (i.e., at least three (3) of the (5) forecasting tools declaring a sell reading). Thus, we quickly review the other (4) of the (5) for their current status:

Chart-5 (Advance Real Retail & Food Service Sales [August 2019]—percentage change from a year ago) is our second forecasting tool. As it shows, the Consumer remains positive in a weak economy—clearly visible in the next Chart.

Chart-6 (Industrial Production Index [August 2019])—our third forecasting tool—has fallen into Recession territory; thus, it has become one (1) of three (3) needed to cause a sell signal from the five (5) forecasting tools.

Chart-7 (All Employees: Total Nonfarm Payrolls/Civilian Labor Force [August 2019]—year-over-year change)—the fourth of our forecasting tools—clearly shows, like Chart-5 for Retail Sales, a positive contribution to the economy.

Chart-8 (10-Year Treasury Constant Maturity Minus 2-Year Treasury Constant Maturity [August 2019])—the fifth of our forecasting tools—has become negative (i.e., has Inverted, with the 2-Year higher than the 10-Year), with any Inversion creating a sell signal. (Note: Once Inverted, this tool remains a Recession signal until a subsequent Recession has once passed; the Inverted Yield Curve has no value in predicting Expansions.)

Thus, the Inverted Yield Curve has become the second (2) of the three (3) needed to cause an actionable sell signal from the five (5) forecasting tools. Finally, remember if and/or when there are three (3) of the five (5) negative, the 40-week Moving

Average of the S&P 500 must also signal sell (i.e., current S&P 500 closing below its 40-week MA). Currently the S&P 500 is 5.53% above its 40-week Moving Average. Its range over the past 10 years is as low as 12.79% below the Moving Average and as high as 19.20% above the Moving Average.

Thus, the final count currently of positive vs negative forecasting tools is two (2) Negative vs. three (3) Positive, revealing the near-Recession-call, which we believe lies directly behind the Fed's moves to help prevent Recession by lowering interest rates.

To strengthen its advancement, and to keep from further weakening into a contraction, the economy needs to have Industrial Production reverse back to the positive, as well as to have no further deterioration among those forecasting tools still positive.

Thus, we remain guardedly optimistic using our five (5) forecasting tools. This leaves consideration of the two (2) key concurrent, or "Nowcasting," signals.

Chart-9 (Aruoba-Diebold-Scotti Business Conditions Index [August 2019]—offered by the Philadelphia Federal Reserve) shows a -0.20 reading for August, making the sell level of -0.80 remain a significant distance away.

Chart-10 (Chicago Fed National Activity Index [August 2019]—the Chicago Fed's current "Nowcasting Index), at -0.14, also remains well away from the -0.70 sell signal.

In conclusion, with three (3) of five (5) forecasting tools and both "Nowcasting Indexes Positive, our view remains: **Economic Weakness, Yes—Recession, No!**

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