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Market Update – *It's all about the Fed*

by David A. Jaffe, M.D.

After a fourth quarter market swoon of 19.5% from its earlier high (the S&P 500 ended 2018 down 4.38%), investor sentiment swung from fear about being *in* the market to regret about missing *out* on surging stock market gains. The S&P 500 rebounded 13.65% in the first three months of 2019, its best quarterly performance since 2009.

Many analysts opined simply that the recent market sell-off was "overdone", and it's true that the stock price correction created attractive valuations for previously pricey equities. Likely the most important fundamental change for the first quarter was restrained monetary policy, the U.S. Federal Reserve and other central banks around the world putting interest rate hikes on hold. Many had worried that rates would continue to rise in 2019, with the risk of precipitating a recession. Optimism about progress in U.S. – China trade talks further boosted investor enthusiasm.

While holding up better than the S&P 500 through the market decline of 2018, the PASI stock portfolio is lagging the market modestly for 2019 year-to-date with a return of 12.21% (PASI and market returns include reinvested dividends). Leading the market in 2019 has been a rebound in volatile technology names, while more conservative recession-resistant shares such as health care have attracted less investor interest for now.

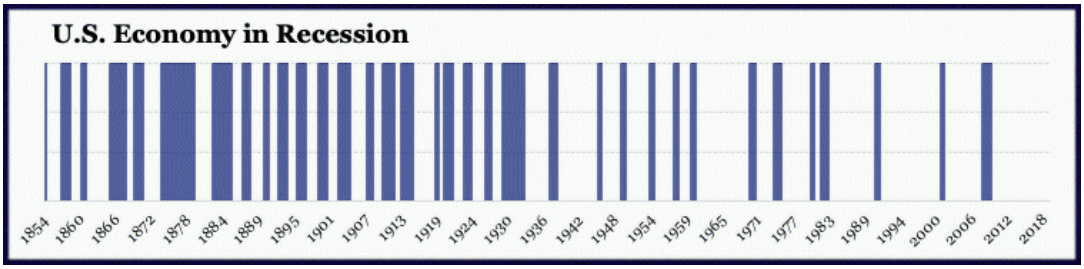
Recent market turbulence and the big first quarter rebound have prompted some clients to ask about protecting profits as the market again approaches all time highs. It is worthwhile to review the value of our balanced structure with a fixed stock-bond target. We rebalance accounts on an ongoing basis, looking at your current mix and target in conjunction with virtually every stock or bond trade. Using the first quarter of 2019 as an example, our average stock holdings gained 12.21% while corporate bond returns averaged 2.20%. *Untouched,* an account targeted for a 50:50 mix would have ended the quarter with 54.4% of dollars in stocks and 45.6% in bonds. Our discipline, however, leads us to

systematically move some of those stock dollars into bonds to maintain the fixed stock:bond target, in essence "banking" stock gains in the very stable bond portfolio. Conversely, in a declining market the stock percentage shrinks below target and we use account income (dividends and interest) as well as bond maturities to add to the stock holdings and restore the targeted stock:bond mix. It's a great strategy which leads us to do what every good investor knows they should do: "buy low and sell high!"

The Next Recession

by Nathan Polackwich, CFA

It's been almost ten years since the 2008/2009 recession officially ended – Enough time that it's natural to wonder whether a new one might be around the corner. Of course, recessions (defined as a significant decline in economic activity lasting more than a few months) are notoriously difficult to predict. Economists sometimes don't even realize the economy is in recession until reviewing the data months later! Although it's been a decade since U.S. growth last contracted, some comfort can be taken from the fact that recessions have become less frequent and of shorter duration over time, as illustrated by the chart below.



What accounts for this increased stability? And what's the best way for us to even approach such a far-reaching question? The philosopher Karl Popper argued that it's easy to find evidence in favor of virtually any proposition. But such corroboration can never be conclusive because the discovery of a single exception can refute it. The classic example of Popper's assertion was the seemingly self-evident belief in the western world that all swans were white…until 1697 when a Dutch explorer first encountered black swans in Australia.

To Popper, then, scientific knowledge is driven more by falsification than verification – We can never know definitively if a proposition is true (e.g. all swans are white). But we can say with certainty that it's false based on just one deviation. Negative information, then, is more valuable than positive corroboration. In human domains – such as the reasons for greater economic stability – Popper's falsification concept suggests we can learn more from past mistakes than recent successes. So what went wrong before the modern era?

1800 to Civil War – With the U.S. economy immature and dependent on agriculture (90% of laborers were farm workers in 1800), economic downturns through 1830 were mainly driven by events in Europe. For instance, the end of the French Revolutionary Wars in

1802 caused a sharp drop in commodity demand (and prices) that put the U.S. economy into recession. Another downturn occurred from 1807-1810 due to a trade embargo against Britain and France in response to both countries' seizure of U.S. merchant ships during the Napoleonic Wars.

Unlike the French Revolutionary Wars, the Napoleonic Wars (ended 1815) left continental European agriculture in shambles, which indirectly led to a U.S. commodity and land boom (inflamed by reckless bank lending). The simultaneous recovery of European farming and efforts by the 2nd Bank of the U.S. (a precursor to the modern Federal Reserve) to curb speculation popped the bubble in 1819. The result was a real estate bust, banking panic, and depression (a particularly severe recession) that lasted through 1823.

The U.S.'s close economic relationship with Britain caused two more recessions in the 1820s. One involved the meltdown of Britain's banking system over bad Latin American loans (1825). A humorous anecdote from this crisis concerns large sums lent (and lost) to a Scottish adventurer/fraudster named Gregor MacGregor for investment in the mythical country of Poyais. MacGregor was so convincing that a few hundred unfortunate people even tried to emigrate to "Poyais" expecting a developed British colony but instead finding only uninhabitable jungle MacGregor had acquired from a local king for jewelry and rum. A trade war between the U.S. and Britain over the English colonies led to another recession in 1828.

Two major economic downturns then occurred in the lead up to the Civil War. In 1837 President Andrew Jackson crushed a speculative, debt-driven land boom by signing a bill requiring all government land sales be conducted in gold or silver. The fallout was another major banking panic and depression that lasted until about 1844.

More reckless lending, this time in the railroad industry, caused a financial meltdown in 1857 and bank runs across the country. One victim of the Panic of 1857 was future Civil War hero and U.S. president, Ulysses S. Grant, who went bankrupt and famously had to pawn his gold watch to buy his family Christmas presents.

Civil War to Great Depression – Despite some modest downturns, the U.S. economy didn't collapse during the Civil War (though Southern wealth did) with a boom in the North offsetting the devastation in the South. Growth then largely continued until the passage of the 1873 Coinage Act, which retired silver currency and effectively put the U.S. on a gold standard. This caused a drastic decline in the money supply and soaring interest rates. As credit dried up, banks, railroads, and industrial companies started failing en masse. So began one of the worst depressions in U.S. history, which lasted until about 1879.

After a brief recovery, more typical downturns in the railroad industry led to minor recessions in 1882 and 1887. Another speculative bubble in the railroad industry then formed and burst in 1893 taking down major players like the Philadelphia and Reading Railway and Union Pacific. As usual, a widespread banking panic followed with hundreds of failures across the country. Concerns that dwindling gold reserves would force the government to abandon the gold standard added to worries. Events finally stabilized in

1895 when the government shored up its reserves by borrowing $65 million in gold from a private banking syndicate led by J.P. Morgan.

From 1900 to the Great Depression, the U.S. experienced multiple minor recessions. The reasons were various and included a stock market crash in 1901, a banking panic in 1907 related to a failed attempt to corner the copper market (J.P. Morgan comes to the rescue again), the government breakup of Standard Oil in 1910, a reduction in military spending after WWI, and Ford halting production for six months while it retooled its factories in 1926.

A notable though brief depression did occur in 1920/21, however, somewhat foreshadowing the Great Depression nine years later. A major factor in both depressions was the actions of the Federal Reserve, created in 1913 to centralize control of the monetary system and supposedly alleviate the banking panics that had continually plagued the U.S. economy.

The origins of the 1920/21 downturn stemmed from the Federal Government's pressure on the Fed to keep interest rates low to finance WWI military spending. This caused the value of the dollar to fall, making it attractive for speculators to redeem U.S. currency for gold (which the government was forced to temporarily halt during the war). After the war, surging gold redemptions forced the Fed to hike interest rates and dramatically shrink the money supply causing a sharp economic contraction.

The beginning of the Great Depression was no different than other major boom/bust cycles with a long-term expansion (the Roaring Twenties) propelled by speculative investment eventually going bust and culminating with a stock market crash in 1929. Three additional factors then conspired to turn what might have been an ordinary recession into a historic catastrophe. The first was the Dust Bowl, which devastated U.S. agriculture (still 30% of employment). The second was the terribly mistimed Smoot-Hawley Tariff Act of 1930, which succeeded only in further dampening global trade. The third and most critical factor was Federal Reserve policy.

The Fed's first mistake was doing nothing to stop bank panics from rippling across the country. During the first 10 months of 1930 alone, 744 U.S. banks failed (about 9,000 would ultimately go bankrupt). The next big policy error occurred in 1931 when, in an echo of the 1920/21 depression, the Fed hiked interest rates to defend the gold standard.

The Fed's idea was that higher rates would lower speculators' desire to redeem U.S. currency for gold. While the medicine worked, the side effect of further spectacular banking panics/failures ended up being far worse than the cure. Not surprisingly, the moment the U.S. abandoned the gold standard (1933) a powerful recovery commenced forthwith. Four years later, however, U.S. government spending cuts and Fed rate hikes (reflecting the government's desire to "normalize" fiscal and monetary policy) caused the Great Depression's final leg down that lasted until WWII.

WWII to 1982 – Recessions in this period were mostly characterized by post-war declines in government military spending (WWII and Korea) and Fed rate hikes to fight the threat – sometimes real but often imagined – of inflation. Inflation did become quite real, of course, in the 1970s due to a confluence of factors starting with large budget deficits (and the associated flood of dollars) related to the Vietnam War. Resultant inflation caused a resurgence in gold redemptions[1] and the final abandonment of the gold standard that the U.S. and its trading partners had operated under following WWII. Later compounding the inflationary pressure were OPEC's oil embargo in 1973/1974 and supply cuts in 1979/1980. The high inflation of the 1970s was only brought under control by the radically tight monetary policy of Fed Chairman Paul Volker, who doubled interest rates to 20% in 1980/1981 at the cost of two very sharp recessions.

Lessons for Today – The good news is that many of the contributing factors to the recessions/depressions prior to the modern era no longer apply.

- The U.S. economy isn't dependent on a single, volatile sector like agriculture.
- Foreign wars don't exert much influence over the supply and demand of U.S. goods and services.
- U.S. military spending isn't about to plunge from the conclusion of a major war.
- Banking panics are no longer a significant threat due to the Federal Reserve's status as lender of last resort and regulatory changes like stringent capital requirements and FDIC insurance.
- Thanks to the abandonment of the gold standard, the money supply doesn't have to be cut and/or interest rates increased to maintain gold reserves in a weakening economy.
- Oil price spikes don't affect U.S. economic growth like the 1970s or even 1990 when an oil price shock from Iraq's invasion of Kuwait led to a small recession. This resilience reflects lower household consumption of gasoline and a boom in U.S. shale oil production that's significantly reduced U.S. oil imports (to the point where the increase in U.S. oil production in response to high prices now almost offsets the hit to consumer spending).

Some risks, of course, remain. The economy is still vulnerable to a stock market crash, as the bursting of the Internet bubble in 2000 demonstrated. The housing bubble and Great Recession of 2007-2009 were also stark reminders that speculative booms and busts driven by reckless lending haven't gone away. While the U.S. economy is now mature and diverse, major recessions in Europe or China (or both) could also impact growth enough to cause a downturn.

Two more immediate risks to the economy are the threat of a global trade war (unlikely with the U.S. Presidential election next year) and further Federal Reserve rate hikes due to

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[1] Under the post WWII gold standard (called Bretton-Woods), only countries' central banks, not individuals (or speculators), could redeem U.S. dollars for gold.

inflation fears. The Fed's recent rate increases likely contributed to a modest slowdown in the fourth quarter of 2018. If the Fed continues to raise rates, I have no doubt they will eventually succeed in provoking a recession. Thankfully, they now seem to be on hold.

Looking at the economy overall, then, I don't see any unusually significant causes for concern. Although the current expansion is a decade old that doesn't mean we're necessarily "due" for another recession. That's not to say a downturn is impossible – just that the odds of one in 2019 don't look any higher than for the average year.

"Time in" the Market

by Christopher M. Brown, MBA

The stock market ended last year with the worst December drop for the S&P 500 since the Great Depression (down 9%), and the worst December on record for the Nasdaq. According to Morningstar, long term U.S. funds had their greatest monthly outflows since the depths of the credit crisis in October 2008. In fact, in 2018 just about every single asset class one can invest in — from global stocks to government debt to corporate bonds to commodities – posted negative returns or unchanged performance in 2018. This heightened volatility caused many investors to flee and subsequently miss out on the first-quarter 2019 rebound when the S&P 500 roared back to gain 13.65%.

Corrections of greater than 10% are more common than you might think. According to J.P. Morgan, since 1980 the average intra-year drawdown for the S&P 500 index has been -14%. There were 21 years (out of 38) where the drawdown was -10% or greater. Of those 21 years, 15 (71%) still finished the year with flat or positive returns.

Some investors think they can outsmart the market by nimbly jumping in and out. Others allow emotions to get the best of them during times of market turbulence. Either way, trying to "time" the market is a dangerous game that often leads to long-term underperformance.

Last year, J.P. Morgan published a report that examined the S&P 500's best and worst single-day performances over a 20-year period between Jan. 1, 1998, and Dec. 29, 2017. Notably, this period includes the Great Recession and the dot-com bubble. The report found that investors who remained invested over the entire 20-year period (over 5,000 trading days) would have made 301.4%, or 7.2% per year on average. But investors who missed just 10 of the biggest single-day gains had their returns more than halved to just 100.30% or 3.53% per year. Shockingly, missing only 30 of the best trading days left you with a loss of -16.69%, or -0.91% per year.

Most importantly, the data confirmed that the S&P 500's biggest gains tended to come within two weeks of the biggest single-day losses. Thus, anyone waiting on the sidelines for the coast to clear after a sharp decline likely missed out on some of the market's biggest single day gains. These results are a strong reminder of the importance of "time in"

the market (rather than timing the market), as missing even a handful of days can have a devastating effect on an investor's total returns.

In the end, we are only human. Despite our best intentions, we are all susceptible to the emotional biases that can lead to poor investment decisions. That's why adhering to a disciplined investment process is so critical.

At PASI, we work closely with our clients to establish a plan and set their stock and bond allocations at levels appropriate to their financial situation and consistent with their tolerance for risk. During volatile market conditions, we remove emotions from the equation by systematically rebalancing clients' portfolios to maintain their asset allocation. This ensures that we're automatically adding to stocks during corrections while trimming gains in expansions, the exact opposite of what an emotional investor would likely do.

While the stock market will always have periods of poor returns, the economy and earnings will continue to grow, and stock prices will ultimately follow. Next time you hear about the market dropping, pull up a long-term chart of the S&P 500 for some perspective on just how insignificant short-term losses can be and how important it is to invest for the long haul.

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