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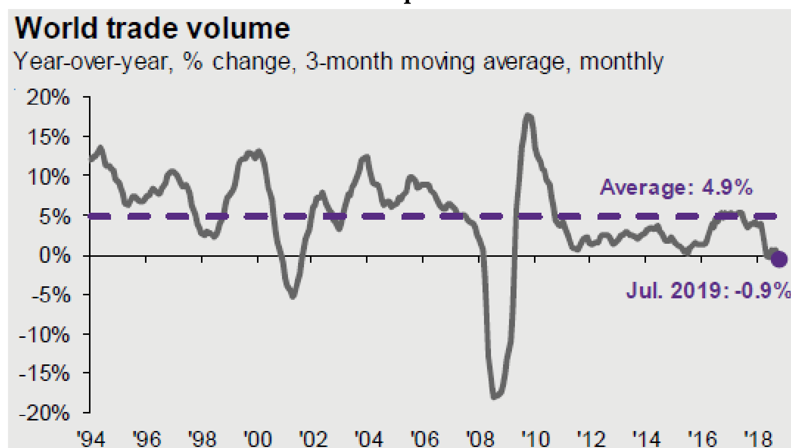
Emotions and Investing – A Bad Cocktail

The sharp rally in risky assets that investors enjoyed during the first half of 2019 abated in the third quarter, as mounting evidence of slowing economic growth weighed on investor sentiment and increased market volatility. The global manufacturing sector showed particular weakness, as the extended US/China trade conflict dented business confidence and investment. Graph 1 shows that global trade growth has recently declined significantly after strong acceleration over the previous year, the result of higher tariffs and decreased business confidence. Concerns about economic deceleration prompted multiple central banks (including the Federal Reserve and the European Central Bank) to initiate new monetary easing. After four interest rate hikes in 2018, the Fed has lowered rates twice this year, and is expected to initiate several more cuts over the next year. Geopolitical events continue to add to market uncertainty: in addition to trade disputes, investors weigh uncertain outcomes in Hong Kong and the Middle East, a looming Brexit deadline, and impeachment proceedings in advance of a US Presidential election year.

Despite all of these market-roiling events, third quarter results were respectable, and year-to-date gains have been quite strong: the S&P 500 returned 1.7% for the quarter and 20.6% through 9/30. As of this writing, the S&P 500 is within 1% of its all-time high. Foreign stock markets have lagged the US, but have still rewarded investors: despite modest third quarter losses, developed and emerging market stocks have returned 13.4% and 6.1% respectively. High yield bonds returned 11.4% for the year, and the drop in interest rates boosted REITs and high grade bonds, which returned 28.5% and 8.5% for the first three quarters.

All considered, 2019 has been yet another excellent year for **investors who have stayed the course**, despite unremitting negative news headlines. In fact, this year underlines the old adage that markets "climb a wall of worry," in that they tend to rally when investor sentiment is most negative, and conversely fall amid excessive optimism.

Graph 1



Source: JP Morgan

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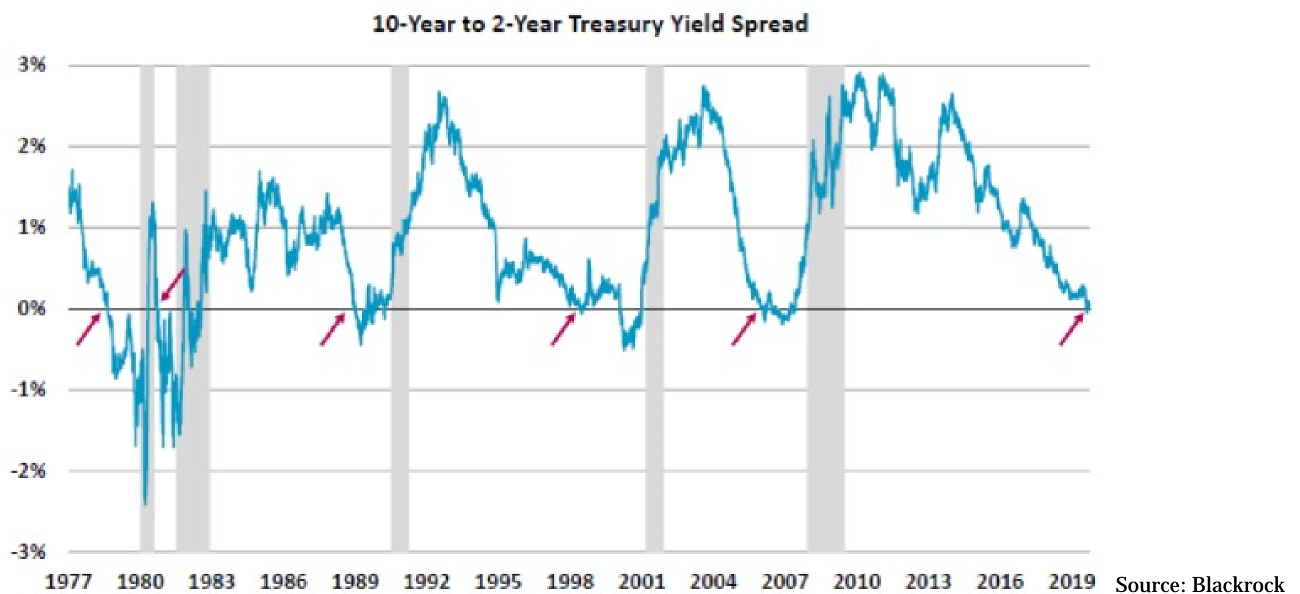
There has been much talk in financial media of the risk of a recession (typically defined as two consecutive quarters of negative real growth), given the clear slowdown in global trade and economic growth. Often such reports cite the "inverted yield curve" in the US as evidence of a looming recession. The yield curve plots the relationship between interest rates and debt maturity. Typically longer maturity interest rates are higher than shorter ones, to compensate lenders for the increased risk of lending capital for longer. When short-term interest rates exceed longer rates the yield curve is said to be inverted. This is considered to be a recession indicator, partly because lower long-term rates indicate decreased demand for credit, and the expectation of slower growth. Graph 2 shows that the US Treasury yield curve recently inverted, with the 2 year bond yield exceeding that of the 10 year. Such a phenomenon has preceded each US recession in the last 50 years, with no false signals. This record has fed recession fears and prompted scorn toward those who suggest that perhaps "this time is different." In fact, this time is very much different in at least one sense: there has never before been a situation where central banks have bought trillions of dollars (and other currencies) worth of long maturity debt, a distortion which has lowered long-term interest rates, and contributed to the yield curve inversion. While a recession is of course ultimately inevitable, this distortion and the difficulty in predicting the timing of its onset greatly diminish any actionable value that this signal may offer.

Graph 2



Source: Blackrock

The difficulty in predicting the timing of a recession or stock market correction makes it appropriate to return to a theme we regularly articulate: **the importance of crafting an appropriately risked investment strategy, and then sticking with it over market cycles…regardless of news headlines.** In our second quarter commentary (***Time as a Risk Dimension***, 4/12/19), we discussed how volatility represents only a limited, static measure of investment risk, and demonstrated how portfolio risk changes over extended timeframes. In other words, portfolios that are very risky over short holding periods often tend to have lower risk (and higher returns) over longer periods, as market prices recover and advance across economic cycles.

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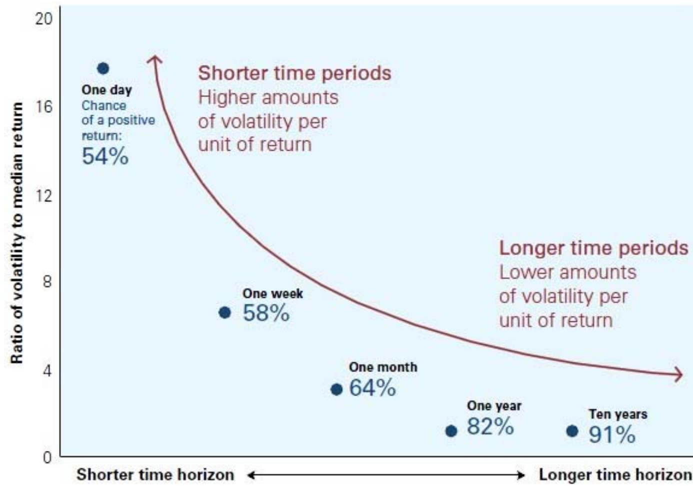
Graph 3 illustrates this concept by showing the relationship between S&P 500 stock market returns and volatility over a 30 year period ending 12/31/17. While the probability that the stock market was up in a given day was only 54%, the probability of a positive return over a given 10 year period was 91% (and this period included two severe bear markets!).

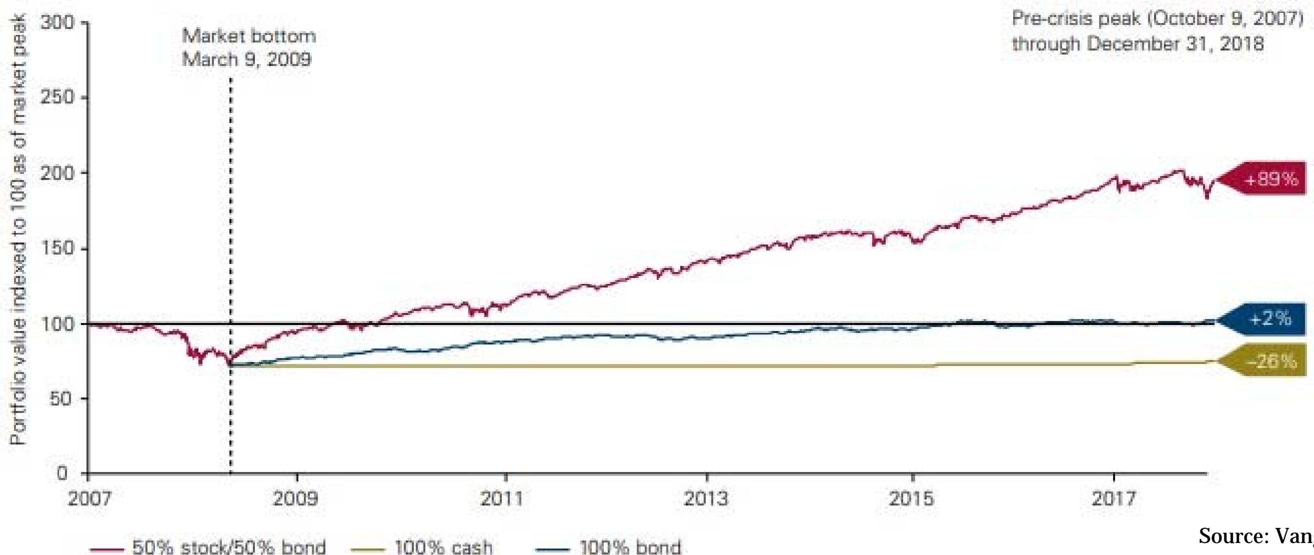
Graph 3



Source: Vanguard

Graph 4 shows the real-world impact of three different hypothetical investment strategies that might have been followed after the '08/'09 downturn. The first outcome reflects a 50% stock/50% bond portfolio held throughout the crisis, which returned 89% by the end of 2018 (and which would be up about 100% now). The other two outcomes reflect defensive strategies adopted at the market bottom: a switch to an all bond portfolio (which has only just recovered its losses), and a switch to an all Treasury bill portfolio (which locked in market losses and has yet to recover them after over 10 years).

Graph 4



Source: Vanguard

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The take-away is that emotions and investing are a bad mix. Stick with the plan across market and economic cycles, and review the plan annually to ensure that it still reflects your current strategic needs. When markets get volatile, look for opportunities to take advantage of the volatility rather than a change in strategy. One current opportunity presented by the recent drop in interest rates is **the chance to refinance debt** – mortgage rates are currently close to all-time low levels.

Thank you for your trust, and please don't hesitate to contact a SFA team member to arrange a meeting to review your personal financial plan. And to discuss opportunities.

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