Argent Wealth Management, LLC

Investment Outlook
Spring 2019

First Quarter 2019 Review; Second Quarter 2019 Outlook

Expecting a Retest

Equity and other "risk" markets, such as high-yield bonds, staged a breathtaking recovery during the first quarter. Importantly, the recovery in asset prices was broad-based. International equity markets and emerging markets kept pace. Within the United States, small-cap and mid-cap stocks bested returns on the largest stocks. That is in sharp contrast to the narrow leadership that we cited at certain times last year. At that time, so much of market returns was driven by a small number of exceptional large capitalization growth companies (e.g. the "FANGs").

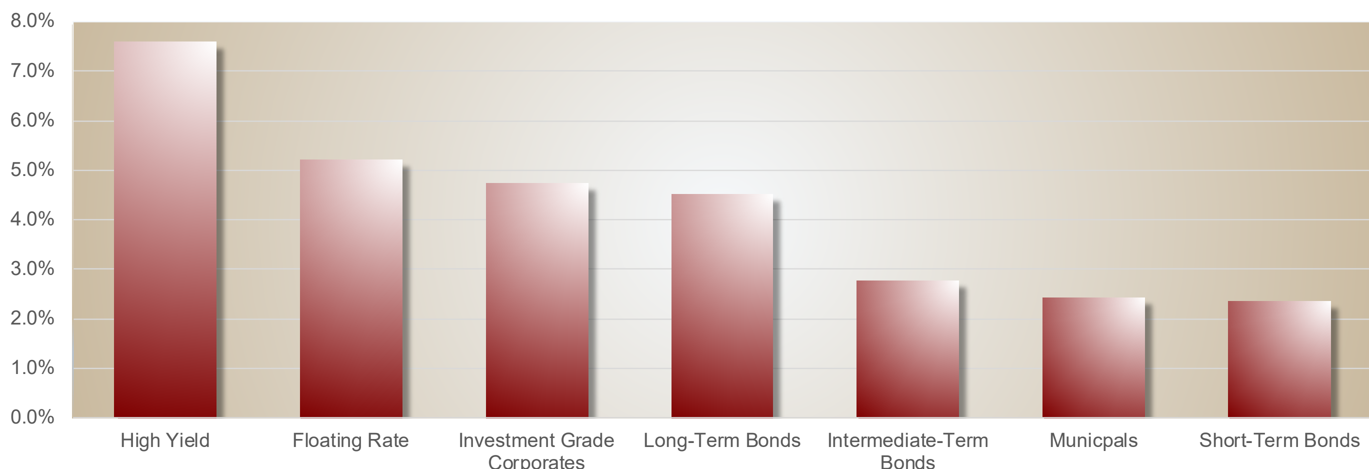
It is not unusual for markets to experience a sharp rebound following such dismal quarters (declines of 20% or more). The December 24 market bottom did have all of the classic signs coincident with a major bottom. Retail investors redeemed their equity investments at a record pace. Sentiment touched truly despondent levels, an excellent contrary indicator, when extreme levels are reached.

"Having said that, the sharp recovery did have certain features that make us skeptical about the sustainability of the advance."

First, the vast majority of recoveries experience some kind of retest of market lows. It is actually more common for the second decline to set a new and lower low. In many cycles, that second low is a major opportunity to add risk to portfolios.

Second, yields of treasuries and higher-grade bonds around the world dropped precipitously. For example, the yield on the German 10-year bund went into unimaginable negative territory. Plunging yields on higher-grade securities are normally associated with weak economic conditions, widening credit spreads and the expectation of recession. It is unusual for risk assets and higher-grade bonds to both rally so significantly at the same time.

Fixed Income Performance Year-to-Date



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Certainly, the major pivot from the Fed in December played a critical role. Not only did the Fed move from a posture expressed as recently as last fall as "being a long way from a neutral policy" (expecting significant additional increases in interest rates), but they also scaled back on planned reductions in their balance sheet. As we noted in our last Outlook, balance sheet reductions were having a larger negative effect on liquidity than most market participants may realize. Not any more.

There were, of course, other positive market forces, such as expectations of a favorable trade deal. We believe that a major breakthrough, such as a comprehensive deal, could send markets higher yet. However, the market now expects a deal. A collapse in talks (not what we expect) would be a major blow. A deal without specifics is more likely to be a "sell on the news" scenario.

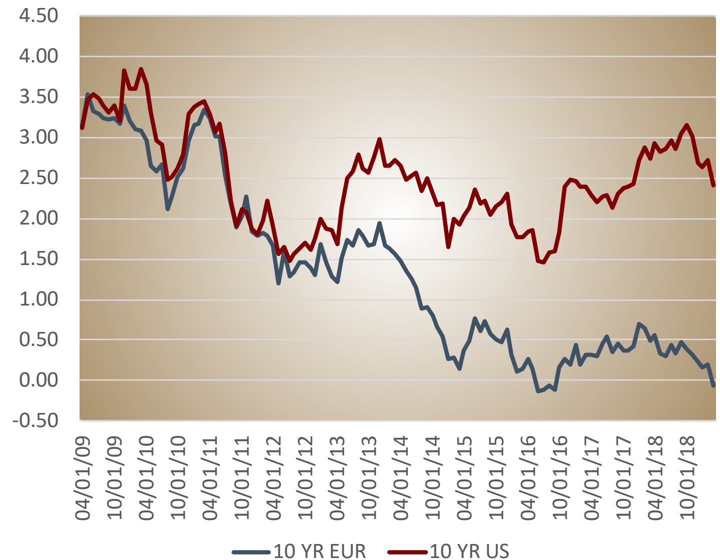
The bottom line is that we think some kind of "retesting" of lower market levels is more likely than not. We do not expect a full test of December lows and certainly not the more historically normal second, lower low. A pullback in the range of 10% is a more probable scenario.

Does an Inverted Yield Curve Signal Recession? We Think Not.

Markets were captivated with the recent inversion of the Treasury yield curve (longer yields being lower than shorter-term yields). That resulted in many more bearish strategists trotting out forecasts of recession. They cite the statistics of almost every U.S. recession associated with an inverted yield curve, which is a legitimate claim. However, as with many "canned" statistics, it is more complicated than that.

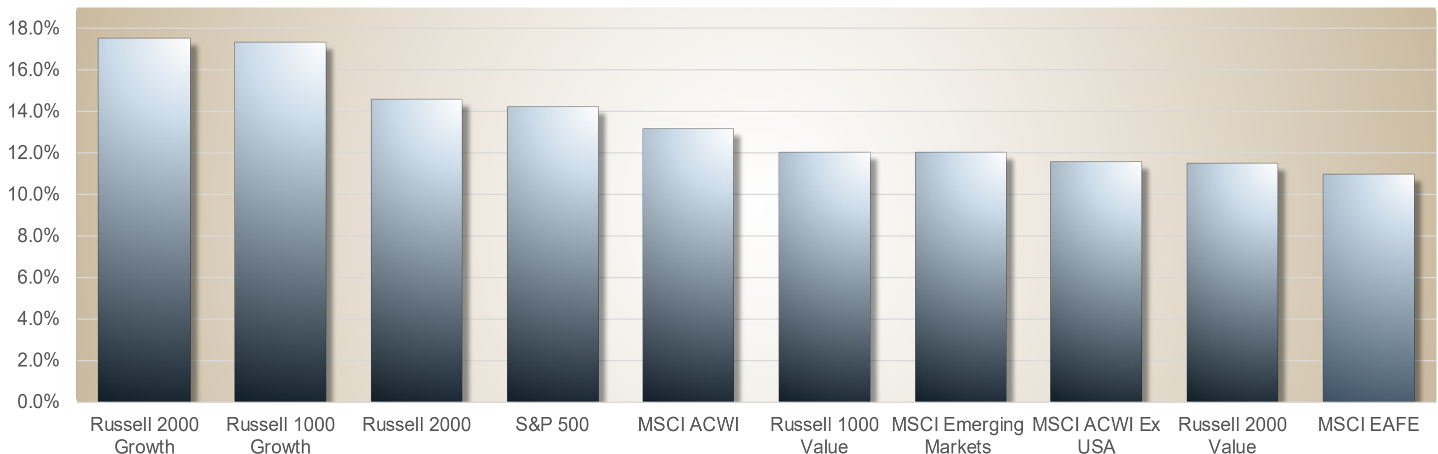
To begin, we believe that a meaningful portion of the inversion in U.S. yields was the result of non-U.S. investors seeking yield in our markets. With negative yields in so many developed regions, investors are seeking yield wherever they can find it. As such, a 2.5% yield on our 10-year Treasury looks compelling if the alternative is a zero or negative yield.

10 Yr. U.S. Versus European Yields



Maybe more importantly, the Fed stopped their interest rate increases at a lower level than in past cycles. In many of those cycles, the Fed was driving up interest rates to quash surging inflationary expectations. They were effectively creating a recession, although no Fed member would ever admit to that.

Equity Index Performance Year to Date



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Many prior cycles resulted in real yields (the yield minus the rate of inflation) in the range of 3% or more. The normal consequence of a real yield that high is to depress lending activity. If credit spreads are also wide, as they normally are at that point in the cycle, corporations also cut back on borrowing. It is the reduction in lending activity, and in consumer expectations, that results in the oncoming recession.

This time around, credit spreads are well-contained. Borrowing in the high-yield market has surged in the past quarter. Mortgage rates have also dropped a full percentage point from cycle highs. Housing activity has already improved entering the all-important spring season.

These are not the signals we would expect to find if a recession were around the corner. Our baseline scenario is for growth rates in the United States to center around 2% in the coming quarters. While that is not as robust as last year, it is a respectable rate of growth.

Cautious Does Not Mean Bearish: We Look to Buy Equities on Weakness

The primary reason for our cautiousness is grounded in market expectations. The rebound is just too sharp and expectations are too high in our view. While we do not expect a recession, we also do not expect the torrid pace of earnings growth to continue. Much of the surge in profits was a result of the tax cut. That created both a onetime surge in profits (as the marginal corporate tax rate was slashed) and a short-term boost in economic activity.

Currently, both monetary and economic policies, while not restrictive, are less accommodating. While the Fed backed off further rate increases, the combination of past rate increases and reductions in the balance sheet are just being realized now. That is normally a process that takes 12 to 18 months. Fiscal policy is also less accommodating. Discussions are underway about reducing government spending. At a minimum, it is hard to imagine how the administration could stimulate the economy with a budget deficit so large.

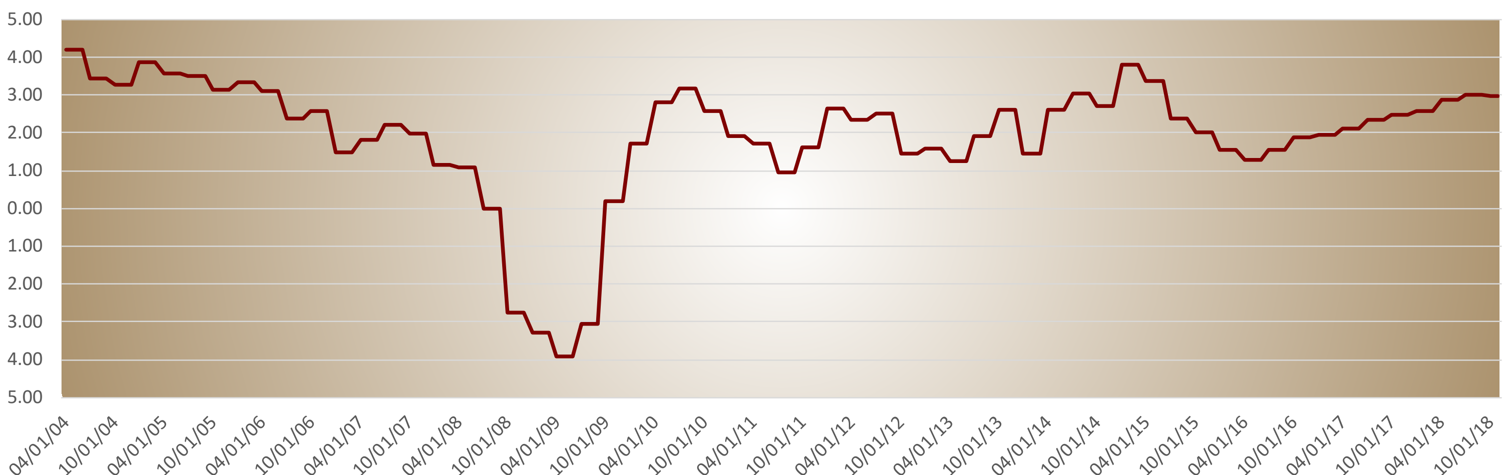
As such, profits should be able to resume modest growth. The problem is, markets may expect more than that.

An alternative bullish scenario relies on an expansion of valuation (P/E ratio). That argument has some merit, as bond yields remain low. It is possible that investors feel compelled to buy equities because "there is no alternative (TINA)."

While certainly possible, we do not believe that a material expansion in P/E multiples is likely. Expectations of future earnings growth should center on maybe 5% to 7% per annum, but less than that in the next few quarters. Bond yields, while low, are not zero either. A 3% to 4% yield can be earned safely with a short-term investment-grade bond ladder.

The reality over the next few years is expectations of modest returns for both stocks and bonds. Modestly positive returns is still a lot better than zero. However, the reality also points to the cautious and somewhat tactical approach that we are taking.

Real GDP Chart (YOY%)



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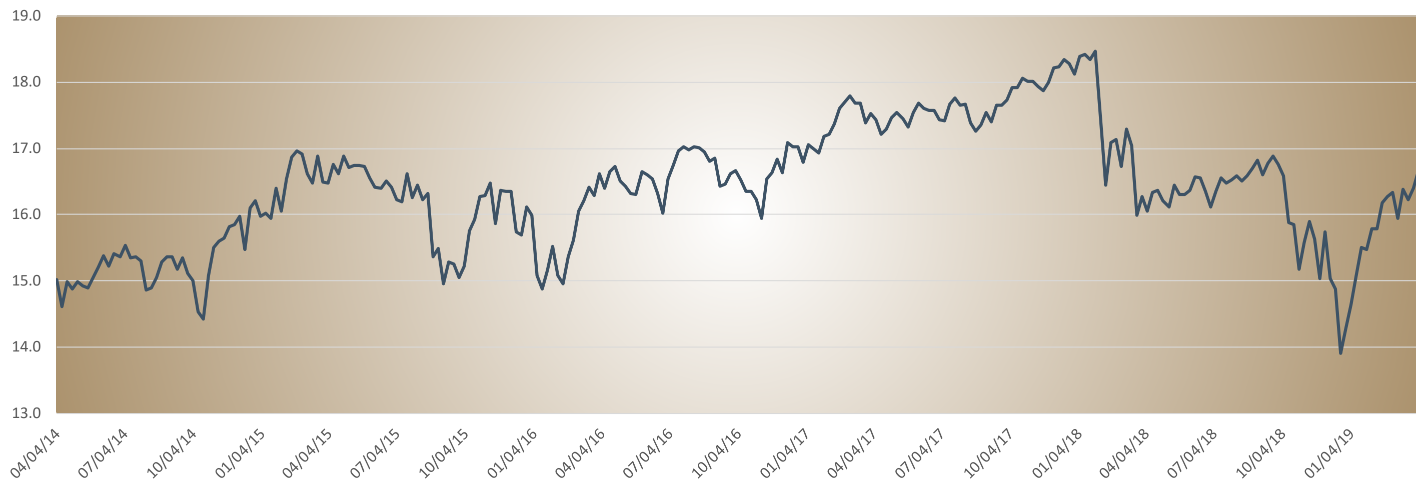
SPDR S&P 500 ETF Trust - Forward P/E



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Do Private Equity and Private Real Estate Still Make Sense? Yes, Selectively.

We have cited in prior reports the benefits of certain private assets. If these assets are invested in properly, they can both materially improve returns and reduce volatility. The challenge is that they are complicated and illiquid. They also have long investment horizons of typically six to 10 years. As such, they are not suitable for many investors.

The concern that many have, including ourselves, is that valuation levels are generally high. The economic expansion is already one of the longest on record. While we do not envision a recession in the near team, a recession will come at some point.

While valuations are high in general, there are still pockets of value. We have built up strong partnerships with some excellent general partners that seem to be able to find favorable companies (or buildings) at fair prices.

Our current strategy is to continue to build our PE and private real estate portfolios carefully and selectively. For our longer-term clients, that means recycling some, not all, of proceeds from successful exits. For newer clients, it means selectively adding to these categories.

Controlling Risk/Being More Tactical

While we always construct fully diversified portfolios and control risk, the way we do that can change depending on market circumstances. At earlier points in the bull market, that meant staying committed to a higher level of risk assets.

At the current point, it means having a somewhat lower exposure to equities than are normal and having a lower equity beta (volatility). This is not a time to have maximum exposure to aggressive growth stocks, as the premium paid for faster-growing companies remains unusually large. We favor more quality-oriented and dividend-focused sectors. It also means having limited exposure to areas such as high-yield bonds. These markets do not have return potential commensurate with our assessment of risk.

We also believe that tactics matter. That means trimming some risk and looking to add that risk back at a more favorable price. Markets never adjust evenly or rationally. Downward adjustments are generally more violent than up markets. These moderate tactical adjustments matter more when market returns are more modest.

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