WEALTH MANAGEMENT INTERNATIONAL, LTD.

Proactive Investment Management & Financial Planning

Global Perspectives, July 2018: Proactive Investment Management for Today

By now, our regular readers are probably familiar with our logo and company name as they appear above (and on the first page of every article we write). However, we suspect few have really focused the tagline that appears with them: "Proactive Investment Management & Financial Planning." We do think our clients understand and appreciate the proactive *financial planning* they get here at WMI. We work hard to probe their goals and needs. We develop personalized strategies to help them get where they want to go, and we take the initiative to regularly review their progress with them. However, our clients and prospective clients rarely ask about the proactive *investment management* we provide. They may have only a vague understanding of what proactive management entails and why it might benefit them. As it turns out, we think the U.S. economy and financial markets are now entering an important transition period that will illustrate the value of proactive investment management. Below, as we describe how we're managing our various strategies in the evolving environment, we think it will become clearer how and why proactive investment strategy makes sense.

Proactive Investment Management

Our version of "proactive" or "active" investment management comes down to how often changes are made in a portfolio's asset allocation, i.e., the percentages allocated to different asset classes, such as bonds, U.S. stocks, foreign stocks, real estate, and commodities. In our proactive approach, the investment manager aims to capture unusually strong returns or minimize risk by periodically adjusting the asset allocation in response to signals in the economic or financial market data. For example, if the manager judges that the signals are pointing to a potential downturn in the economy and stock market, the manager might sell some of the portfolio's stock holdings and invest the proceeds in bonds or some other less-volatile asset class. This "market timing" approach might be relatively aggressive, as when the allocation changes are frequent and geared toward capturing even small excess returns. It can be especially aggressive when it entails frequently buying and selling individual securities, rather than the diversified, index-tracking funds that we generally favor. Our version is relatively conservative, as our adjustments are generally made only when significant market moves are expected. The more aggressive forms can generate a lot of trading and tax costs. Our more conservative approach aims to limit the negative impact of commissions and capital gains taxes.

In contrast, an investment manager using the "passive" approach generally sticks with a chosen asset allocation or portfolio of individual securities through thick and thin, regardless of whether the particular assets are appreciating or depreciating. The passive approach assumes it is too hard to accurately discern upcoming market movements. It assumes it is too easy to sell an asset just when it is set to rise or buy an asset just as it is set to fall, and that any added return that might be earned from the strategy would probably get eaten up by high trading and tax costs. Indeed, academic research shows that because of those problems, most actively managed mutual funds fail to consistently outperform similar passively managed funds. On the other hand, the static asset allocations associated with passive management mean that passive funds can suffer long periods of underperformance when their main holdings fall into a bear market. That's painful for investors who are selling assets to fund current distributions or will need their funds in the near term, before the markets recover. It's also painful to suffer a long period of losses when there were signs of a downturn ahead of time, as when technology stocks were widely recognized to be in a bubble during the late 1990s.

The Discipline of Signal Monitoring

In our view, proactive investment management can boost returns and reduce risk when it is disciplined and rational. There has to be a reasonable basis to shift to a more conservative stance, to buy an asset class when few other investors want to, or to rotate investments within a particular asset class. Here at WMI, we believe that certain signals in the macroeconomic data and financial market trends have historically been reliable indicators of how asset prices will behave ahead of time. In our *Global Perspectives* of October 2017, we provided a detailed discussion of many of those indicators. At that time, the vast majority of the indicators pointed to continued good economic growth and rising stock prices

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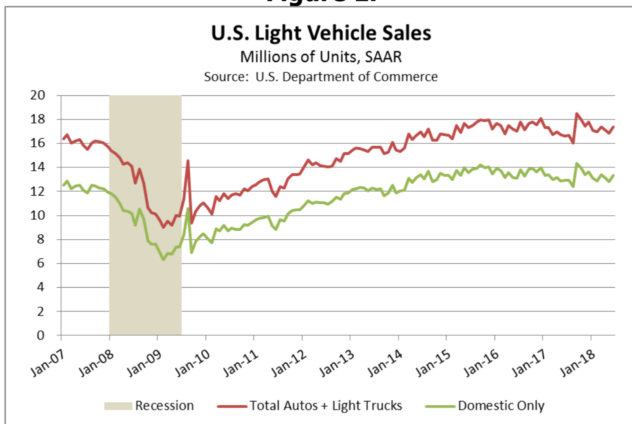
in the United States, which indeed has come true. Now, however, a growing number of those indicators are starting to flash warning signs, as discussed below:

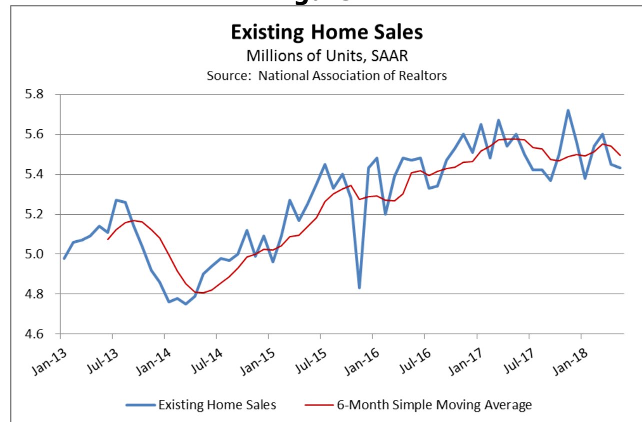
Flat Vehicle Sales. After falling steeply during the Great Recession of 2008-2009, U.S. sales of autos and light trucks embarked on a long, sustained rebound that lifted the annualized selling rate to a record high of 17.973 million units in September 2015 (see Figure 1). The selling rate spiked to a new record of 18.486 million units in September 2017, but only because of replacement buying after that summer's hurricanes destroyed thousands of vehicles. Other than that spike, vehicle sales have been basically flat for the last three years, in spite of the strong labor market and high consumer confidence. We think that's a significant yellow flag, as it suggests the long period of sales growth has left the market saturated. It seems that everyone who is willing and able to buy a new car has already done so. The flat sales probably also reflect the recent rise in interest rates and tighter lending standards. In any case, since the auto industry is such an important part of the economy, we fear that the continued weak sales growth could soon become a significant drag on the economy, corporate profits, and the stock market.

Figure 1.



A Softening Housing Market. Recent data suggests the housing market may also be starting to roll over. Most important, sales of existing homes (the vast majority of the market) have been flat-to-down since late 2016, even though companies are creating lots of new jobs, unemployment has fallen to very low levels, and layoffs are limited. Given the long drought in home sales after the housing bust, and given the resulting pent-up demand, we don't think this softening stems from market saturation. We suspect the pullback comes in large part from rising interest rates. With the Federal Reserve apparently intent on further rate hikes, we think the market could continue to struggle going forward. Since housing is another big part of the economy, we worry that continued soft home sales could further weigh on the economy and corporate finances going forward.

Figure 2.



Inflation Overtaking Wage Gains. More generally, we are also seeing some warning signs in the labor market itself. The key issue is that even though companies are creating lots of new jobs and unemployment has fallen to extremely low levels, wage growth has remained so weak that it is now being overtaken by inflation. Average hourly earnings in June were 2.8% higher than one year earlier, slightly beating the average annual gain over the last few years, but consumer prices as measured by the consumer price index were also 2.8% higher (see Figure 3, next page). In other words, there has been no increase in purchasing power from the rise in wages over the last year. Inflation-adjusted consumption spending is still rising, but mostly because of the recent tax cuts, increased borrowing, and decreased saving – all of which could well peter out in the coming months. In fact, after stripping out the impact of inflation, per-capita spending growth has already fallen below the 2.0% that has historically been a harbinger of recession down the road.

Tight Labor Market Putting Profits at Risk. As we look into the future, we wonder if rising inflation and stagnating purchasing power will prompt workers to demand significantly bigger raises going forward. In fact, we think firms may have to start paying more just to fill all the new jobs they're creating. We find it especially significant that in spite of the very low unemployment rate and strong labor demand over the last few years, there has been virtually no increase in the share of the adult, civilian population that is either working or looking for work (the "labor force participation rate"). Our previous analysis has shown that most of those outside the labor force are there because they're retired, disabled, caring for loved ones, or in school. To entice more of them into the job market, companies would probably have to boost wages quite a bit further. If firms

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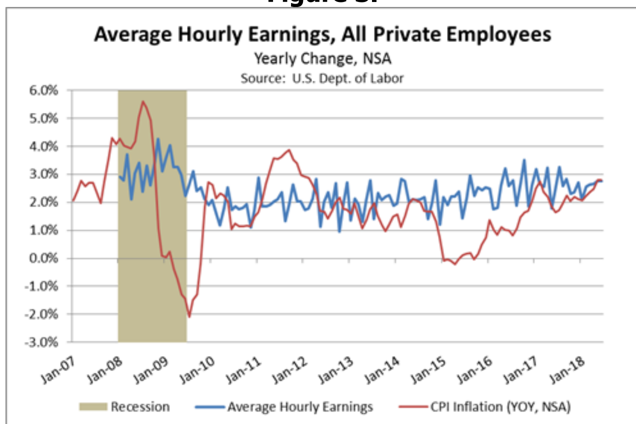
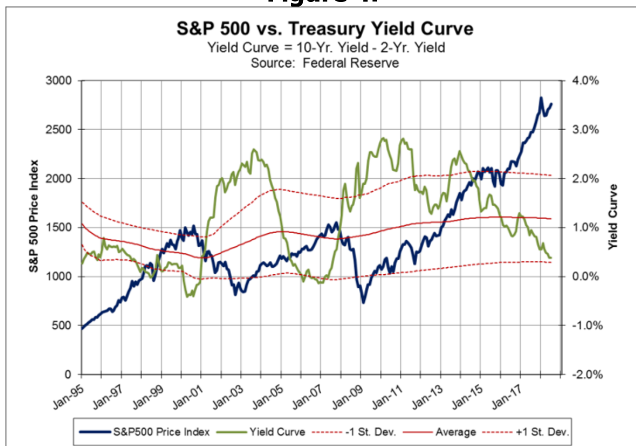
can't grow their workers' productivity fast enough to offset those wage hikes, the result would likely be reduced profit margins and a weaker stock market.

Figure 3.



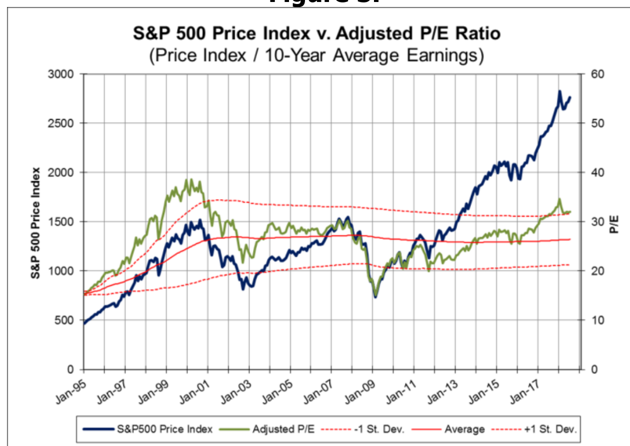
Flattening Yield Curve. As mentioned above, rising interest rates have boosted business costs and sapped consumer purchasing power. In addition, we're also seeing a warning sign in the narrowing difference between short-term and long-term interest rates (the "yield curve"). In the past, it has often been a negative sign when short-term rates have risen to the point where they equal long-term rates. As shown in Figure 4, the yield difference between the 2-year and 10-year Treasury notes is now almost down to zero, as it was before prior market downturns.

Figure 4.



High Stock Valuations. Another yellow flag is simply that the long bull market that began in March 2009 has now pushed stock valuations to very high levels, as measured by the ratio of price to earnings per share (the P/E ratio). As shown in Figure 5, it has historically been a negative sign when the P/E ratio rose to an extreme high and then started to fall back. The ratio hasn't yet fallen back below the critical level (the higher dotted line in the chart), but it is close. If stock prices now pull back enough for the P/E ratio to breach that critical level, it could be an important signal of an impending recession and an upcoming downturn in the stock market.

Figure 5.



Extreme, Unsustainable Earnings. Finally, our analysis indicates that in the past, a significant market downturn has often followed a period when earnings per share (EPS) spiked to an extremely high level and then fell back. As shown in Figure 6, EPS has indeed staged such an upsurge lately, reflecting both the continued good economic expansion in the United States and the impact of recent tax cuts. Historically, earnings could stay at extremes like this for some time, but they are likely to retreat at some point. When they do, we think they will be signaling an important inflection point in the market, for which we want to be prepared.

Figure 6.

Potential Strategy Adjustments

Our analysis indicates the various yellow flags identified here have usually preceded a downturn in the stock

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market by six to twelve months, so we are not panicking yet. Even the non-economic and non-market risks that we see (such as the administration's aggressive posturing in national security and international trade disputes) are not necessarily going to drive the stock market lower in the immediate future. Rather, we think the continued strong economic growth and market momentum that are still so evident today should keep boosting corporate profits in the near term. We therefore think it makes sense to maintain a healthy exposure to stocks for the time being (in our strategies that include them). All the same, the evidence suggests the road may well become more challenging within the next year. We therefore want to start preparing for such an eventuality in order to minimize the potential damage to our portfolios. Although we are still analyzing exactly how we want to do that, the most logical moves may be:

Reducing Exposure to Stocks. The yellow flags identified above suggest consumers may be reaching the point where they are less willing or able to boost their spending, while rising interest rates and other costs could soon start weighing on corporate profits. Our key strategy adjustment going forward is therefore likely to be gradually reducing exposure to stocks in our various portfolios. How much to cut stocks will depend on how quickly the economic and market news deteriorates, if it does at all. If the economy starts to slow sharply, we may also reorient our remaining stock exposure toward those sectors that have traditionally fared relatively well during an economic slowdown, such as healthcare, consumer staples, and utilities.

Increasing Exposure to Bonds. Rising inflation and higher interest rates are typically a headwind for bond prices, as they have been for U.S. fixed income over the last few years. Still, it's important to remember that the Federal Reserve has already been hiking rates for some time. With a few more rate hikes in late 2018 and early 2019, the policymakers may well be approaching the end of their tightening cycle. If the cost pressures and rate hikes to date really do start to slow the economy significantly, as suggested by the data presented here, we think the end of the rate-hiking cycle could potentially come sooner than investors now expect. That would likely allow bonds to stabilize and eventually start rising again, especially if the slowing economy pushes investors out of stocks and back into fixed income. We therefore think it makes sense to consider gradually increasing exposure to bonds. Until the Fed is done with its current rate hiking, we think it makes sense to allocate relatively more cash to those fixed income assets that have traditionally held up well in the face of rising inflation and higher rates, such as short-maturity obligations, floating-rate notes, Treasury inflation-protected securities (TIPS), and perhaps even corporate bonds.

Balanced Use of Alternative Assets. There is a wide range of "alternative" assets, all of which could behave differently in the evolving environment. For example, publicly-traded investment real estate trusts (REITs) have been challenged over the last couple of years, as they often are when interest rates are rising, but we think they could make up some lost ground as the rate-hiking cycle gradually comes to an end. Much the same can be said for infrastructure funds. Meanwhile, since a lot of the current inflation problem reflects rising prices for crude oil and other hard assets, we think commodity funds could do well until the economy slows more significantly. Given the current international tensions, we also especially favor gold and other precious metals. In sum, we currently think that the evolving situation calls for a relatively balanced, even-weighted approach to REITs, infrastructure, commodities, precious metals, arbitrage, and private equity.

Conclusion

Without doubt, it's difficult to identify turning points in the economy and financial markets ahead of time (which is why "passive" managers don't even try), but we think our continual, detailed monitoring gives us important insights. Our monitoring and analysis indicate that, at present, the U.S. economy continues to grow well and retains a lot of momentum, while key foreign economies are also doing relatively well. However, our monitoring has identified multiple yellow flags that point to soft spots in certain areas. Those soft spots seem to arise from factors such as market saturation, resource shortages, and rising costs (including higher interest rates). We believe those are exactly the kinds of problems that often occur late in an economic expansion, before a market downturn. As practitioners of active investment management, we therefore think it's time to start gradually reducing risk in our various portfolios. We will continue to monitor developments closely, and we may speed up, slow down, or even halt our risk-reduction program at any time as warranted by the incoming data. All the same, in order to gain as much return as possible while preserving our clients' capital in the evolving situation, we think the best way forward is to start gradually reducing our exposure to stocks and other riskier assets, while bolstering our exposure to bonds and keeping our exposure to alternative assets well balanced.

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