There are always “worries” accompanying the investment environment, and worries remain elevated despite the size and length of the bull market in U.S. equities starting in 2009. The pain of the greatest bear market since the Great Depression remains a not so distant memory. As the U.S. economic and stock market recoveries approach record lengths and as worries over Federal Reserve and trade policies grow by the day, we thought now would be a good time to address these worries and the possibility of a bear market in U.S. stocks.
In a typical economic and stock market cycle, economic growth absorbs production capacity, inflation pressures become apparent, and investor euphoria gets expressed in market behavior. In 2000 we saw the peak of the Internet investing bubble and in 2007 we observed the peak in speculative housing investment. In both periods, the Fed had raised the Federal Funds interest rate well above the prevailing inflation rate and above the level of longer term interest rates, thereby inverting the yield curve. Today’s investment environment is more different than similar to prior market peaks, in our opinion.

First

First, the Fed remains accommodative toward economic growth as evident by the Fed Funds rate being below the inflation rate and by the positive shape of the yield curve, as shown on Exhibit 1. The shape of the yield curve has flattened as the Fed has begun normalizing monetary policy by raising short term rates above the unprecedented zero rate policy and as the long end of the yield curve has been held down by persistently low inflation expectations and a global regime of even lower non U.S. sovereign debt yields. For context, the 3%+ yield on longer dated U.S. bonds is a bargain when compared to the sub 1% rates on German and other non U.S. sovereign debt. The flattening of the yield curve begs the question: will the curve invert with short rates going above long rates? We do not know the answer to this with full confidence as the Fed could back away from its stated intentions and as longer term rates could go up or not. What we do know is that Fed Chairman Jerome Powell and others on the Fed are well aware of the leading relationship an inverted yield curve has with prior recessions, that they have stated that they do not want to invert the curve, and that stock market peaks can occur more than a year following a yield curve inversion should it develop. Therefore and all else equal, we remain constructive on U.S. equities and do not believe a bear market looms.
Second, we do not observe the type of investor excesses that were so prevalent in internet stocks and real estate that occurred during prior U.S. stock market peaks. We do not regard the speculative activity in Bitcoin and, recently, marijuana stocks, as being of sufficient scope and size to compare to prior investment bubbles.

One area of excess may be observed in the bond market where persistently strong demand for “low risk” assets and yield—as paltry as those yields have been compared to history in the post 2008 environment—has been met with record issuance and in large part from issuers with below investment grade bond ratings. Should we experience a recession, many of these companies could have difficulties meeting their obligations. However, credit spreads and other data do not suggest a recession looms. We will closely monitor credit spreads and other factors to determine whether defensive action is eventually warranted.

Greater debt issuance and the cut in individual tax rates have raised concerns on the growing budget deficit. While the annual budget deficit relative to our economy’s annual production is no greater than recent years and is well below what was experienced in the Great Recession of 2008, it is true that the cumulative deficit has grown and would, perhaps, need to be reckoned with “sometime.” The growing deficit has not held down stock prices which are primarily driven by corporate earnings whose growth remains well above 20%. A wealth tax or other remedy could be imposed in future years but, for now, the growing budget deficit is not a meaningful stock market issue.

One area of “headline” concern has been the ongoing trade battle in which we are engaged with our trading partners. Economists and investors prefer free markets that allow the most efficient flow of goods and services. The end of the Cold War, the fall of the Berlin Wall, China adopting a more free market approach in certain sectors of its economy, the formation of the Eurozone, and other developments have broken down trade barriers and enabled multinational companies to produce goods more efficiently and consumers to enjoy lower prices. Companies have globalized their supply chains and have achieved higher profitability. Threats to this regime have caused investor angst and remain an uncertainty. Should ongoing negotiations with Canada, China and other trading partners result in more free and fair trading terms, prospects for global economic growth would be enhanced. Failure to come to agreement would result in an incremental cost or “tax” on the global economic system and lower global economic growth prospects.

The trade/tariff headwind should be considered in light of the significant fiscal stimulus from tax cuts and reduced regulation which, together, well exceed the estimated drag from announced tariffs. Fiscal policy, as acrimonious and unsettling as it now appears, does remain positive.
Conclusion

The fundamentals remain positive for U.S. equities: reasonable valuation, strong earnings growth, and still accommodative monetary and fiscal policies. Our biggest worries remain centered around inflation and whether a larger than expected increase will cause the Fed to eventually choke off the economic expansion and send the economy into recession. The nearer term risk is low, but investors will most likely remain nervous about this issue.

Recently heightened inflation concerns brought about by a stronger than expected economy and tensions around our relationship with China may have triggered the recent sharp selloff in U.S. equities. For context, we believe this “correction” is occurring within a bull market trend and we note that corrections are normal. In fact, what is not normal is to have stocks advance in a steady, linear fashion. Various sentiment and price trend indicators suggest this latest correction is nearing conclusion.

Interest rates on money market funds and longer term bonds have increased to levels that begin to provide appeal and, finally, some competition to stocks. We are monitoring trends in the fixed income market to identify the most attractive opportunities.

In contrast to a healthy U.S. stock market environment, non U.S. stocks and Emerging Market equities in particular have been under pressure since the previously observed economic momentum in these regions sputtered in the spring and as the Dollar gained strength. The spread in equity performance between U.S. and non U.S. stocks appears to have reached an extreme currently, and the pace of Dollar strength has ebbed. Progress on trade negotiations with China would support Emerging Market equities, though serious talks are not considered likely until after mid-term elections. Exhibit 3 shows returns of various asset classes.
From the Managing Director

Dear Valued Clients,

I am writing this as we begin the last quarter of 2018. It has been an interesting year on so many fronts. For purposes of my message, I will stick to the financial environment and how it may impact you achieving your financial goals.

We have seen October start with some significant market volatility. It is in times like these that working with our team is of major value to you. It can be a challenge not to react emotionally when we experience periods of extreme market volatility. However, we continue to counsel clients that staying focused on the long term view is what will help them best achieve their life’s financial goals. Keeping a steady course is what will best get you to your destination in the end.

We are looking forward to our Investment Forum on Thursday, November 1st from 5:00 to 8:00 p.m. at the Andover Country Club. Marci Rossell, former Chief Economist for CNBC and Co-Host of Squawk Box, will be our keynote speaker. I look forward to seeing you there.

Thank you for your continued confidence in Enterprise Wealth Management. May the upcoming holiday season be a safe and joyous time for you and your families.

Sincerely,

Stephen J. Irish, CFP®, CPA
Managing Director, Enterprise Wealth Management
Chief Operating Officer, Enterprise Bank

At Enterprise Wealth Management, our mission is to help clients achieve their financial goals by providing professional investment management, extensive resources, and independent, objective advice that you can trust. Enterprise Wealth Management was established in 1992.

Our clients are successful executives, professionals, entrepreneurs, non-profit organizations, private foundations, and retirees who desire a financial partnership that can provide access to investment opportunities and alternative strategies.

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