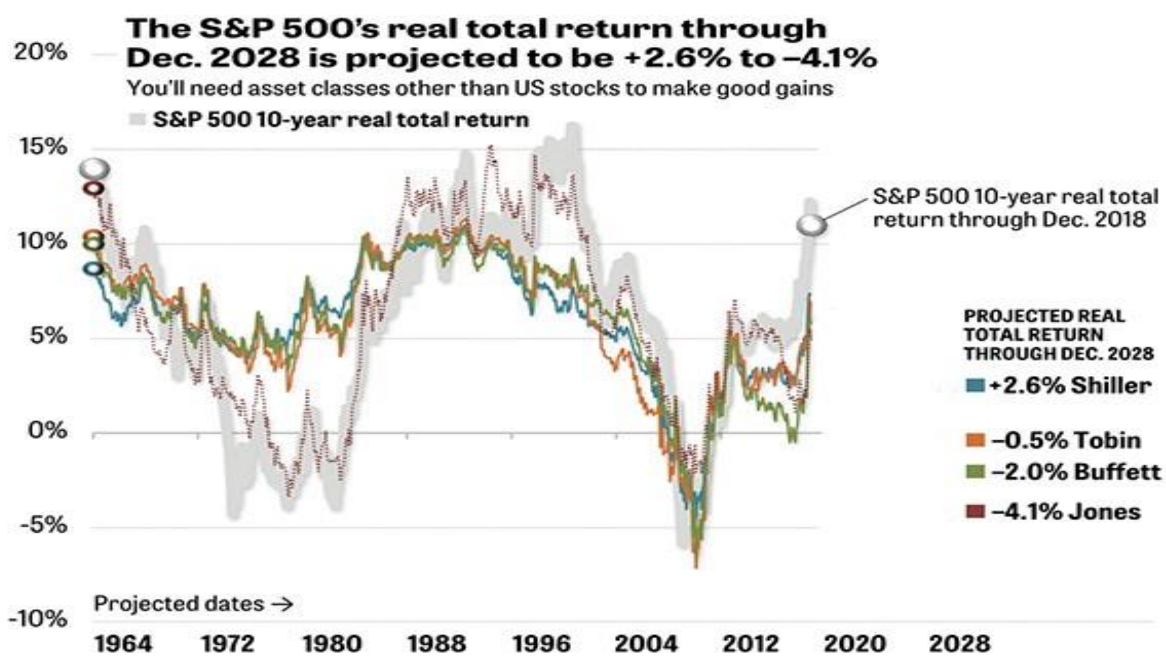
Jan 23, 2019

Market Insights for Week Ending Jan 18, 2019

A Crystal Ball that Actually Works (most of the time)!

If you have every asked me the question, "What do you think the market will do this year?" you most likely received a smile and the most professional and informative non-answer I could conjure. It's not that I don't want to answer, it's just that I don't put much faith in my, or anyone's else's ability to predict such things. There are certainly times when I think the probability of a certain outcome is high, but even that doesn't mean my timing would be right. To put a bow on this point, Bloomberg surveys 19 Wall Street strategists at the beginning of each year and asks them this very question. The result for 2018: zero predicted the market would go down. The average prediction was for a gain of 8%. Does that make these people inept? Not at all. It just shows that predicting the future can be more difficult than we would like to believe.

While that holds true over the short-term of just a few years, longer-term indicators have a surprisingly strong ability to predict long-term outcomes.



Source: Marketwatch

The chart above lists several of the most widely followed long-term market indicators (pulled forward ten years to make easy comparison with the actual 10-year real total return of the S&P 500, in grey). The legend on the right shows the projected returns of these indicators through 2028. The blue line, Shiller PE, is calculated by taking today's S&P 500 price and dividing by inflation-adjusted earnings over the previous 10 years. The orange line, Tobin's Q, takes the market value of all US equities and divides it by the cost to replace all those companies assets. The Buffett indicator, green line, divides the S&P 500's market value by US GDP. Finally, the red line, Jones, is basically the Buffet indicator with an adjustment to GDP based on changing demographics.

Why Do We Care?

My follow up to the non-answer about what the market will do this year usually involves extending the timeframe anywhere from 5-10 years. Here is where we think some more predictable information can not only be forecasted but used in a thoughtful way.

Over the past month and a half, the market has been extremely volatile. First moving in an almost straight line down, then doing a complete 180 and going straight back up. While those short-term moves have dominated the media's attention, we see them as mostly noise, yet still important building blocks in the long-term trend. That is why the information from the chart above is valuable and worth exploring. It gives us a high probability of knowing where the market is going over the long-term. It is like having a crystal ball that actually works.

With the crystal ball in hand, short-term market activity helps us decide when to make tactical risk adjustments in the portfolios. What the numbers above (the crystal ball) are telling us is that equity returns over the next ten years, are likely to be lower than they have been in the past decade, possibly significantly lower.

Investors often have a hard time accepting this because our brains won't allow us to properly discount concepts far into the future (the behavioral finance concept is a combination of "recency bias" and "hyperbolic discounting"). Investors often believe whatever happened in the recent past, in this case good markets, will most likely continue. Though the data above would certainly be counter to this conclusion.

How can this information, that there is a higher probability of lower future returns, be used to guide an investor's strategy today? One thing investors should do is re-evaluate their risk exposure. Investors who were aggressively invested over the last decade have been handsomely rewarded, but that strategy may not make as much sense going forward. If downside market volatility bothered you in December, now may be a good time to re-evaluate your asset allocation. HCM has reduced risk exposure on two separate occasions during 2018, moving from an overweight exposure to equity risk to modest underweight. Also, HCM has built these lowered estimates into our retirement planning forecasts to ensure that clients have the highest probability of successfully navigating their financial future.

Because the US is expected to produce some of the lowest returns among key developed markets over the next decade, HCM continues to explore opportunities outside of US equities. We also believe that certain fixed income holdings offer an attractive mix of income and protection. Even within the US space, companies with dependable and growing dividend streams provide investors with exposure to high quality companies that can help reduce portfolio risk and provide predictable-growing income.

Ultimately, HCM believes that maintaining proper diversification and appropriate risk exposure based on long-term return potential will help our clients successfully navigate the impact of lower equity returns over the next 10 years. Also, our ability to make tactical adjustments will allow us to capitalize on emotional reactions of others to extreme markets.

Weekly Focus – Think About It

"A goal is a dream with a deadline."

-Napoleon Hill

Market Activity

Performance last week for the four major asset classes were:

- U.S. Stocks – Russell 3000 (IWV) – Gain of 2.85%
- Developed Foreign Markets (EFA) – Gain of 1.72%
- Emerging Markets (EEM) – Gain of 2.01%
- Fixed Income (AGG) – Loss of -.19%

(Note: performance is based on the change in price plus dividends)

Last Week's Headlines

-Initial jobless claims continued to post record levels, with the weekly number of 199,000 the lowest since 1969 and reflects a tight labor market

-Markets were mixed after 4-weeks of positive returns for the S&P 500, with tariff negotiations with China remaining front and center

-Existing home sales decreased 6.4% month-over-month in December and total sales were 10.3% lower than the same period a year ago. The report shows a softening housing market, evidenced by the deceleration in the median selling price growth rate and sales declines across all regions

Eye on the Week Ahead

-Earnings will continue to roll in, with around 25% of S&P 500 companies set to report

If you have questions about our long-term return assumptions please contact a member of HCM's Wealth Advisory Team:

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Additional Notes:

- The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.
- Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.

- Past performance does not guarantee future results.
- You cannot invest directly in an index.
- Consult your financial professional before making any investment decisions.

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