HCM WEALTH ADVISORS

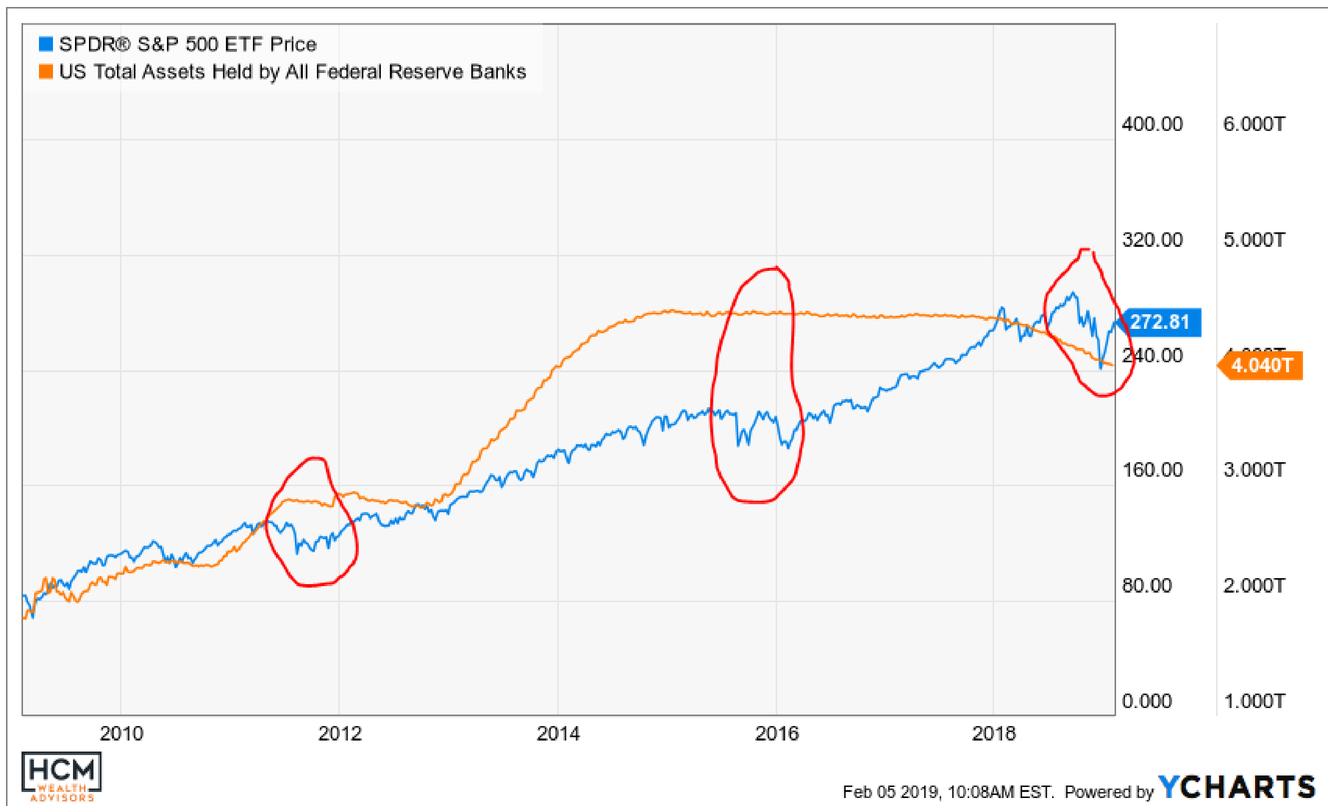
Feb 6, 2019

Market Insights for Week Ending Feb 1, 2019

"Patience is a Virtue"

Be patient…it's a phrase I find myself muttering to my 7-year old son almost daily. Unfortunately, it is often met with groans or protests. Being patient requires not getting what we want when we want it, which most times is RIGHT NOW! But sometimes you can have your cake and eat it too, even if the person baking the cake was adamant that there would be no treats.

On January 4th, Fed Chairman Jerome Powell changed the tone of previous Fed statements and said the Federal Reserve is "listening very carefully" to the market. This was all the market needed to hear to feel comfortable that the Fed would once again begin to provide a tailwind for risk assets. On January 30th, Powell not only delivered more cake, but he brought donuts, pies, cookies and candy too. The Fed again talked about being patient with interest rate hikes and added that the reduction in their balance sheet would no longer be set on auto-pilot and could be stopped or slowed if the "data" dictates such a move. In a world where economies are slowing in many places, this was music to the market's ears.



The chart above shows the price of the SPDR S&P 500 ETF(SPY) in blue plotted against the total assets held by the Federal Reserve Bank, in orange, also referred to as the Fed's balance sheet. You will also see three red circles. These represent the most significant market drawdowns, in terms of price, over the past ten years. What you will notice is that each market decline came during a period when the Fed's balance sheet (orange line) was either flat or trending downward. This is when they are draining

liquidity from the financial system. The most signifcant period occurred at the end of 2018 with the orange line sloping downward at its fatest rate in the last decade.

Why Do We Care?

Seeing the price movements in the chart above, we can understand why something as simple as a relaxation in monetary policy can spark a rally in risk assets. The simple hope that the orange line will begin to flatten back out is enough for investors to stop asking tough quesitons and revert back to the default trade that has worked for so long. Is the Fed "accomodative"? If yes, buy. If not, don't.

While the above strategy may seem somewhat tongue-in-cheek, the results have been good and investors tend to flock to what has worked. But ignoring the bigger aspects of this complete 180 degree Fed flip-flop ignores why this is happening. Many have already forgotten that the Fed raised rates .25% in December and expectations were for an additional 1-3 hikes in 2019. Only 6 weeks later, that narrative has completely changed and the market has now priced in a rate CUT. What caused such a radical policy shift in such a short period of time?

To begin with, the Fed states they have no official mandate other than price stability(inflation) and full employment. It says nothing about stock prices, yet their timing seems very convenient. But let's set that aside for now and focus on what the Fed claims to be really good at: identifying economic conditions. Factset Research Insights lists Q1 2019 earnings growth at -.8%, with more companies issuing negative guidance than average. Trade wars continue with China. US growth forecasts are slowing, along with Japan, the UK and the Eurozone. We could list more but you get the point. This begs the all important question: Can the Fed overcome all this slowing or have they already overshot?

This is the question HCM has been grappling with for several weeks. We have maintained our modest equity underweight but are re-evaluating our positioning in light of the recent Fed policy pivot. While price action plays a role in informing these decisions, fundamentals play a more important role in determining longer term trends and our decisions in allocating our risk budget.

The emotional side of the brain sees the recent price action and feels like we are "missing out." And while the recent rally has been impressive, we don't yet believe the recent change in Fed policy is potent enough to overcome the gathering fundamental headwinds. It is not even clear that they truly want to interrupt a modest orderly decline in the business cycle. With that said, our management process is moving us closer to incremental increases that will bring us back to a neutral equity risk exposure.

Weekly Focus – Think About It

"Believe that you can, and you are half way there."

-Theodore Roosevelt

Market Activity

Performance last week for the four major asset classes were:

- U.S. Stocks – Russell 3000 (IWV) – Gain of 3.59%
- Developed Foreign Markets (EFA) – Gain of 2.43%
- Emerging Markets (EEM) – Gain of 3.5%
- Fixed Income (AGG) – Gain of .70%

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

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Last Week's Headlines

-The Fed's dovish tone helped to boost risk assets while government bond yields dropped to their lowest level since early January before bouncing back.

-Robust jobs data pointed to ongoing strength in the US labor market, though China's manufacturing activity shrank in January for the second consecutive month.

-High-level US-China trade talks ended with China's pledge to buy more US soybeans, yet a comprehensive deal remains elusive for now.

Eye on the Week Ahead

-German factory orders and output will be in focus following sharp declines in prior months.

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- Past performance does not guarantee future results.
- You cannot invest directly in an index.
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