Market Insights for Week Ending Nov 23, 2018

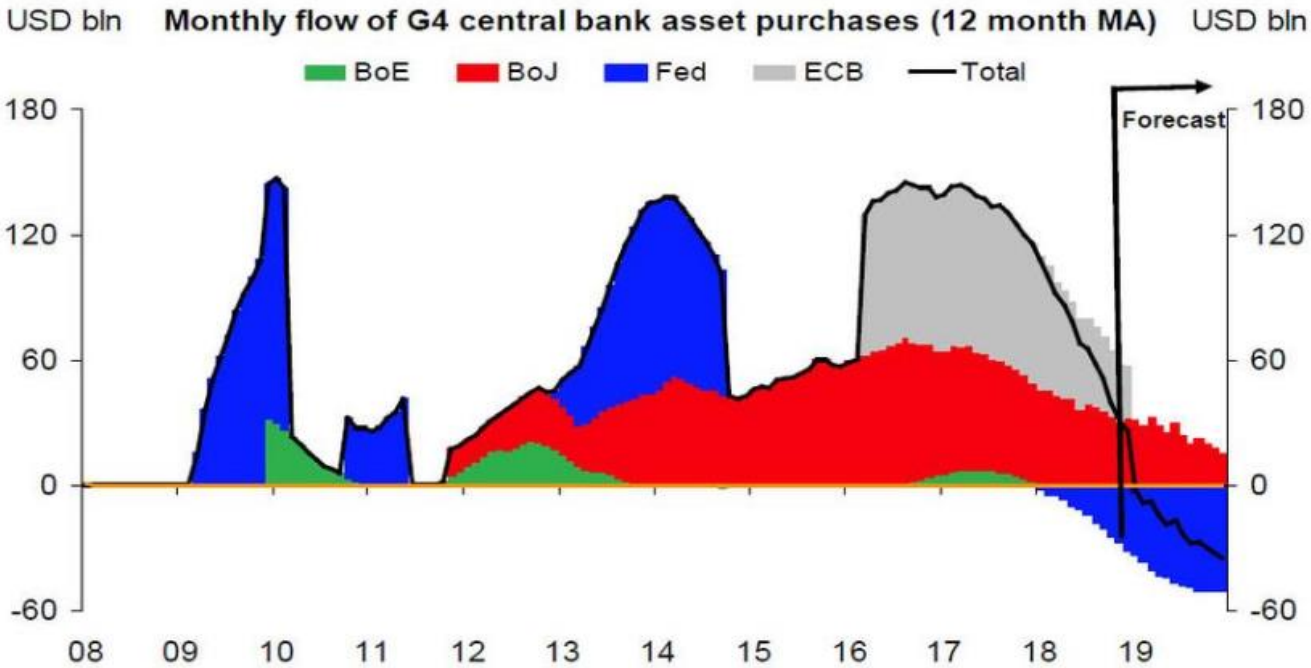
The World's Largest Science Experiment

One of the great mistakes many investors make, both amateur and professional, is to see the markets through the lens of a "scientific study". Science, simply defined, "is the intellectual and practical activity encompassing the systematic study of the structure and behavior of the physical and natural world through observation and experiment". The financial markets, however, are neither physical nor natural. And, because many investors react emotionally, behavioral sciences are considered more relevant when building strategic investment options, than the physical sciences.

For example, compare the "Black Friday" scenes we see on the news as shoppers climb over one another to buy something at a reduced price to a scene where investors are panic selling their investments because the price has been reduced. If this was "real" science, both shoppers and investors would be buying to take advantage of the good deals.

While physical science results in repeatable rules and results, no such repeatable rules and results exist in the investing world. And while everyone knows this to be true, some investors still hope to find a magical formula that will unlock a hidden secret that no other investor has discovered. They hope to predict what will happen, much like "real science" can predict the Law of Gravity.

Even the smartest people in the room, at times, fall prey to this thinking. Google search "James Cordier" for a recent example. But while Cordier was only responsible for around $200 million, there is a group of supposedly "smarter" people who have control over significantly more money. They are known as "Central Bankers", and they pull the strings for economic policy around the globe.



Assumptions: Fed will redeem assets to the terminal cap of $ 50 bn consistent with the FOMC's Sep 2017 decision and the June 2017 addendum. ECB will buy EUR 15 bn worth assets in Oct, Nov and Dec 18 and then stop buying. BoJ to buy the average of 2018 so far in Oct, Nov and Dec 2018 and then stealth taper from Jan 2019 to bring monthly purchases to zero by Dec 2019. FX in the forecast assumed to be the same as Sep 2018.

Source: Fed, BoJ, ECB, BOE, Haver Analytics, DB Global Research

The chart above shows the amount of assets being purchased or sold by the major central banks around the world. The black line is the combined amount at any given time. The main takeaway is that the world's central banks have been net buyers of assets over the past decade. What you should also notice is the black line is set to cross over the zero-mark right around the beginning of 2019. This is when the world's central banks will go from net buyers of assets to net sellers of assets. Ironically, this information has been available for the better part of two years but has mostly been ignored. All of the sudden, investors are starting to take notice that one of the biggest market tailwinds of this bull market is about to go away.

Why Do We Care?

2018 has been absolutely nothing like 2017. Last year almost everything worked, this year almost nothing works. According to Ned Davis Research and Bloomberg, 2018 is on pace to be the first year since 1972 that none of the major asset classes (real estate, commodities, equities or bonds) has a return greater than 5%. Even Treasury bonds returned over 5% in 2008! But often in markets like this, investors fail to examine the why in a critical manner, just blindly accepting that this is a "correction" or a "buying opportunity" or "bear market" or "(insert generic investing term)". Why these things happen are very important.

HCM believes there are many factors that have led to the most recent bout of market volatility. One that cannot be overlooked is the interplay between the Federal Reserve and their intentions to maintain their current glidepath for interest-rate hikes and the ongoing process of reducing their balance sheet. For the longest time, the Fed has been engaged in extremely accommodative monetary policy which supported financial markets around the globe. Regardless of what one believes about the philosophical rationale for this policy, we can agree that it has been successful in driving asset prices higher. But what lies on the other side of this grand experiment is still yet to be seen, and no one, including the Fed, has any empirical data from prior "test-results" of this "science experiment", because there have been no prior attempts in history. Some could argue Japan is a similar case, but that experience doesn't invoke confidence. As the market has started to wobble recently, the calls for the Fed to back off their rate hike projections are picking up steam.

The uncertainty created by this overhang in policy is fear of the unknown. Historically, rate hikes have slowed down economic growth and often led to recession. Some observers refer to the science metaphor and claim "What goes up, must come down". But again, the laws of physics don't apply in the world of financial markets, especially when you have central banks and irrational investors involved.

HCM has weighed the ongoing central bank unwinding process, investors typical behavioral response to difficult markets, along with other aspects of the market to create a plan for how we will adjust HCM portfolios over the coming weeks, if necessary. We feel that, if headwinds continue to build, we will likely experience a tougher environment for risky assets. This may eventually lead us to move portfolios into a more defensive posture. But as of today, many but not all of those triggering events have occurred. Until they do, we are maintaining our current neutral positioning.

If we do take our equity exposure below neutral we will schedule a webinar to discuss the changes.

Weekly Focus – Think About It

"The fewer the facts, the stronger the opinion"

-Arnold H. Glasow

Market Activity

Performance last week for the four major asset classes were:

- U.S. Stocks – Russell 3000 (IWV) – Loss of 3.6%
- Developed Foreign Markets (EFA) – Loss of 1.87%
- Emerging Markets (EEM) – Loss of 2.84%
- Fixed Income (AGG) – Loss of .01%

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

Last Week's Headlines

-High-yielding sectors such as real estate, telecoms and utilities outperformed as tech suffered more losses. Oil prices slipped further and government bonds rallied.

-November PMI data came in broadly underwhelming while durable goods orders fell 4.4% month-on-month, the biggest drop in more than a year.

-The UK and EU agreed to a draft declaration on their future relationship post-Brexit, while the ECB minutes confirmed the central bank will likely end asset purchases in December.

Eye on the Week Ahead

-Inflation data is expected to confirm the ongoing divergence between price pressures in the US relative to those in the Eurozone and Japan. The G-20 summit will be a chance to further trade negotiations between the US and China.

If you have questions about the ongoing market volatility, please contact a member of HCM's Wealth Advisory Team:

Mike Hengehold (Mike@HengeholdCapital.com)

Casey Boland (Casey@HengeholdCapital.com)

Jake Butcher (Jake@HengeholdCapital.com)

Jim Eutsler (Jim@HengeholdCapital.com)

Greg Middendorf (Greg@HengeholdCapital.com)

Steve Hengehold (Steve@HengeholdCapital.com)

Doug Johnson (Doug@HengeholdCapital.com)

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