# Ep:5 Economic Outlook for 2019

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PATTI BRENNAN: Hi, everybody. Welcome back. This is the "Patti Brennan" show. Whether you have $20 or $20 million, this show is for those of you who want to protect, grow, and use your assets to live your very best life.

With me today, I have Brad Everett. Brad is our Chief Investment Officer. We're going to break down what's going on in the economy. Just to give all of you listening today a sense of what stage are we in in terms of this economic expansion and even more importantly, are we headed for recession?

Brad, welcome to the show. Thanks for joining me.

BRAD EVERETT: Hi, Patti. Thank you.

PATTI: Let's talk about this thing. We're hearing it. There's headlines, recession right around the corner, Fed reserve is tightening, lots of different signs of a late stage economic expansion. Can you elaborate on that a little bit for us and for our listeners? Talk about the four things that we look at when we're trying to determine what stage we're actually in.

BRAD: I think any analysis like this is relatively crude. I think there's an infinite spectrum in between the early growth phase and a recession, but I think if you can try to put it into quadrants you can have a little bit of success in trying to figure out what things have worked in the past during similar types of times.

When we talk about late expansion, there's a few things that we consider that seem relatively obvious signs. The first one would be labor markets tightening. There seems like a real shortage of workers, which can begin to constrain activity. If you can't find somebody to hire, then you can't invest, you can't build your business, and that can tend to slow an expansion down.

PATTI: It's interesting because I'm working and gave a keynote to the Economic Development Council. This is a very big issue for small business owners. They can't find qualified people to hire. They want to hire people. They can't seem to attract people either moving into their business or what have you, because there's just a lack of qualified workers out there.

We certainly are feeling that here in this county and on a national basis.

BRAD: Sure.

PATTI: What else?

BRAD: I think another sign is probably tightening credit. Mortgage credits begin to rise. It's harder to get a loan. Even parts of the loan process other than just the interest rates seem a little tougher to get a loan. Order rates begin to creep up.

PATTI: You know what it is? Banks are getting stingier.

BRAD: Sure.

PATTI: We're seeing that as well. Our clients are applying for mortgages. It's taking longer. They want more information. They're getting stingier, whether it be for mortgages, for their business, etc. That again is classic late business cycle activity.

BRAD: Also, so then in addition to that, the Fed typically will begin to contract, that they're very forthright with what they are trying to do, what they're trying to stop, and Fed minutes are 75 pages long. You can figure out what they're projecting in the economy.

PATTI: Exactly what we want to do late at night is read this 75 paper from the Federal Reserve. Yet, it is interesting that in December when they raised rates, the commentary was very, "Look, you're not going to like it, but we're going to stay on this path of increasing interest rates whether you like it or not. That's our job."

The market reacted so negatively to that, losing in December 13 to 15 percent just on large cap US alone. The markets are very sensitive to what Jerome Powell actually says. Fast forward, what did he say in January?

Recognizing the impact of his words, he came out and said, "You know, I know what I said, but here's what that really means. Yes, we are looking to continue the interest rate increases and the tightening cycle, but we are still going to be data dependent. We're taking a flexible approach."

The market went nuts. It's exactly what the market wanted to hear. "Hey, listen, don't push us in this box. Don't put us into a recession." The Federal Reserve doesn't want to put us into a recession. What their mandate is, two things, number one, their mandate is full employment. Well, we certainly have that with an unemployment rate of 3.7 percent.

Control inflation. Inflation is below two percent. That's their two mandates. Guess where we are? We are also at a period of still historically low interest rates. Since they seem to have the buffer of they've solved the problem, we're where they want us to be. They're increasing interest rates.

I think that people felt much more comfortable that he was going to take a flexible approach to that whole thing.

BRAD: I think as a sleep aid, too, it is nice in the sense that if you can get through one or two pages a night before you fall asleep, by the time you get through one version, the next one will be out shortly after you finish that.

PATTI: Absolutely. We're waiting with bated breath, that's for sure.

BRAD: It's exciting stuff.

PATTI: Then last but not least...

BRAD: You finally start to see pressure on earnings growth. That is not yet, but I think when you see the fourth quarter numbers come out, and it's certainly most analysts do expect that in the next three to nine months to start seeing not declines in earnings, just slower growth, not the same high growth rates that we've seen over the last few years.

PATTI: I think it's important for our listeners to understand that the growth is measured year over year. Embedded into 2018 was this wonderful tax cut for corporations that actually helped their earnings. It helped those comparisons. Compared to 2017, wow, that was terrific earnings growth!

Once we get that 2017 out and now we're comparing 2019 to 2018, we may not see that double digit earnings growth. It still doesn't mean that those companies are not good companies to invest in because there's still some growth. It's just might not be as fast as it was before.

I think that that's important to keep in mind, that there was that fiscal stimulus in all of this that helped things along. The goal there was to extend the economic expansion that we've been enjoying for the last 10 years.

Brad, as a chief investment officer, we take all of these things in. If we believe that we are in the later stages of this business cycle, what do you recommend for the people that are listening today?

BRAD: I think it's never the same for everybody, I guess, first of all. We look at it on an asset class basis. Some things aren't going to matter to you because that's not something that's in your portfolio, and it's not an appropriate investment.

We look at it on a broad asset class basis. What does this mean for bonds? What's it mean for US equities? What's it mean for alternatives? What's it mean for international investments and go that way. To think about what it means for bonds, a rising interest rate environment does not mean that you should avoid bonds.

If I remember correctly, the Barclay's Egg has actually only been negative four times since 1980. A bond is a total return investment, so as long as you're receiving income and coupons.

Faster than the value of the bond itself is declining, you can still have a positive rate of return. Bonds are not something you need to avoid. I think for us, this is a time to be shorter duration, higher quality.

The effect of a change in rates is far more drastic to a longer term bond, so we want to stay short. Especially for people that have the money set aside for spending, we want to go much higher quality. If there is a lot more volatility in the stock market, high yield bonds often can almost act more like an equity investment than a bond investment.

I don't know that the extra yield that you can get from a high yield poor quality bond can give you enough to offset the downside. If the S&P goes down 20 percent, I don't think high yield bonds, they're not going to save you from that and they're not going to be a safe haven during that time.

PATTI: Let's go back to something earlier you said about duration. For our listeners today, let's define that so that they can wrap their brains around this. It's a neat kind of simple and easy way to determine how much risk are you actually taking with that bond or bond fund? Let's define it for them.

BRAD: I think duration, there's a few different ways to measure it. We think of it as a weighted average of when you're going to receive the money. To use an extreme example, if we had a bond that matures in a week from now for $100, I don't particularly care what the interest rates are in the economy because I'm going to get my money in a week.

If the bond doesn't mature for 100 years and interest rates go up, there are going to be a flood of new investments that will look very appealing compared to this old one I have at the old interest rate. I've got to sit with that one for the next 100 years.

The value of that could drop significantly, so there's going to be pressure to sell that and to buy the new one at the new higher interest rate. You would tend to think that longer duration bonds would preferred stock to it can affect preferred stock in similar ways would be much more volatile in times of changing rates.

PATTI: Basically, duration, to narrow it down, it's a way to determine the sensitivity of that bond or bond fund to rising interest rates. By definition, give or take a little bit, but basically for every one percent rise in interest rates, a bond will fall by its duration.

Let's go through a real example. Let's say that you've got a bond that's paying three percent. Let's say the duration is five. The price loses five percent but remember during that year, you got three percent interest. Your total return on that bond is 2, not 5. By shortening the duration, if you got duration of two, and you're still getting your three, you're actually getting a positive return.

BRAD: You'll still capture that same three every year for the next five, as long as you continue to hold it.

PATTI: That's the other thing. That is the other part of duration. Just because it goes down one year, you're still getting that interest every year that you continue to hold that bond or bond fund.

It gets a little bit trickier when you're talking about ETFs and bond funds. The goal or the hope there is if you choose to have professional management that you're having those professionals manage duration, manage the risk of that bond portfolio so that you won't be subject to as much volatility.

Or conversely as we're going to learn in a minute, sometimes you want that higher duration. Especially after we go through that tightening cycle, you think it's close to done or you're done, that's often a good time to extend that duration, right?

BRAD: Yeah. Lock in to a higher coupon for as long as you can.

PATTI: Exactly. That's terrific. We've talked about the bonds. We can scale back on the riskier asset classes, go shorter duration, higher quality, etc. That's especially true for people who are receiving distributions  retirements, etc.

One thing I don't want anybody to interpret or hear in this. We are not changing the asset allocation of the total portfolio. If your goal or if your financial plan suggests that you should have 10 percent in cash, 30 percent in bonds, and 60 percent in various types of equities, that ratio stays exactly the same.

What we're trying to do is within each of these asset classes, reduce the risk during the later stages of economic expansion. Again, I'm saying that as if it's a fact. It is not a fact that we are in a last stage of this business cycle. We just want to frame it within that context of, gee, we've just gone for a terrible bear market of a loss of 20 percent.

The market is a leading indicator trying to anticipate what's going to happen in the economy in the next 9 to 18 months. Keep in mind, everybody listening, the market is not always right. Just keep that in mind.

Let's talk a little bit about, gee, if we're in the later stages, 10 years into this thing, what are we doing on equities? What should be people begin to think about as it relates to their stock funds.

BRAD: There's arguments to be made on both sides for stocks and they're valid. That's how the market has gotten where it is because there's 50 percent of the money on the one side of the price, and 50 percent on the other side. You can see a lot of the negatives. Volatility has begun to return to the market. Again, like we talked about before, there's expectations for fading earnings growth.

There has been, despite the lack of workers, surprising lack of inflationary pressure on wages. But if that does arrive, companies would again...It almost feeds itself. If you can't find employees, then you have to pay them more. As you're going into this late stage recessionary cycle, now your profit margins are lowering because you're having to pay employees more and things like that. That can feed on itself.

The other thing that works against the stock market now is for so long, there's not really been a compelling alternative to stocks anyway. Would you consider cashing out something that had a three percent dividend in order to put it at the bank and earn a tenth of a percent? I think stocks had a staying power there just because there was very little appeal to investing in anything else.

That's not true anymore. If you can find a short term bond fund that pays three percent, then maybe you consider just taking the yield and taking the volatility out of your portfolio. There are compelling alternatives that begin to arise as interest rates begin to go up again.

PATTI: It's really interesting because we saw that through 2018. That came through in terms of the trading volumes on a day to day basis and the volatility. In 2018, for example, the stock market rose or fell by one percent 84 times last year. Just to give you a feel for how much that is, in 2017, it did that only six times.

Volatility, up or down, has definitely increased because people are trying to figure out, gee, where should I be? They're restructuring portfolios. Again, understand that this is a lot of traders, not necessarily investors. You don't want to necessarily make your portfolio decisions based on what traders are doing, because they're being paid to trade.

You're an investor. The most important thing is let the financial plan guide you in terms of how your allocation should be and some of the decisions that you might make, if we are in fact in this later stage cycle.

BRAD: I think there's a difference in incentives there too. The traders probably got a time horizon of 30 seconds to 10 minutes in a lot of cases. That's just not the case for most people. They have certainly a different trading pattern and incentive to act.

PATTI: There are certain sectors within that 60 percent again, just using that as an example that are a little bit more resilient during this period of time, aren't there?

BRAD: Yeah. On a whole sale basis, we have definitely made shifts from more volatile growth oriented stocks to value...

PATTI: Folks, if you were watching us today, I'm knocking on my head because we got really lucky there. Did that earlier in the year only to see that large growth stock like Apple. I don't know if you hold Apple. If you have Apple, you watched your stock, your holding, fall by 40 percent. That's a lot more than the overall stock market lost during this period of time.

The GOGO stocks, they go, go, go, but boy when they fall, they fall like a rock. By shifting a little bit less...Again, we're not talking all in or all out. We are talking tweaking and reallocating. Taking those gains. Yes, you have to pay your taxes, but I think that's what you're supposed to do, right? Sell high?

BRAD: That's the goal, yeah.

PATTI: What do you think?

BRAD: The goal to investing is to make money, right?

PATTI: You got it. OK. That's good. Defensive sector. Let's define for people who are listening. How do we translate that?

BRAD: It's interesting. There's a couple of ways to think about it in what are the things that are still necessary? Not necessary consumer staples. I think that's almost even more necessary than what we're thinking. But when times get tough, you find that discretionary spending would drop. What are the things you still need? You need energy. You need to buy toothpaste still.

PATTI: Utilities.

BRAD: You can't give up brushing your teeth just because the stock market's down five percent.

PATTI: Don't tell Lily that, right? [laughs]

BRAD: I know. No kidding. We want to drift into those staple sectors that have shown a lot of resilience. I think valuation matters too. Some things will arise as just being cheaper relative to what they had been in the past. That makes it more attractive too, and a valuation comes into the sweet spot where you're ready to invest again. Energy is one of those things for sure.

PATTI: Certainly. If you just take a look at the broader bases after the 20 percent loss, P/E ratio on the S&P 500 went down to 14.1. Anybody who is an expert in this area would say, "Hey, that's pretty low." It's probably undervalued if average is about 15. It's not dirt cheap, but it's certainly not overvalued by that measure.

Other areas that got especially hit before that were underperforming significantly were small cap stocks, especially value, small cap value. They got hit especially hard prior to this. While they certainly took it on the chin as well, it does present some interesting opportunities. Again, if you buy low and it goes lower, it's OK because you didn't buy high and watch it go lower. Does that make sense?

BRAD: Yeah, absolutely.

PATTI: That's the key here in managing and taking a fresh look at the portfolio. What about international?

BRAD: Sure. The case for international has actually been relatively strong for a while. We just haven't seen it, as US investors we just haven't seen the returns. I guess there's two components to your return if you're investing in international stock. One is the return in the local currency. What did someone who lives in Japan earn on their Japanese investment.

The second component is bringing the money back in the United States. For you to actually sell your investment, you have to get your investment back in dollars. You have to sell yen and buy dollars. That currency return can be a pretty significant portion of the change in the value of your investment.

At the beginning you sell dollars to buy yen. Let's for a year, you invest in a Japanese company. At the end of that year, you have to sell your yen and buy dollars again for you to spend it. That currency change can be a pretty significant one.

PATTI: It's interesting because when you look on a worldwide basis, the US has been the one economy that has been growing. The other economies, they've also been growing but not at the same rate. That can have a significant influence on the value of the dollar because people want to invest in the area that is actually growing. That's definitely a factor.

What's really fascinating is to look at the different periods of time when international has outperformed versus the US and the amount of the outperformance that is attributable to the currency. It's fascinating.

BRAD: Yeah, can be a lot.

PATTI: If we take a look at the seven cycles since 1970, it's pretty interesting to see. First of all, in each one of these silos, the outperformance they've changed hands. One period of time it's the international, then the S&P outperforms, then the international, then the S&P. Literally, they trade places in each particular period of time.

What I think is also fascinating is the amount of the outperformance that's primarily attributed to currency. It can be, for example in the '70s, the outperformance on international was 48 percent of the result. If we go back to...Let's look at the S&P 500 during the '80s. That was 90 percent of the outperformance just had to do with the dollar strengthening.

We have got to keep that in mind as we're looking at the international investments. For those of you who are listening at home, does that mean that we want you to study the dollar, to study the currency and pick only those areas where the US currency is going to start falling relative to that particular local market? The answer's no.

We don't want you to be doing that. It's just bringing up that to the surface. Letting that bubble up and understanding that it is a factor in how these investments perform. Just because the international hasn't performed as well in the last 10 years...

By the way, the underperformance is significant over this time period. As of the end of 2018, the international markets as measured by the world index was up 90 percent. Not bad for 10 years, right? But the US was up 271 percent. That's a significant outperformance.

Here we talk about diversify, diversify, diversify. We add that into our portfolios, and yet we're doing it and it's just pulling away, reducing the returns. We all know that eventually these things will trade hands, and you want to have something in there to add a little bit of a turbo charge to your portfolio.

BRAD: The tough thing is that I guess this is another form of market timing it'd be tough to figure out, especially with currency, when will the cycle change? We'd expect at some point, there will be some significant amount of time where international stocks outperform the US, but when that begins and when it ends is pretty tough to figure out.

Again, we always want to have access to both and have investments in both. Again, like you said, you were just tweaking back and forth in minor amounts to try to take advantage of where we think everything falls.

PATTI: Excellent. Let's talk about the trade deficit, because that does have an impact on the international, etc. We're talking about trade, and the tariffs, and all of this. Our president is really concerned about the imbalances that have occurred over the years, especially with China. How does that impact all that? What creates the trade deficit? How concerned are we? What should we be doing about it?

BRAD: That's just one of the other things that can affect the value of the dollar. We just have to think through this equation, for some reason very unnatural to me. If we're exporting more than we're importing, then the dollar is going to rise in value because people need to buy dollars in order to buy our goods. The opposite would be true if we're net exporting.

The tariffs. This is probably the thing that would cause the direction of US and international stocks to go one way or the other. We don't know how it's going to turn out, but that could be the dominating factor of the next relatively major market move. That's the thing that's on the horizon that's so unclear. It affects a lot of things. Like long term business investments, things like that.

Politically, it matters. Jimmy Carter, probably the last person to try to get reelected during a recession, and it did not go well for him. You get reelected based on economic strength, other than a few other things, like wartime or something like that. But for the most part, you need a strong economy as you're going into reelection.

China needs it too. They're further along this process than we are. Probably more in a recessional period than we. There's certainly incentive on both sides to get it done. It's easier to start a war than to finish one.

PATTI: Boy, is that the truth. We have got to be really careful, because as this thing takes on and continues, etc., it is those tensions between those two countries. It's pretty scary. The one thing that is classic and textbook is that tariffs can definitely cause recessions. It can cause slowdowns, and it's bad for the entire world economy. One way or the other, they have got to get it solved.

For those people who are concerned about some of this stuff that China has been doing, there are legitimate concerns about the fact that China has been cheating a bit. It's hard to do business in China. You run the risk that the government is going to take over your company whether you like it or not. You've invested billions and billions of dollars.

I just had a pharmaceutical executive in. They were looking at starting operations over there. They decided not to for that fear. Sure enough, a competitor did. Opened operations in China with a particular division. Within a few years once it was up and running billions of dollars later, the Chinese government took over, and they were SOL.

It is a concern. Something does need to be done. Hopefully, the two sides can come together and figure it out.

BRAD: Even the greater effect that I've heard than the actual price of the level one cost of the tariffs, it was one of Fidelity call. They use the example of the iPhone 15. The tariffs change very little the phones that are for sale now and what's in the pipeline.

But when you're looking that far away, how do they make the plans for their development not knowing what all the components are going to cost? They can't lock in the long term contracts to do things like that. The real cost is in the business development that was never undertaken.

PATTI: That's the thing that is very difficult to measure. What would Apple have been able to launch if this wasn't going on at this point in time? It's like all decisions, it's a wait and see. You do that for six months, a year, two years, etc. You're not going to get your iPhone 15. It really undermines innovation and undermines progress if it lasts too long. It is a fine balance.

When we take a look at the overall...We often talk about the impact of a president. Typically, a president does not have really that much of an impact on either the economy or the markets. This is an unusual period of time where we've got someone who is very visible and is tweeting, and things of that nature. It does seem to be affecting sentiment.

That level of uncertainty that is typical in the contraction of the economy. People just not knowing what we're really dealing with and deciding, "I'm just not going to make any decision. Let's just wait and see how this thing plays out." That will definitely undermine confidence and what people do. Therefore, it affects the stock market. It affects the bond market as well. Everything.

BRAD: In a lot of ways, the president is like the chief public relations officer for the country. That's his influence on, like you said, sentiment, the feelings, consumer confidence, things like that. But the business cycle will last three or four presidents.

PATTI: That is a really good point. Just because this thing lasted 10 years doesn't mean that it has to be over. We look at Australia. Australia has had 26 years of growth. They have not had a recession at all. Just because it's lasted for 10 years doesn't mean that it has to be over, which is I think the most important takeaway.

We can talk about all of these things, but the most important takeaway is nobody really knows where we are. For those of you who are uncomfortable, we got our bear market. It happened. Hopefully, we run that excess out of the system and we can look forward to better times ahead.

I think that for those of you who are listening, let's wrap this up for everybody, Brad.

I think there's three takeaways  three key takeaways. Number one, don't panic. Just because we could be closer to the end, it's not the time to be changing your overall investment policy, your asset allocation.

We were talking earlier, and you mentioned David Kelley's comment. Why don't you tell listeners what his comment was about the light switch?

BRAD: [laughs] We try not to think of investing as a light switch that you turn on and off. You don't just decide that you're all in on equities or all out on equities. It's a series of dimmer switches where you fade one way, fade another way.

You fade a little bit between geographical regions. You fade a little bit between market caps. You fade a little bit between different sectors and things like that. You need to participate. The money that you need in three months probably shouldn't be in the stock market anyway.

This is all for things that with a much longer investment in mind than any single piece of news that you're going to hear tonight on the news or any headline. These are all things that are for way down the road. We've had terrible times before, and there's always a disaster on the horizon.

The stock market has steadily ticked up over the decades. I think that's what we want to keep our eye on. If you need the money shorter than that, then let's think of something else to put it in.

PATTI: OK, everybody, so the three key takeaways, first of all, Brad Everett, thank you so much for joining us today. I think it was a great, important, timely conversation. Three takeaways, number one, don't panic.

Number two, remember the light switch and the dimmer. It's not on and off. You want to fade one way or the other. Last but not least, just because we've been doing this for 10 years, we've had this wonderful expansion, doesn't mean that it has to be over any time soon. Remember Australia.

That's it for today's show. Again, thank you so much, Brad, for joining me.

BRAD: Thank you, Patti.

PATTI: Thank you all. Thank you all for listening to us today. It means a lot that you tune in, spend 20 or 30 minutes with us hearing about these different subjects because we do this for you.

Number one, I do think it makes us better. It helps us to zero in on the things that we believe are important. More importantly, we want to make sure that it's helping you. If there's anything else that you'd like to hear about, definitely go on our website, send us a message, say, "Hey, Patti and Brad, can you talk about A, B, or C?"

Sometimes we can, sometimes we can't. We're going to talk about the things that we believe we're experts at, where I believe that we do real financial planning, which might include portfolio management, risk management, how to put your kids through college, making sure that you never run out of money for the rest of your life.

That, to me, is real financial planning. The things that we've talked about today are things that give us the tools and the intellectual capital to help make decisions that are right for you. Again, thank you so much. I'm Patti Brennan, and we'll see you in the next podcast.