March 2019 Newsletter: Slowing Growth, Macro Update

March 11, 2019

Market Overview

CAPE Ratio	U.S. Market Valuation
30	Very High

Gold Price (oz)	12 Month Change
$1,298.35	-2.8%

Market/GDP	U.S. Market Valuation
137%	Very High

Silver Price (oz)	12 Month Change
$15.34	-6.5%

Gold/Silver Ratio	12 Month Change
84.64	4.0%

Currently Attractive Sectors:
Emerging Markets, Cash-Equivalents
US Financial Sector, Energy Sector
Commodities/Producers
Quality/Value/Yield Stocks

Recently Published Articles:

- My Favorite Investing Books
- A Realistic Investment Calculator
- P/E Ratio: Why Investors Need Better Valuation Methods
- The Best Forward Returns Might Be Outside of the U.S. (FA Trader)
- The Corporate Debt Problem is Real (FA Trader)

- Japan’s Central Bank Bubble is Truly Remarkable (Seeking Alpha)
- Are Gold and Silver Reasonably Priced Right Now? (Seeking Alpha)

Aggressive Vs Defensive Positioning

I like to do an update on recession indicators every few months to see where we stand in the market cycle.

My goal is not to try to time the market precisely. However, knowing where we stand in the cycle can help inform us on how aggressive or defensive we should be. Highly-valued stocks late in the business cycle historically give worse returns than cheap stocks earlier in the business cycle.

Aggressive can mean holding more stocks or riskier stocks, while defensive can mean having less stock exposure or insisting on investing in higher quality businesses.

Right now from everything I’ve seen, I’d characterize recession indicators as beginning to flash yellow, meaning that things are starting to look the way they often look about a year or two before a recession, historically speaking. They’re still not yet flashing red, which would imply that a recession is imminent.

A mistake that I think a lot of investors make is that they tend to think in a binary way and go “all-in” or “all-out” on an idea.

If they are enthusiastic, they put way too much money into something, like cryptocurrencies or cannabis stocks which have both been hot over the past couple years. If you find yourself very excited about any particular area, it’s probably the case that a lot of other people are excited about it too and you should seriously question what valuation multiples you’re willing to pay and how much of your portfolio you’re willing to put in. Sometimes less is more.

Alternatively, if they fear a recession is coming, investors may sell a lot of assets and go to cash. That’s a really hard thing to pull off successfully because the precise timing of both exit and entry points becomes very important.

Sometimes it is because of fear that investors make such big moves, while other times, especially among professionals, it's because of over-confidence in their investment thesis about what will happen and when.

I receive a lot of emails from people saying they went all or mostly into cash in 2016, for example, and have been trying to figure out how to get back into the market since then. They understandably don't want to invest heavily at the top of a market cycle, but don't want to miss out on further gains either.

Rather than make large changes based on market conditions or opportunities, I gradually shift my exposure around to areas I find attractively-priced with good long-term potential. This minimizes taxes, keeps turnover relatively low, and avoids over-committing to any one investment thesis.

For this approach, I only make investments about once per month, through a combination of new capital and occasional position changes. If emerging markets sell off and become attractively-priced, for example, I gradually start increasing my exposure to them. If I'm bullish on precious metals, I begin leaning a bit into them. Whenever there's an energy price crash, like in 2015 or 2018, I happily go bargain-hunting with some new cash or by re-balancing some small area of my portfolio into that sector.

When we had a rapid 20% sell-off in U.S. stocks that bottomed in late December 2018, I was originally planning to put my next set of portfolio contributions into investments in mid/late January, but chose to put them in a couple weeks early to take advantage of those briefly cheaper prices.

In extreme cases, like if we get a huge crash in the S&P 500, I would likely make a bigger change to invest into that, but that's generally a once-a-decade phenomenon. Even in that scenario, there's only about 20% of my portfolio that I would consider shifting around at once.

Update On 5 Key Recession Indicators

Most of the biggest bear markets are due to economic recessions. A recession is officially defined as two or more consecutive quarters of negative GDP growth.

The tricky thing about that definition is that it's backward-looking. Using the above definition, we can't even be sure we're in a recession until at least 6 months into it.

And historically, the S&P 500 tends to hit a peak and begin declining several months before a recession officially begins.

- The official start of the 2007 recession was in December of 2007, but the S&P 500 peaked in October 2007 and declined thereafter.
- The official start of the 2001 recession was in March 2001, but the S&P 500 peaked six months earlier, around September 2000.

It's folly to try to predict exactly when a recession will begin, but it really helps to have an idea of at least which phase of the business cycle we are in. Recovery-phase, middle-phase, late-phase, and recession-phase all have rather observable elements. Most of them suggest we are later in the cycle currently.

Exactly how far? That's harder to say.

What Makes a Good Recession Indicator?

There's a recession probability indicator maintained by Professor Jeremy Piger, which takes into account multiple variables and is charted here by the St. Louis Federal Reserve:

Chart Source: St. Louis Federal Reserve

Actual recessions are shaded in grey for this and most charts here. The blue line here is the recession probability calculation between 0% and 100%.

While something like that might be useful for policymakers, we can see why it wouldn’t be very useful for investors. It gives no advance notice, and only starts to even hint at a recession in the month or two leading up to the recession when stocks are historically already falling by that point. And it doesn’t give a very clear indicator of a recession until deep into it.

But how about something like heavy truck sales?

Indicator 1) Truck Sales

Chart Source: St. Louis Federal Reserve

Now, that typically gives a warning about a year ahead. When truck sales hit a peak and then drop off, watch out! There are a couple of false signals there, like in 1995 and 2015, but overall that's a pretty useful set of data to keep an eye on.

The drop-off in 2015 was due to the energy price crash at that time, which was a recession in the energy sector that affected banks (who lent to energy companies) and industrials (who transport energy and supply tools for the energy sector) and slowed overall economic growth for a few quarters, but not enough to cause an outright broad recession.

This indicator looks okay for now, but is a metric I'll continue watching. We had a dip in January that looked concerning, but it recovered to cyclical highs in February.

Indicator 2) Unemployment Rate

CNBC reported a few weeks ago that over the past 70 years, since the end of World War 2, every single time the official unemployment rate rose by 50 basis points (0.50%), the economy entered a recession or was already in one by that time. Looking at the data, that does seem about right.

Charted below is the U.S. stock market capitalization (red line) compared to the official unemployment rate (blue line):

Chart Source: *St. Louis Federal Reserve (see 70-year history)*

The unemployment rate went up to 4.0% in January, up 30 basis points from its low at 3.7%. However, in February it dipped back to 3.8%.

Low unemployment also tends to historically correlate rather nicely with stock market tops, but it’s unclear if we’ve quite reached the cyclical low yet.

Indicator 3) Yield Curve

Before most U.S. recessions, the yield curve turns negative (inverts), which means short-term treasuries begin yielding more than long-term treasuries. On this chart, the 10-year yield inverts under the 2-year yield when the blue line hits the black horizontal axis:

Source: *St. Louis Federal Reserve*

The yield curve has already partially inverted, with 2-year treasuries yielding more than 5-year ones. But the 2-year hasn't quite inverted over the 10-year yet.

In some low interest rate countries like Japan, the yield curve has stopped inverting before recessions due to ultra-low rates across the maturity spectrum.

However, a flattening yield curve is almost always associated with at least a slowing economy (if not an outright recession), and is a warning signal whether or not it ends up inverting this time.

- **Related article:** Why Interest Rates and the Yield Curve Are So Important

Indicator 4) Corporate Debt to GDP

This is one of my favorites, because the credit cycle is a big part of what drives the market cycle. Recessions are shaded in gray:

Chart Source: Gluskin Sheff

Companies tend to take on more debt as the business cycle progresses, until they max out their balance sheet. When the economy flattens out and starts to deteriorate, they are forced to deleverage.

Over the past decade, low interest rates have allowed companies to take on record debt levels, and they've used a lot of that money to buy back shares to boost EPS growth and dividend growth. Eventually they'll need to slow down that debt accumulation, perhaps this year or next year. And if EPS growth and dividend growth slows, it's harder to justify high valuations.

Indicator 5) Stock Valuations

Admittedly this isn't exactly a recession indicator but it's critical for determining expected returns.

The following chart shows the total market capitalization of U.S. stocks (blue line) compared to U.S. GDP (red line):

Chart Source: St. Louis Federal Reserve

I recently discussed the factors that have elevated this ratio in recent years here:

- The Best Forward Returns Might Be Outside of the U.S.

How to Invest a Lump Sum?

As I mentioned earlier in this issue, a common question I receive is how to handle the following situation that investors find themselves in:

- The investor has a lot of cash, either because they pulled money out of the market some time in the last few years, or they are just starting to invest after building up savings, or they received a lump sum from an inheritance or similar event.

- The investor is aware that we're 10 years into what is shaping up to be the longest economic expansion in U.S. history, and that stocks are historically expensive by most metrics, and they suspect better buying

> opportunities will come soon. They are concerned with investing a lot of money right at the market top, and then have everything crash down around them and lose half their money.

The answer in most cases, I think, is to build a diversified portfolio and then begin dollar-cost averaging into it. At least, that's what I would do and am doing. This means to put an equal amount of money in every month, to begin building the portfolio over time.

We have to consider human psychology when making decisions like this. For a lot of people, if they get unlucky and put a huge chunk of money into the market right when it peaks, and then lose 30-50% of it over the next year in a crash, they're going to freak out, sell at the bottom, and swear off investing for years.

The safer option for many people is to start putting money in gradually, especially considering where we are in the market cycle. When you put money in gradually, it doesn't really matter whether you're at the top of a market cycle or the bottom of it, because you have way more to invest later. If you start putting money in now, and the market crashes, you'll be fine because you know you still have a lot more money to keep contributing.

That's the middle-of-the-road answer between hoarding cash and going all-in, and I think it makes sense most of the time.

Dollar-Cost Averaging Example

An example is my new real-money M1 Finance newsletter model portfolio, which is updated later in this issue.

I started it six months ago in September 2018, which was right before the market top in 2018. It's been a volatile time in the market:

Before I started this one, I had three different portfolios at other brokerages. I found out about M1's system for position management and loved how it worked, so I started that 4th account specifically for this newsletter.

I put in $10,000 to start with in September, and began adding $1,000 more every 6 weeks before each newsletter issue, while continuing to contribute to my other larger portfolios. That's up to four issues now, so I've put in $14,000 in total to this one. This hopefully makes it approachable and relatable for new investors.

Due to where we are in the market cycle, the portfolio has some defensive elements including a 25% allocation to cash and precious metals, with the other 75% being in U.S. and foreign equities, including a focus on somewhat conservative dividend stocks.

I maintain flexibility with it; in early January when equity valuations became more attractive, I shifted some cash into growth stocks. But I also keep turnover pretty low, and usually only consider changes every six weeks or so when I put my regular allocation in.

Here’s how the value of that portfolio looked during this recent rapid sell-off and recovery:

That’s not so scary, right?

All of those vertical increases are my four $1,000 contributions. The first couple months were rough, with the portfolio hitting a bottom around Christmas time with a 8.67% decline from its top. This, however, is favorable compared to the S&P 500 which was down over twice as much, thanks to the diversification and defensive elements in the portfolio.

If you have cash and are looking to invest, you don’t have to jump in perfectly at the right time. You can start now, gradually, and take advantage of opportunities as they come.

In addition, while U.S. stocks are historically rather expensive, most foreign markets are not. A globally diversified portfolio is not necessarily over-priced at this time, especially if it also contains some defensive elements.

Portfolio Updates

I have four investment accounts, and I provide updates on my asset allocation and investment selections in each newsletter issue.

These include a primary passive/indexed retirement account, two actively-managed brokerage accounts at Fidelity and Charles Schwab, and the new account specifically for this newsletter at M1 Finance.

I use a free account at Personal Capital to easily keep track of all my accounts and monitor my net worth.

M1 Finance Newsletter Portfolio

As previously described, I started this account about five months ago with $10k of new capital, and I put an additional $1k into it before each newsletter issue.

It's by far my smallest account, but the goal is for the portfolio to be accessible and to show newsletter readers my best representation of where I think value is in the market.

I chose M1 Finance because their platform is free and allows for a great combo of ETF and individual stock selection with automatic and/or manual rebalancing. It makes for a great model portfolio with high flexibility, and it's the investment platform I recommend to most people.

The more I use it, the more I love it.

After adding $1,000 in fresh capital in February, here's the portfolio today:

The portfolio's defensive exposure to dividend stocks, gold, short-term bonds, real estate, and lower-valued international equities protected it from a big chunk of the U.S. stock declines in Q4 of 2018. And I shifted a bit into growth stocks in early January, which helped during the bull market that came in early 2019.

The portfolio is mildly outperforming the S&P 500 so far, and with less volatility. We'll see how it does over the next few years together.

Here's the more detailed breakdown of the holdings, including recent changes:

Changes since previous issue:

- I added several single-country ETFs and reduced my exposure to Europe/Japan a bit more.
- I added Wheaton Precious Metals (WPM) and First Majestic Silver (AG) to the commodities pie to increase my silver exposure a bit.
- I sold BNS and IVZ to buy JPM and BLK. I like all four companies though.
- I shifted around the general allocations slightly.

Primary Retirement Portfolio

This portfolio is my largest and least active. It purely consists of index funds that automatically rebalance themselves regularly, and I rarely make changes.

Here's the allocation today:

From 2010 to 2016, this account was aggressively positioned with 90% in equities and enjoyed the long bull market.

Starting in 2017 in order to preserve capital I dialed my equity allocation down to 60% (40% domestic, 20% foreign). This was due to high stock valuations, rising interest rates, and being later in the market cycle more generally. If and when the U.S. economy encounters a recession and significant bear market, I would likely increase equity allocations to upwards of 90% once again.

Related Guide: Tactical Asset Allocation

One reason this is so conservative is that my active portfolios are more concentrated and aggressive, so I consider them together when determining how to allocate assets.

This is an example of a fund that takes a rather hands-off approach but that still makes a tactical adjustment every few years based on market conditions.

This employer-based retirement account is limited to a very small number of funds to invest in, unlike the M1 Finance account. I would have some commodity/gold exposure and more foreign stock exposure if there were more/better fund options.

Active Portfolios

My accounts at Fidelity and Schwab are mainly for individual stock selection, single-country ETFs, and selling options:

Changes since previous issue:

- My cash-secured put options on the United States Oil Fund (USO) expired profitably. As a recap, after oil prices crashed from about $76 to $50 per barrel, I sold put options on USO in November 2018 at a strike price of $10.50 (equivalent to about $49/barrel) with an expiration of 2/15/2019 to diversify into cheap oil. This made an **8.2%** gain in about two and a half months.

- I reinvested the proceeds of that investment into the VanEck Vectors Russia Small Cap ETF (RSXJ), which is intended to be a long-term holding. The Russian stock market is risky but very cheap, and historically the cheapest countries tend to outperform.

- I sold covered-call options on the Brazil ETF (EWZ), which has been an existing holding for a while. From September 2018 to February 2019, it went from $32 to $43, which was a 34% rally. At that point in February, I decided to sell June 2019 covered calls for a strike price of $48 for $1.27/share. This would generate an extra 3% yield in less than 4 months while still leaving considerable capital appreciation upside potential (about 11%) over the next 4 months.

Final Thoughts

One of my favorite investors is Howard Marks, a billionaire distressed bond investor with a great multi-decade track record.

If you haven't read his first book, I recommend it.

He doesn't try to time the market, but he does like to pay attention to the market cycle to help inform his decisions on how aggressive or defensive to be.

As he has described, one of the questions he frequently asks himself is whether the current market is characterized by:

1. rich valuations, risk-taking, and too much money chasing too few deals
2. extreme fear, a refusal to lend, and very low valuations of risk assets
3. existing somewhere in the middle of those two extremes

The answer to that question helps him determine whether he should position himself more defensively (when everyone else is aggressively taking risk and assets are expensive), or whether he should invest more aggressively to take advantage of bargains (when everyone else is afraid to buy and assets are cheap), or somewhere in the middle.

This following chart shows the percentage of initial public offerings (IPOs) that are not profitable, for each of the past 38 years. I think it gives a decent answer to Howard's question:

Chart Source: Jay Ritter, CNBC

The year 2018 was a record year for this metric; over 80% of companies that went public in 2018 had negative earnings.

In my opinion it's one variable that implies that investors are currently willing to take a lot of risk and invest in non-profitable new companies with the hope that they will grow rapidly and eventually solidify their business models to become profitable.

And investors are currently paying very high valuations on these bets; 10x revenue is the norm for these types of companies.

For example, Snap Inc. went public in 2017 and is currently trading for a $12+ billion market cap with $1.18 billion in 2018 revenue. And that's after losing 2/3rds of its share price. Uber made $11.3 billion in revenue in 2018 and hopes to go public this year at a valuation of $120 billion. These companies are not profitable yet.

In his most recent annual shareholder letter, published in February 2019, Warren Buffett described that he is holding excess cash and waiting for bargains because high-quality companies are expensive right now:

> In the years ahead, we hope to move much of our excess liquidity into businesses that Berkshire will permanently own. The immediate prospects for that, however, are not good: Prices are sky-high for businesses possessing decent long-term prospects.
>
> -Warren Buffett

He's been saying that for 2-3 years now after buying the dip during the energy price crash a few years ago. He wants to make another huge acquisition but can't find a good one at a price he's willing to pay. There's too much money, in both public and private markets, chasing too few deals.

There are some sectors that look reasonably-priced in my opinion for investors with long time horizons:

- residential real estate
- midstream natural gas
- banks and asset managers
- foreign equities
- commodities/producers
- semiconductor companies

Just about any other place I look is really expensive. Software, consumer products, utilities, IPOs, hot companies like Tesla and Netflix and cannabis stocks- these are all quite pricey by most metrics.

The next issue is planned for late April. Thanks for reading!

-Lyn

This site provides equity research and investment strategies to give you the insight and data you need for managing your money through all market conditions.

Click **here** to join the free investing newsletter.

Featured On:

Let’s Connect:

Stock Ideas & Market Info:

- The Shiller PE (CAPE) Ratio: Current Market Valuations
- Contrarian Investing: Smart Moves for 2023 and Beyond
- 4 Economic Bubbles Growing In the United States
- Safe High Dividend Stocks: 20+ Strong Picks For 2023
- 5 Rock-Solid Blue Chip Dividend Stocks That I’m Bullish On Now
- 7 Top Stocks to Buy and Hold for the Next Decade and Beyond

Build Wealth:

How to Build Wealth Fast- This Chart Shows What it Takes

How to Increase Your Credit Score to 800 and Above

The 5 Most Impactful Tactics to Save Money I've Ever Found

12 In-Depth Tactics to Seriously Boost your Energy

Investing Basics:

How to Invest Money Intelligently: The Starter's Guide

How to Invest in Stocks and the Stock Market

Roth IRAs: How to Optimize Yours

Federal Thrift Savings Plan (TSP): The Ultimate Guide for 2019

How to Survive a Stock Market Crash or Bear Market

Experienced Investors:

Covered Calls: A Step-by-Step Guide with Examples

Selling Put Options: How to Get Paid for Being Patient

Equal Weighted Index Funds: The Pros and Cons and Which to Pick

Discounted Cash Flow Analysis: Complete Tutorial With Examples

Disclaimer

Get The Book

This digital book describes my process for finding great stocks, and comes with streamlined calculators to determine fair value.

Check it out here.

Premium Membership

Search this website