Registered Investment Advisor Firm

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Mid-Year Reflection

As investors, we all get things wrong from time to time. At the end of last year, most investors assumed that the tax cuts passed in Washington would fuel the bull market higher. That hasn't happened yet. Investors also assumed that higher levels of inflation or volatility would take place, which is starting to materialize.

As long as you adapt your thinking and strategy to reflect the new market reality, this is not a big deal.

Investing success doesn't require prognostication; it takes a willingness to acknowledge miscalculations and to make tactical adjustments. Fear isn't what usually kills a bull market; it's often the lack of fear, or a sense of comfort and confidence.

In 2017, complacency was beginning to set in. The CBOE volatility index (VIX), the so-called fear index that gauges investor anxiety, had 14 of the 20 lowest days in its history.

In just the first three months of 2018, the S&P500 index experienced more daily swings of 1% or greater than in any year since 2009. The S&P500 Shiller P/E climbed above 31, nearly double the historical average of 16.

But don't panic because the markets are showing sign of volatility. Use this volatility as an opportunity to re-evaluate how much risk you want in your portfolio.

If you can handle a 10% or larger fall in the short-term – like the February correction – then its fine to stay heavily weighted to stocks and keep buying the dips. However, if the drop is too discomforting, then change your allocation to lighten your exposure to equities.

Inflation, or rising prices on goods and services, hasn't been a real threat to investors for more than a quarter-century. In fact, for the past decade, the Fed has been fighting to keep deflation from wrecking the economy after the global crisis. But with business activity finally growing, the consensus forecast has been for a "modest" increase in inflation.

In early February, stocks fell 9% after average hourly earnings for workers grew 2.9%. Not only a large jump since 2009, it was seen as an omen for rising inflation. Wholesale prices that manufacturers pay (PPI) have been rising faster than the Consumer Price Index (CPI). The concern is the PPI is a leading indicator of CPI.

The threat of inflation shouldn't scare investors. Inflation may be heating up, but it is not at historical highs. Equities provide a partial hedge while Treasury Inflation-Protection Securities (TIPS) provide a hedge against unexpected inflation.

The Fed has been slowly raising interest rates since December 2015. Markets don't necessarily mind rising rates, higher yields are a sign of a growing economy. It is only a problem if rates grow faster than expected.

Analysts expect the Fed to raise 4 times in 2018 to a level of 2.25% by year-end.

The threat of inflation now raises the probability to the 4 hikes this year.

A bigger rate question is the Fed's balance sheet. The Fed is unwinding its $4 trillion portfolio, which would boost the supply of bonds on the market – driving prices down and yields up.

With the Fed helping boost short and long-term rates, investors need to be wary of interest rate risk. Many strategists suggest focusing on shorter-term debt that will mature soon and can be reinvested at higher yields. Prices decline less on shorter-term bonds than on longer-term bonds as rates rise.

Many market watchers thought stocks were bound to rise in 2018 following the signing of the Tax Cut and Jobs Act of 2017 because of the lowering of personal income tax brackets and dropping the top corporate rate from 35% to 21%.

With the tax cut signed and profit growth for the S&P500 off to a roaring start, the S&P500 has been relatively flat. Call it the classic case of the old saying "buy the rumor and sell the news." With tax cut anticipation, the market was up nearly 22% in 2017, but flat in 2018.

Reassess your international exposure. If you haven't been rebalancing, your exposure to foreign equities would be less as the US markets outperformed. Many strategists believe foreign shares are so much cheaper now. Also think about emerging markets as well as developed markets.

For years, it paid to be aggressive in the stock market. Nowhere did this strategy pay off more than technology stocks like the FAANG stocks. These five stocks returned an average of 47% in 2017. Few analysts forecast such gains for 2018, but few assumed many of these stocks would struggle.

Many FAANG stocks are struggling more than the broad market, signaling that market leadership could be shifting.

The technology sector typically performs well when interest rates are rising – like now. But diversifying your technology exposure with broader sector equities or funds will rebalance your portfolio to match your risk.

If you need help or more information on this or any other financial matters, contact Bob Davis at (707) 648-2024.

FED Watch

The Fed raised rates at their June meeting, as expected, by a quarter percentage point. Currently, the September meeting has a 72% probability for rates to rise and a 42% probability of the December meeting being another rate increase. The Fed will also continue the process of reversing quantitative easing by allowing assets to mature off their balance sheets, rather than re-investing them. They expect to be at $50 Billion quarterly by October 2018.

Next meeting:
July 31st and August 1st

Castle Rock Wealth Management

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