Registered Investment Advisor Firm

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Recession?

For many months, noted financial analysts have been predicting a recession in 2019, mainly based on the Federal Reserve (Fed) tightening monetary policy and a global economic slowdown, primarily Europe.

The Fed seemed to be on an autopilot quantitative tightening and a lot of talk about economic modeling. They raised rates in December 2018 and indicated that they would raise two more times in 2019 and keep raising them. The S&P 500 lost 9% in December, its worst performance for the month since 1931 and ended 2018 with a 6.2% loss, its biggest in 10 years.

After the December Fed Open Market Meeting, Jerome Powell (Fed chair) changed the direction of the Fed. He has now indicated he plans zero rate hikes in 2019 (maybe even a rate cut) and possibly none in 2020. He also sees a lower Gross Domestic Product (GDP) in 2020 and 2021 so he wants the Fed to be ready to help the markets keep from falling into trouble.

But there are other recessionary indicators besides monetary policy. One is the inversion of the Treasury yield curve. Historically, inversions of the yield curve have proceeded many of the US recessions. Due to this correlation, the yield curve is often seen as an accurate forecast of the turning point of the business cycle leading to a recession in about a year. The inversions have proceeded each of the last seven recessions. The curve inverted late in 2018 and again in early 2019. An inverse yield curve predicts lower interest rates in the future as shorter-term bonds are demanded, sending short-term yields above long-term yields.

Other indications are weaker housing activity; soft consumer spending; the tiny 20,000 increase in February payrolls (compared to the 223,000 monthly average gains last year); slowing European economies; deceleration growth in China and the ongoing China trade war.

There is a small chance of a soft landing such as in the mid-1990s. At that time,

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the Fed ended its interest-rate hiking cycle and cut the federal funds rate with no ensuing recession. The other 12 times the central bank restricted credit in the post-World War II era, a recession resulted.

It's also possible that the current economic softening is temporary, but a revival would bring more Fed restraint. Policy makers want higher rates in order to have significant room to cut in the next recession, and the current 2.25% to 2.50% range doesn't give them much room. The Fed dislikes investors' zeal for riskier assets, from hedge funds to private equity and leveraged loans, as well as speculations like Bitcoin. With the resumption in economic growth, a tight credit-induced recession would be postponed until 2020.

The 2007-2009 recession, the most severe downtrend since the 1930s, saw the S&P 500 Index plunge 57% from its peak to trough. The Fed raised its target rates from 1% in June 2004 to 5.25% in June 2006, but the main reason for the financial crisis was the collapse in the inflated subprime mortgage market.

Similarly, the central bank increased its rates from 1% in June 1999 to 6.5% in May 2000. Still, the mild 2001 recession that followed was principally driven by the collapse in the late 1990s dot-com bubble that pushed the tech laden NASDAQ Composite Index down 78%.

The 1973-1975 recession, the second deepest since the 1930s, resulted from the collapse in the early 1970s inflation hedge buying of excess inventories. That deflated the S&P 500 by 48%. The rate hikes from 9% in February 1974 to 13% in July 1974 was a minor contributor.

The remaining 8 post-World War II recessions were not the result of major financial or economic excesses, but just the normal late economic cycle of business and investor overconfidence. The average S&P 500 drop was 21.2%

At present, I don't see any major economic or financial bubbles. The possibilities are excess debt among US nonfinancial corporations and the heavy borrowing in dollars by emerging-market economies in the face of a rising greenback. Housing never fully recovered from the subprime mortgage debacle. The financial sector is still deleveraging in the wake of the financial crisis. Consumer debt remains substantial but well off its 2008 peak in relation to household income.

Consequently, the recession I foresee will probably be accompanied by an average drop in stock prices. In 2018, the S&P 500 fell 19.6% from October 3 to December 24, but the recovery since has almost eliminated all that loss. A normal recession-related decline of 21.2% - meeting the definition of a bear market- from the October 3 top (2925) would take it to 2305, down about 18% from current levels, but not much below the Christmas Eve low of 2351.

If you need help in understanding recessions and how to survive them or

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any other financial questions, contact me at (707) 648-2024.

FED Watch

As expected, no rate hike (or cuts) at the March FOMC meeting, but Jerome Powell indicated that there is very little chance of a rate hike the rest of 2019 and even a cut in 2019 (right now a 40% chance by September). The Fed has indicated it will slow down rate increases and be patient as they see GDP slowing in 2020 and 2021. The Fed will continue the process of reversing quantitative easing by allowing assets to mature off their balance sheets, rather than re-investing them and plan to taper this process and plan to complete by October of this year

Next meeting:
April 30th and May 1st.

Castle Rock Wealth Management

Castle Rock Wealth Management is a Hybrid Advisory firm servicing the needs of clients across the United States.

Castle Rock Wealth Management custodies some client assets at Charles Schwab & Co. Bob's office is located at 714 Marin Street, Suite #C, Vallejo, CA 94590. The telephone number is (707) 648-2024.

If you have questions or would like further information on this month's topics or any other financial or investment related subjects, please contact me by phone or through my email address at:
bob@crwmadvisors.com

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