FINANCIAL FOCUS

PETERSON FINANCIAL SERVICES

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MISGUIDED POLICY DECISIONS KILL BULL MARKETS, NOT AGE. IS THAT HAPPENING?

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Fourth Quarter 2018

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QUARTERLY MARKET RECAP

The markets corrected severely in the last quarter of 2018 as persistent and legitimate concerns over two major policies intensified. The sectors of the market that had provided the greatest gains through September were the ones that declined the most this quarter. For the fourth quarter, the DJIA dropped 11.83%, the S&P 500 declined 13.97%, the NASDAQ plunged 17.54%, and the small-cap Russell 2000 dived 20.51%. Foreign equities saw no relief mainly due to slowing global growth ex-US and Brexit confusion, declining 11.82%. The Federal Reserve continued to raise rates and while it trimmed its expected course for 2019 scheduled increases, that wasn't enough to prevent the unsettling of markets upon that announcement on December 19. The Dow Jones Corporate Bond Index lost 0.40%. In the face of all this, economic data is better than the market is pricing in, but investors look forward about two to three quarters and what the market is saying today is about expectations for the coming summer of 2019. And this misguided trade war is also upsetting to the markets. But, indexes became oversold, and in the last handful of trading sessions it mounted a comeback, but serious damage needs repair. Offsetting this, the job market, wage gains, productivity, and GDP growth are all healthy. These issues are the topic of this newsletter.

THE STOCK MARKET IS GIVING SIGNALS TO THE FEDERAL RESERVE, IF THEY'LL JUST LISTEN

This last few months of market misery is rooted in two misguided policies which run the risk of severely curtailing economic growth and if left unchecked, may even lead to a recession. These two policies are a trade war waged through the wielding of tariffs, which we've mentioned our concern about previously, and monetary tightening through the Federal Reserve's interest rate increases. It's the latter issue we'll discuss here.

Historically, bear markets do not come to be as a result of aging bull markets. They result from harmful policy enactments. Our assessment throughout this period of correction has been that the underlying fundamentals of the markets, outlined at the end of the Market Recap above, are so far strong enough to withstand some level of harmful policies – as long as they don't go too far. The concern now is that this may go too far. The vast majority of market corrections should be ridden through since selling into them comes when losses have mounted and often just as capitulation occurs and a new rally starts. But at that point the investor sold low, is in cash, and doesn't benefit from the reversal. By the time he believes the new rally is for real, he buys back in at higher prices. The result of this is that he'd have been better off if he'd just withstood the volatility and held on. That's been our reasoning. But the Fed raising rates too much might actually cause a recession and that's what the market is trying to forecast.

For decades the Fed has subscribed to an economic theory known as the Phillips curve which posits that low unemployment is inherently inflationary. And as such, strong economic growth that results from that low unemployment – which we are enjoying right now – risks "overheating" the economy. Never mind the fact that there is no historical data to support this theory. Just what is an "overheated" economy? During the 1980s we had declining unemployment, declining inflation, and GDP growth far above what we have today. But the Fed believes this, and more importantly, sets policy based on it. So, with 3%+ growth and 3.7% unemployment, they think they need to raise rates to put the brakes on the economy to lower inflation. But their own data and forecasts indicate that inflation is at or slightly below their 2% target and they expect it to *decline* next year to1.9%. Further, they also forecast growth dropping to the 2.5% range. So why keep raising rates?

The fact is, “normalizing” rates should have happened around 2012 when the recovery was just starting and had a long horizon. And that should have been accompanied by winding down the assets on their balance sheet several years ago, and gently raising the Fed funds rate. Since rates were kept too low for too long, which we’ve mentioned before, they now feel the need to catch up on their schedule. But doing too much too quickly is also destructive.

Here’s the problem with this. There is simply no sign at this point of an inflation break out. And, by purchasing power measures, official inflation is overstated. It doesn’t take into account value for a dollar of purchase. An example of this is an Apple iPhone 8. It has 25% faster processing than the iPhone 7, 70% faster multitasking, 30% faster graphics, an 83% better camera, and an engine enabling AI and augmented reality. Yet it’s $849 price is exactly the same as the preceding iPhone 7. When you get more for the same price, that’s *deflation*. Countless examples of this situation populate the economy. The Fed doesn’t consider this as it only looks at price changes.

There’s also no sign of the “cost-push” wage inflation the Fed worries so much about. It’s not in the data. Productivity is rising at 1.8% holding down prices. Global growth is slowing, indicating a spillover to our domestic economy which is why analysts expect lower GDP next year. The Fed’s own favorite inflation measure, the PCE deflator, has been *falling* for months. The dollar is strong against both gold and other currencies and needs no defending. Commodities like oil and farm products are way down. Housing and autos are sensitive to rate increases and both those sectors are declining. The Fed is unwinding the largest monetary experiment in modern history. Recent global central banks’ multi-trillion bond purchases and years of net zero real interest rates are uncharted territory and there’s no road map for walking that back.

The markets are telling the Fed to ease up and review their three years of rate increases. When Chairman Jerome Powell signaled four weeks ago that they may pause by stating the targeted “neutral” level is near, the markets rallied. But when the FOMC met three weeks ago and rates were raised again and guidance indicated two more in 2019, the markets sold off hard. If they’d said they’re holding pat for the time being to assess developments, the markets would have rallied. That’s what we were waiting to see. They could maintain flexibility by resuming tightening if inflation and other data warranted it. That would have been the wise course of action. Now that they’ve proven Fed independence from President Trump’s political pressure, perhaps they won’t do the two increases next year.

Sentiment indicators reveal this sell-off is fear-driven and excessive. That is often an indicator of the bottom and leads us to erring on the side of further patience right now. Keep in mind that 85% of all trading is controlled by computer models and passive investment formulas, which forms blocks that move in lockstep and quickly.

“The stock market is a device for transferring money from the impatient to the patient.”

- Warren Buffett

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ABOUT PETERSON FINANCIAL SERVICES, LLC

As an aside, we wish to remind our clients of our various services. While we’ve specialized in portfolio management over the last several years, we continue to provide financial planning and insurance services. Longtime clients may have forgotten this, and newer clients may not be aware of this. Additionally, we build our business through referrals, and much appreciate them. Please keep us in mind as you come across friends, family and colleagues who might benefit from our financial services. We appreciate your business.

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CONTACT

1726 Clarkson Street
Denver, CO 80218

Phone: (303) 831-4800

E-Mail:
kirk@petersonfs.com

Hours of Operation
7:30am–5pm M-F

Visit us on the Web!

www.petersonfs.com