

NORTH FLORIDA WEALTH ADVISORS

Market Musings

December 11, 2018

Divergence Market Musings

"I like to be an optimist, but I like to be a realist, too."

~Tom Petty

Recently I received a call from a client who was concerned about the apparent disconnect between his perception of the economy and the performance of the stock markets. The U.S. economy has been on an upward trajectory since the economic bottom of 2009. The surprise election of President Trump added considerable fuel to the economic fire and the markets and economy virtually went parabolic with the anticipation of tax relief and reduced regulations. I would argue that the strength of our economy was the most underreported story of 2018. While reasonable minds may disagree on the long term consequences of these actions, the near term did produce tangible results. However it appears that the markets are signaling that this was a "sugar high".

Let's take a look at the returns of many popular indexes: (from Bespoke
12/7/2018)

SPY	S&P 500	+0.06
QQQ	Nasdaq 100	+4.19
IJH	MicCap 400	-5.09
IJR	SmallCap 600	-2.13
EFA	EAFE (International)	-11.86
EEM	Emerging Markets	-14.81

A deeper dive into our markets would show that generally speaking, housing stocks are down (-19%), materials stocks down (-13.10 %) and energy stocks down (-9.48%) contributing to the general market malaise. Internationally there are bear markets in 13 of 23 major country stock market ETF's. One would think that if the equity markets are flat to down, let's hide in bond funds. The Barclays Aggregate bond fund is down -1.05 and the Vanguard Total Bond Market ETF is down -1.18%.

Looking back at my July 16 2018 Market Musings I wrote: *Overseas what was viewed as a synchronized global recovery appears to be wobbling. Trade and tariff issues have taken their toll along with several European centric issues. In no particular order: Germany's economy appears to be slowing, Italy is openly talking of exiting the European Union (not sure that happens quickly), their own migrant issue and Brexit, to name a few. China is clearly in the administration's crosshair.*

Emerging markets have really been hurt by the strong US dollar and the trade & tariff talk. It is hard to ignore the dynamic demographic that emerging markets offer, but for now it's time for patience. I suspect

that we are in a slowing growth story and I continue to believe that we will have a positive 2018. I feel that returns could be positive but below historical averages.

One of my favorite market axioms is that the market is a forward looking indicator. If true, the market perceives an economic slowdown or a recession in 2019 / 2020. Unfortunately no one sounds an alarm at the beginning of a bear markets or recession; you only know it when you are in one and can look back at the data. Much of the concerns that I described in July still exist and when adding tariff's, a global potpourri of political instability (including here), and rising interests rates one can only continue to sound the alarm of caution.

The markets are extremely vulnerable to headline risk as evidenced by the wild swings from hope to fear when tariff talks with China hit the news. I am also concerned about the deep political acrimony and potential for impeachment proceedings against President Trump. If he is legitimately found guilty of something, then the markets would happily move on with President Pence. If the impeachment proceedings are just political theatre for fundraising and political posturing for the 2020 election, then the markets may be tumultuous as even less legislation will be accomplished. I am thinking about immigration and infrastructure bills. Make no mistake, the acrimony is palpable and if the tables were turned, the forthcoming events would probably not change.

While I remain cautious (realist) I am also an optimist. US equity valuations while not cheap, in my opinion, are also not expensive.

International equity valuations remain very attractive but are hampered by considerable geo political uncertainty (Paris riots etc). Long term investors need to remain committed to equities as a mechanism to build wealth and offset the negative consequences of inflation to your purchasing power.

In the interim, I think some caution is warranted. Investors with long term time horizons may find today's valuations compelling enough to look past the anticipated continued volatility. For many clients, I have paired by equity exposure and added short term certificates of deposit to help reduce the volatility.

As I close, I invite you to continue reading my addendum to this missive which further details the benefits of diversification. We will continue to maintain our multi asset, globally diversified portfolios based on our perception of your risk tolerance. As always, please do not hesitate to contact us.

Thank you for the confidence and trust you have placed with our firm.

Christopher J. Conner CFP® Charles "Al" Cockrell CFP®
Kristopher Cotton "Trip" Hargraves

PS: As we enter the holiday season, I wish you good health, happiness and peace. I have found that spending time with family and friends is of paramount importance.

Diversification

"Diversify. In stocks and bonds, as in much else,

there is safety in numbers"

~Sir John Templeton

I have always found diversification to be bedrock of portfolio construction. Simply stated no one knows which asset class will outperform the next. Let's talk a look at diversification:

1. Equity diversification divides invested assets with different styles, sectors and geographies which all can run counter cyclical. Different subsets growth / value, small / large and US / International tend to zig when the other zags.
2. The purpose of diversification is to hopefully temper the wild swings of volatility while earning the full returns over the long term. The proverbial "safety in numbers". Another way of looking at diversification is the smoothing your overall portfolio volatility over time. Please think of this in terms of decades, not months.
3. Naturally, when we diversify and we have not magically selected the best asset class to invest 100% of our funds (gambling) our total returns are muted. However, choosing the asset class which underperformed the most with 100% of our funds could be financially catastrophic.
4. A properly diversified portfolio WILL ALWAYS contain an underperforming asset. That is the evidence that you are diversified. Counterintuitive I know; but nonetheless correct.
5. We never chase the winners; rather we rebalance based on time horizon and risk. This year's winner could be next year's loser - then what have we accomplished?
6. Rebalancing allows us to take some profits in our outperformers and reinvest them into our underperformers. A mentor of mine likes to say "discipline over conviction".
7. My fundamental approach is a multi asset global approach. I simply do not know when US equities will outperform international or when value companies will outperform growth. Fortunately for me, I have a lot of company because no one else knows either.
8. My goal is to provide you a diversified portfolio that is risk adjusted. If you are a conservative investor, we know that you need equity exposure, but you may not need the volatility that comes along with small growth companies. If you are an aggressive investor, we would

probably not invest in large value companies but rather large growth companies.

I hope that this missive on diversification will assist you in looking at Investing thru a long (decades) lens.

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