Retirement Income Solutions

Helping to grow and preserve your wealth

Synchronized Global Growth

October 2017

Summary

The global stock market in 2017 can be described with one word – steady. The U.S. election created some bumps in financial markets in 2016, but, since that time, synchronized economic growth around the world created a very stable environment for stocks. Financial markets seem to have absorbed the three planned Fed rate increases for 2017, and recession risk is low for now. Although it is only a matter of time before volatility returns to stock markets, it has been five years since U.S., international, and emerging markets all realized double-digit returns in the same year.

A Steady Ride

\# of "big move" days

Year	0.5%	1.0%
2017	37	3
2016	85	42
2015	80	32

Source: Bloomberg

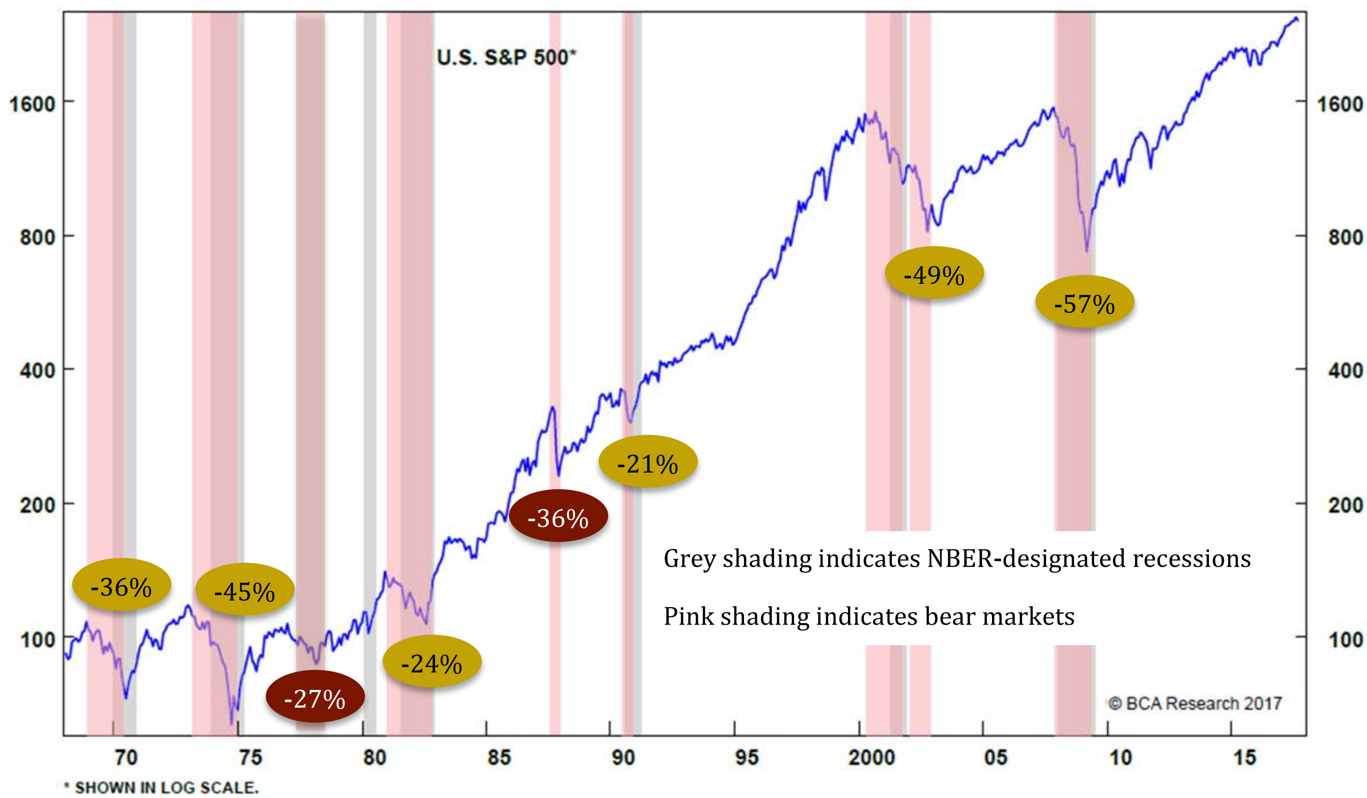
- **Global growth is synchronized.** U.S. data is strengthening (the Purchasing Managers Index is the highest since 2004), and Europe saw its largest GDP growth since 2011 of 2.3%.
- **Recession risk is low in the near term.** However, if the Fed moves more aggressively due to inflation concerns and unemployment spikes, those risks increase significantly.
- **A bear market decline is unlikely in the near term.** Seven of the last nine bear market declines coincided with a recession, and the two exceptions are not good analogies for today.
- **The maximum drawdown in the U.S. this year has only been 2.8%!** The only year since 1928 that saw less volatility was 1995. The maximum drawdown for "world stocks" (an aggregate of all major stock markets) was only 2.0%. There were only three trading days where global markets moved more than 1%, compared to 42 and 32 in 2016 and 2015, respectively.
- **The Fed is less accommodative but still far from restrictive**. Most recessions were triggered by aggressive monetary tightening (i.e. raising interest rates) by the Fed.
- **U.S. equity market returns were solid**, but international markets led the way with gains of over 20%.
- Stocks were positive over the summer, but **winter returns have exceeded summer returns** in all eight years since the financial crisis.
- **The four-year presidential cycle indicates potential risk in the summer of 2018,** which could be triggered by the potential for a recession in 12 to 24 months.

With recession risk low, stocks should outpace bonds over the next 3 to 6 months. Accordingly, on October 4th, we moved client portfolios to their Maximum equity positions. Since extremely low volatility did not end over the summer, a modest correction could occur in the winter months. Although a correction may be uncomfortable, stocks should generate better returns than bonds in the near term. While good economic news is refreshing, higher expectations can lead to disappointment. Close monitoring of market and recessionary indicators will be important in 2018.

Bear Markets & Recessions Usually Coincide

Over the last 50 years, the most negative periods in financial markets were associated with recessions. It is not surprising that an economic downturn would damage the valuation and outlook for stock market investments. The most negative periods, known as "bear markets," are commonly defined as declines of 20% or more. Since 1967, there have been nine bear market declines, and seven of the nine bear markets coincided with a recession.

Absent a recession, bear market declines are rare. The two outliers occurred over 30 years ago in 1987 and 1977, during very different environments. In 1987, the economy was strong but inflation was ramping up quickly. As a result, the Fed was forced to act aggressively, raising interest rates by 1.25% in under six months (from an already "lofty" 6% to 7.25%). The rapid tightening of monetary policy spooked markets and generated a 36% decline. In the 1970s, the economy was characterized by both high unemployment and major concerns about inflation, and 1977 was no exception. The economy was not nearly as strong, unemployment was significantly higher at 7.5%, and inflation hit 7%. The Fed was forced to act aggressively, raising interest rates from 6% to 10% in less than 18 months; during that same period, stocks fell by 27%.



Although recessions can be difficult to predict, most forward-looking indicators show very low risk of a recession in the next 6-12 months. The global economy seems to be synchronizing with the U.S. ISM Purchasing Managers Index at the highest level since 2004, and European GDP at its highest growth rate since 2010-2011. With inflation under control, the Fed is normalizing policy but is far from creating a tight monetary environment. Other technical indicators do not show signs of deterioration. Although a recession cannot be ruled out completely, the weight of the evidence says no recession in the near term and thus no bear market… yet.

Improved Prospects for Growth Generate an Unnaturally Calm Year

Global economic growth has accelerated recently for the first time in many years. Since 2012, expectations for global growth have fallen every year after the initial forecasts were generated. The long-awaited economic recovery seemed right around the corner but proved ever elusive. Each year from 2012 to 2016, high expectations were met with slower and reduced expectations of growth. Projections were revised down and then down again. However, the consensus for 2017 and 2018 has been mostly revised up not down.

An analysis of stock earnings generates the same history of disappointment as well as the same recent improvements. Each year from 2012 to 2016, high expectations and projections were revised down; most periods fell by 50% or more. So far, the consensus for earnings has held steady with expectations for double-digit gains in 2017 and 2018.

Global GDP Growth Consensus

Year	Initial	Actual *	Change
2012	3.4%	2.3%	Down
2013	3.1%	2.4%	Down
2014	3.1%	2.7%	Down
2015	3.2%	2.6%	Down
2016	3.2%	2.5%	Down
2017	3.0%	3.2%	Up
2018	2.8%	3.1%	Up

* or updated forecast
Source: Bloomberg, BCA, Thomson Reuters

S&P 500 Earnings Per Share Consensus

Year	Initial	Actual *	Change
2012	13.5%	6.0%	Down
2013	10.0%	6.5%	Down
2014	11.5%	7.0%	Down
2015	10.5%	0.5%	Down
2016	11.0%	2.0%	Down
2017	12.0%	11.0%	Steady
2018	12.0%	11.0%	Steady

* or updated forecast
Source: Bloomberg, BCA, Thomson Reuters

Due to the improvement in economic conditions, this year has realized an extraordinary period of low volatility. All the political uncertainty and sabre-rattling has been offset by positive economic momentum. Below are a few interesting statistics:

- The maximum drawdown this year has only been 2.8%! The only year since 1928 that saw less volatility throughout the calendar year was 1995, which realized a maximum drawdown of 2.5%.
- The S&P 500 has gone for quite an extended period without a 5% correction (323 trading days), its longest stretch in 21 years.
- If the S&P 500 can manage new highs in November, that will mark the longest period ever without a 3% correction.

Average Number of Days Without a Correction

S&P 500, 1928-2017

	Since 5% correction	Since 10% correction	Since 20% correction
Mean # days	50	167	635
Current rally # days	323	417	2162

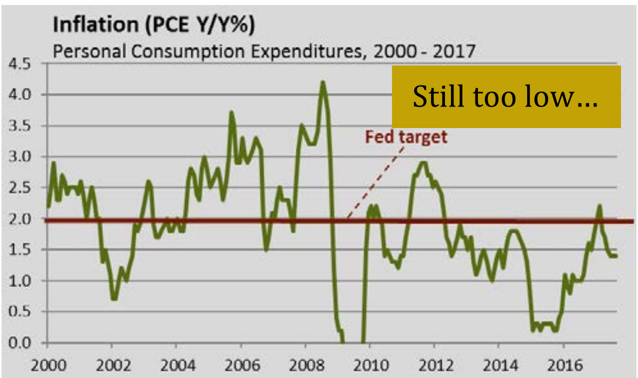
Source: Ned Davis Research

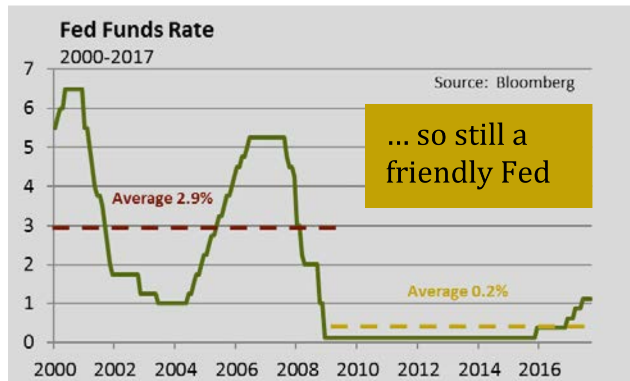
While the low volatility does create a sense of security, it can only last so long. Although more aggressive allocations are warranted, it would not be surprising if the market saw its "biggest" correction of the year in the next few months. If a larger single-digit correction comes soon, that would likely be viewed as a return to normal volatility and new base for equity market growth.

When will the Bull Market End? Waiting on the Fed and Inflation…

Over the last several months, economic conditions have continued to improve. The bull market is mature and should be monitored carefully. It is only a matter of time before the next recession arrives, but a scan of the environment indicates there is still room for equity markets to advance.

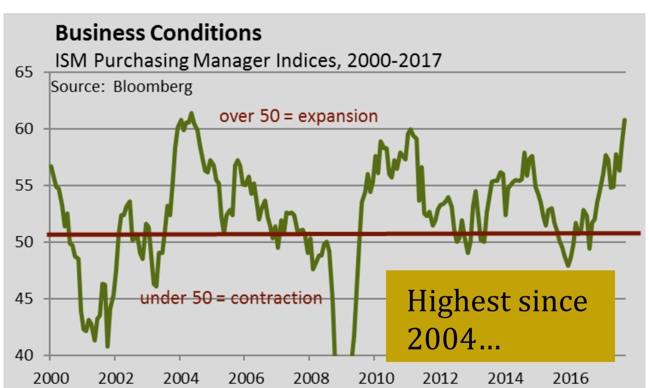
Most bull markets come to an end when the Fed realizes it is behind the curve on addressing inflation concerns. Despite actions by the Fed to be less accommodative, the market is absorbing three Fed fund rate increases this year quite well. Although it will continue to be less friendly, monetary policy is not yet tight or restrictive. Currently, there are few inflation concerns, but certain indicators show those pressures could mount in mid-2018 or early 2019.

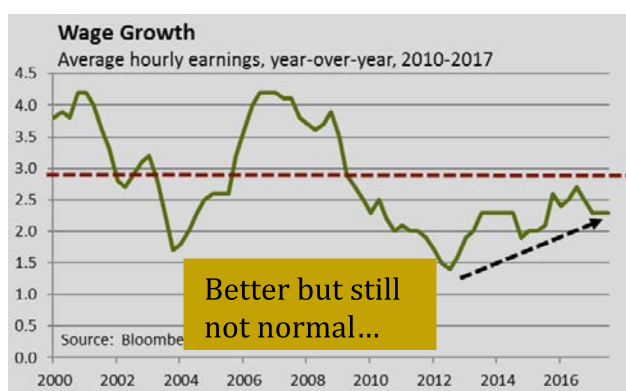




1) **Inflation:** Inflation is not a problem yet. The Fed has established a 2% threshold as a healthy inflation target, and despite solid economic growth, most inflation measures have not reached desired levels. Although PCE inflation touched 2% earlier this year, it was not sustained. While the Fed is seeking to normalize monetary policy, it will continue to move slowly since inflation is still not a concern.

2) **Fed Actions:** The Fed is less accommodative but still far from restrictive. The average Fed funds rate (the rate at which banks lend to one another) was 2.9% between 2000 and 2010. In June, the Fed raised the rate for a fourth time to 1.25%; however, the Fed Funds Rate is still well below average historical levels. Interestingly, the Fed seems somewhat perplexed by the lack of inflationary pressure, which will encourage a continuing accommodative stance. In September, Fed Chair Janet Yellen stated, “This year, the shortfall of inflation from 2 percent, when none of those factors is operative, is more of a mystery, and I will not say that the Committee clearly understands what the causes are of that.”





3) **Economy:** After a lull in 2015 and 2016, the economy is accelerating. The ISM Purchasing Managers Index (a measure of business conditions) is at its highest level since 2004.

4) **Wages:** Wage pressures are still not yet evident. Although wage gains have increased over the past few years, they are still below the average increase since 2000. While high wage growth may be good for people on main street, it is also an early symptom of excessive inflation (and thus a potential cause for more aggressive Fed action).

5) **Unemployment:** While unemployment is quite low at 4.4%, it can reach lower levels; in the 1990s and 1960s, it dipped below 4%. Unemployment is typically seen as a lagging indicator since it tends to peak after a recession is over and well after financial markets have begun to recover. However, it does have some merit as an early warning indicator. When unemployment reverses course and increases by 0.33% or more after hitting low levels, a recession has always ensued. No indicator is perfect, but when the unemployment rate begins to turn upward, more caution may be warranted. The current trend is still downward, so it is not signaling caution yet; however, at such a low unemployment level, it would not be surprising to see a reversal in the next 12-18 months.

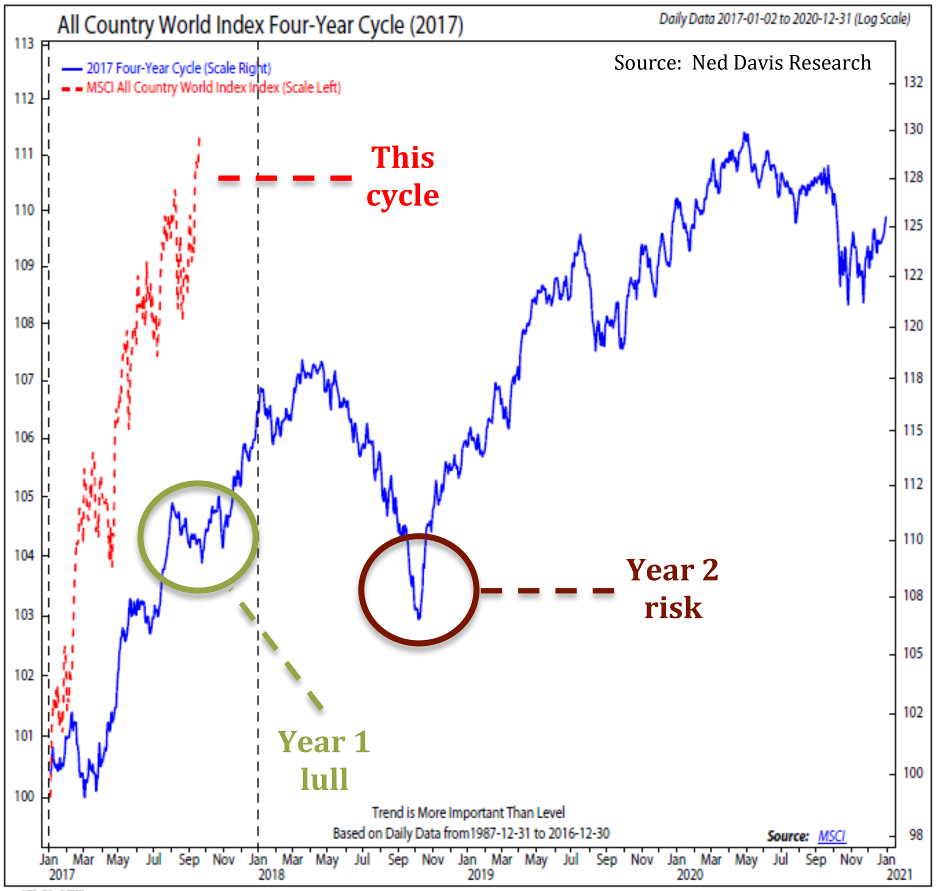
Yellow shaded areas represent NBER recessions; source: Bloomberg

To summarize, with synchronized economic growth in the U.S. and the rest of the world, a recession does not seem likely in the near term. The Fed seems content to move slowly with monetary policy for now. Inflation remains low, allowing the Fed to gradually normalize interest rates. Wage growth is improving, but it is still below a threshold that might trigger a jump in inflation. A low likelihood of recession in the near term implies a reduced likelihood of a bear market decline of 20% or greater.

Four-Year Cycle

While there is often a lull in the late summer or fall of year 1 in the four-year presidential cycle, the potential rally at year end can be strong. 2017 was extraordinarily smooth, and the lull was either very small or did not come at all.

Historically, the typical dip in year 2 of the four-year cycle is much larger than year 1. Therefore, perhaps a more important risk to monitor is the potential for recession in 12-24 months. Since the stock market often reacts before a recession, a mid- to late-year correction in 2018 would line up well with the tendency for markets to pull back in year 2 of the cycle.



Stock Returns – A Strong Start to the Year

So far this year, equity markets have seen their strongest results since 2013. The strength has been complemented by breadth as well. Not only have U.S. returns been solid (up 14% for the year), but international and emerging market returns have posted strong results as well (up 20% and 28% for the year, respectively). Bond returns were reasonable for the year (the Barclays Aggregate was up 3.1% and Treasuries posted a gain of 1.6%).

Investment Returns

As of September 30, 2017

	2017 ytd	2016	2015
All Country World Stocks	17.3%	7.9%	-2.4%
S&P 500	14.2%	12.0%	1.4%
Dow Jones Industrial Average	15.5%	16.5%	0.2%
Small Caps	10.9%	21.3%	-4.4%
International	20.0%	1.0%	-0.8%
Emerging Markets	27.8%	11.2%	-14.9%
Bonds (Barclays Aggregate)	3.1%	2.7%	0.6%
U.S. Treasury Bonds	2.8%	1.0%	1.6%
Commodities	-3.8%	11.4%	-32.9%

Source: Bloomberg

Stocks Positive over the Summer – What's up with Seasonality?

Seasonality refers to the tendency for certain markets to perform differently during the winter months than the summer. The historical impact on stocks has been profound. Since 1950, stocks (the S&P 500) on average returned 7.0% during the "strong" winter months and incurred a small loss of -0.1% in the "weak" summer months. Over time, the impact is quite significant with all of the stock market gains since 1950 occurring in the strong winter season.

Seasonality is remarkably consistent, but it does not impact markets in the same way every year. This year, for example, the market saw positive stock returns during the weak summer months. Although some of the "weak" periods incur losses, it is the combination of relative weakness and risk that is important.

S&P 500 Returns

2010-2017

Year	Winter (Oct to Mar)	Summer (Apr to Sept)	Winter Beat Summer?
2010	11.8%	-1.4%	Yes
2011	17.3%	-13.8%	Yes
2012	25.9%	3.4%	Yes
2013	10.2%	8.3%	Yes
2014	12.5%	6.4%	Yes
2015	5.9%	-6.2%	Yes
2016	8.5%	6.4%	Yes
2017	10.1%	7.7%	Yes
Avg	12.8%	1.4%	8 of 8 yrs

Source: Bloomberg

Recent returns reinforce the longer-term history of strong and weak seasons. In all eight years since the financial crisis, stocks have performed better in the winter than the summer, and the average return is almost 10 times as large during the strong winter months. Three of eight summer periods realized losses (versus none of the winter periods). There have been four corrections of over 10% over that period; three of the four corrections happened in the summer months.

Although most of the time the stock market has positive returns in the summer, the risk that investors face during the summer six months is not the same as the risk faced during the winter six months – more loss periods, more corrections and lower returns. While not perfect, seasonality is still an integral factor in assessing risk to financial markets and remains an important part of how we assess and position client portfolios.

Summary

Stocks should outpace bonds over the next three to six months, and odds of a recession are low in the near term. A fall lull is common in year 1 of the presidential cycle, but it is not guaranteed and seems less likely after the risky months of August and September have passed. On October 4th, we moved client portfolios to their Maximum equity positions. The lack of summer volatility means that a modest correction could occur in the winter months. Although such a correction may be uncomfortable, stocks should generate better returns than bonds in the near term.

We have received a lot of questions about North Korea and its lack of impact on markets. Risk clearly exists on that front; however, most political events have little long-term impact on stock markets. In addition, the hope for tax cuts in the U.S. has focused markets on continuing the positive economic trend.

If you have questions on the investment environment or your portfolio, please call us at 734-769-7727. To find an electronic copy of this document and other recent commentaries, please visit our website at www.risadvisory.com.

Brock E. Hastie
Managing Partner

Karen Chapell
Managing Partner

Todd Kephart
Managing Partner

John Goff
Managing Partner

K. Larry Hastie
Managing Director

R. Griffith McDonald
Managing Director

Margaret Kephart
Sr. Vice President

Pamela Loduca-Massa
Sr. Vice President

These data are for illustrative purposes only and is not indicative of any investment or strategy result. The S&P 500 is an index of 500 stocks representing major U.S. industry sectors. The Dow Jones Industrial Average is an index made up of 30 large U.S. company stocks. Small Cap is represented by Russell 2000 Index, which is an index of the 2000 smallest companies in the Russell 3000 Index of 3000 broad-based U.S. companies. Mid Cap is represented by S&P Mid-Cap 400 Index, which tracks medium-sized U.S. firms, which is broadly defined as a company with a market capitalization ranging from about $2 billion to $10 billion. Developed Int'l is represented by MSCI EAFE Index, which is an index of major international equity markets as represented by 21 major MSCI indexes from Europe, Australia and Southeast Asia. Emerging Markets is represented by MSCI Emerging Markets Index, which is an index that is designed to measure equity market performance in global emerging markets (over 20 countries including Brazil, Russia, India, and China). World stocks (the All Cap World index) are represented by the MSCI ACWI index and is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 45 country indices comprising 24 developed and 21 emerging market country indices. High-Yield is represented by the Barclays U.S Corporate High-Yield Index, which measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt. Investment grade and broad market bonds are represented by the Barclays Aggregate Bond Index includes most U.S. traded investment grade bonds, including Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S. Treasuries are represented by the Barclays Capital U.S. 7-10 Year Treasury index, which measures the performance of U.S. Treasury securities that have a remaining maturity of at least seven years and less than 10 years. TIPS are represented by the Barclays U.S. Government Inflation-linked Bond Index, which includes publicly issued, U.S. Treasury inflation protected securities that have at least 1 year remaining to maturity. Commodities are represented by the S&P GSCI is a world-production weighted index designed to track investable commodities representing the price movements of the world economy.