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U-TURN

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Another calendar year under our belts and another 180-degree turn. In 2018, virtually every major asset class declined in value, many substantially. Investors had few places from which to escape the pummeling outside of cash. In contrast, despite myriad distractions, most financial assets worked out quite nicely in 2019, both within the U.S. and across the globe.

No GPS

Pundits have scrambled to attribute this most recent and dramatic reversal of fortunes. But no one can definitively explain the inexplicable — why stocks rise or fall in the short term. The easiest explanation for the market's surge may simply be that it represented a countermove from the widespread carnage that preceded it. The investment mood shifted with the realization that earlier recession fears had been overblown.

Entering the 2020s and reflecting on the bull market that churned on over the prior decade, we are reminded of the *persistence* of cycles and trends. Nevertheless, history also indicates that they are difficult to predict and challenging to navigate. In 2009, few observers foresaw such a running of the bulls; instead, many advised caution as the world attempted to emerge from a deep and pervasive financial crisis.

Bumps in the road

And although the up-cycle has prevailed, a succession of existential threats to equities has certainly tested investors' fortitude: double-dip recession fears, Europe's debt crisis, fiscal cliff, Brexit, Fed taper, China's slowdown, collapsing oil prices, earnings recession, two U.S. presidential elections, North Korean nukes. More recently, the roadblocks have involved trade tensions and Fed policy.

Such headlines have fueled angst and caused selling pressure at times. As a result, over the 2009-2019 period, the stock market (S&P 500) experienced selloffs of 5% or more on twenty-five different occasions. And there were eleven instances in which stocks corrected by nearly 10% or more. Each market episode seemed to have a troubling rationale associated with it, perhaps portending the bull's demise. With hindsight, the proper position to have adopted was to hold fast.

Time, not timing, is key

Assuming one has a sufficiently long holding period, it generally pays to stay mostly invested. On any given day during the past 90 years, the odds of a positive return have been a bit over 50% — marginally better than a coin flip. But as one extends the holding period, the odds break in investors' favor. For instance, over one-year timeframes, stocks generate positive outcomes about 75% of the time. Over ten-year periods, stocks achieve positive returns more than 90% of the time. This improving success rate stems in part from the power of rising dividends.

However, fear is a primal emotion. Confronted by a threat, humans are wired to take action. So when news headlines seem bleak and security prices all turn red — as was the case in late 2018 — it is difficult to resist evolutionary urges, calmly reflect on market history, and sit tight.

Human nature tends to place too much emphasis on the short term. As Bill Gates has posited, "we always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten."

Tense and tight

But what a difference a year makes. Thirteen months ago, the market fixated on worsening trade tensions and Fed tightening. Whether it was the inverted yield curve or trade-related growth slowdown, traders seemed to be looking for a reason to call the end of the business cycle.

And those fears were not entirely misplaced. The threat of tariffs and other protectionist measures has clearly spilled into the world's manufacturing sector. In 2019, global GDP ended up growing at the slowest rate in a decade. Like those of its trading partners, the U.S. economy has been hampered by an absence of private investment growth as businesses defer capital spending decisions because of policy uncertainty.

This slowdown in capital orders along with rising labor costs has pressured corporate profits. Concurrently, the earnings outlook slipped as the year progressed. FactSet Research now expects that S&P 500 earnings per share will end up essentially unchanged from 2018 levels.

#Don'tFightTheFed

To counter the risk of deteriorating economic conditions, most central banks loosened the strings in 2019, reducing interest rates and expanding money supply. But some investors ignored the Federal Reserve and other central bankers at their own peril. As recession fears have receded, robust stock returns prevailed *despite* weaker economic growth and slipping earnings expectations.

Meanwhile, the Trump Administration has reportedly reached an agreement with the Chinese on "Phase 1" of a trade deal. While this initial stage is unlikely to result in substantive reform, the mere sign of a truce has comforted markets. Both sides have an incentive to deescalate. Chinese policymakers confront a softening economy and deflating producer prices. The president faces a tough reelection battle when many swing-state voters are suffering from the slowdown caused by the trade war.

Bank on it

Based on the statement released after last month's policy meeting, Fed governors apparently believe their 2019 interventions will suffice to keep the economy on track. The bar for additional rate cuts has been raised. Similarly, the likelihood of a new course of rate *hikes* should also be low. Fed policy will remain on alert for rising inflation expectations, but an extended uptick in actual inflation would likely be required before expectations become ingrained at untenable levels.

So U.S. monetary policy should be accommodative this year. And global liquidity is on a major upswing thanks to the easing by central banks across the world. Financial conditions have improved: The yield curve has un-inverted, corporate credit spreads have narrowed, and the dollar has budged from decades-high levels. This backdrop should serve as ballast for economic activity, ushering in a modest rebound this year.

Age is just a number

Therefore, absent a major shock, the geriatric economic expansion should still have some breaths left. Recessions are not born out of thin air. They typically begin after the economy develops excesses — either excess demand that translates into accelerating inflation, or from imbalances in financial markets that manifest themselves in excessive valuations or leverage. The previous two recessions (2001, 2007-2009) stemmed from curtain number two — bursting asset bubbles. However, neither of these narratives holds true today.

For stock owners, this is not merely an academic issue. A deep and durable drop in stock prices requires a significant and long-lasting decline in earnings. These developments occur during recessions. In other words, recessions and bear markets go hand-in-hand.

Inflation dormant but not dead

How will the current business cycle end? The future path of inflation may well hold the key. At some point, easy monetary policy should revive broad-based price pressures, forcing central banks to adopt counter moves. As the saying goes, expansions are ultimately murdered by the Fed. The tight

labor market could prove the channel through which inflation flares up in the United States.

If actual inflation turns out *lower* than anticipated this year, central banks will maintain supportive policies into 2021 and perhaps beyond. But we must be careful what we wish for. Paradoxically, while this backdrop could lead to a further melt-up by stocks — and more cheer for investors — the seeds for a deeper bear market could be sown. Higher multiples for stocks (and other risk assets) would make them susceptible to a greater fall in price. Then a garden-variety recession morphs into the unwinding of an asset bubble. Deja vu all over again.

Resist the noise

However, today, at the dawn of a new decade, the greater threat to stocks seems to reside in political and geopolitical arenas. These forces would be the likely culprits for short circuiting the bull market in the near term.

Invariably, investors' resiliency will continue to be tested by noisy headlines and talking heads. But as this stubborn bull market has demonstrated time and again, it can be both dangerous and unprofitable to base major portfolio decisions on the news. Instead, the best defense against short-term gyrations is to adopt — and stick to — an appropriate long-term allocation plan. And if anything, take advantage of downswings to add high quality securities as they are hit.

— Christopher J. Singleton, CFA, Managing Director

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Our team at Kanawha Capital Management wishes you a healthy, happy, and prosperous New Year.

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