

The Bulls Continue To Bet On The Fed

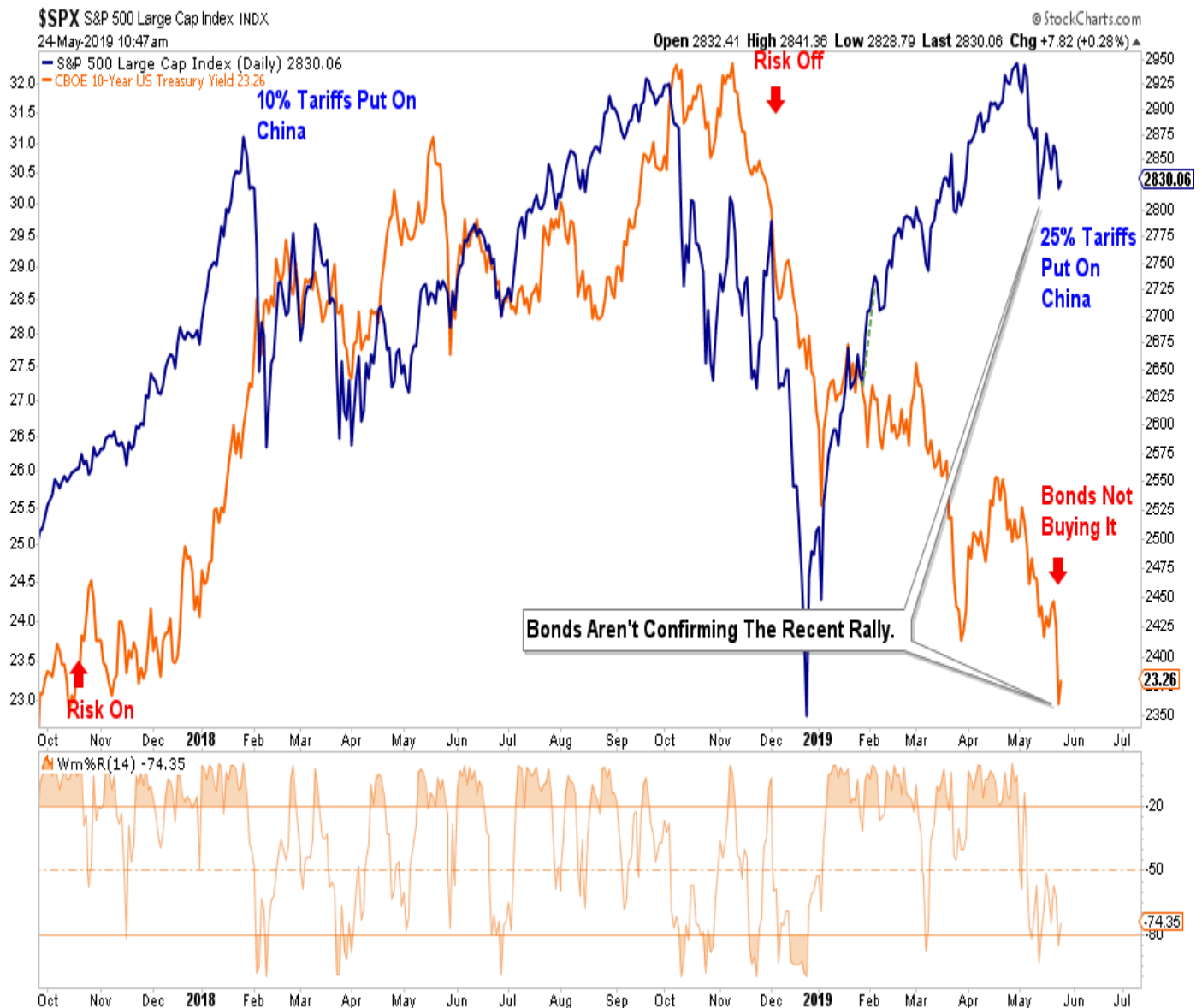


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Market Review & Update

Over the last several weeks, we have been discussing the potential for a market correction simply due to divergences in the technical indicators which suggested near-term market risk outweighed the reward. As is generally the case, bonds have been warning the bullish bias of equity investors was likely misplaced. I have updated [last week's chart](#) for reference.



The increase in risks has had us rotating exposure in our portfolios to a more defensive tilt. We previously trimmed back our overweight exposure to Technology, Then, **two weeks ago, we noted we further tweaked client portfolios by reducing exposure to "trade sensitive" areas by selling half of our holdings in Industrials, Materials, and Discretionary areas.**

Last week, we continued to process of the defensive rotation, reducing risk, and rebalancing allocations. *(We publish our model changes in real-time for our [RIA PRO subscribers](#). (Try NOW and get 30-days FREE))*

"As noted in our newsletter over the last couple of weeks, we are seeing the early signs of a defensive rotation in equities due to the resurgence of the trade war. Therefore, we are moving our allocations accordingly to participate with the

rotation.

We are adding to our real estate exposure, which is interest rate sensitive,• and we are overweighting our defensive holdings in utilities and staples.

After recently lengthening duration in our bond portfolios, we will look for a short-term reversal in rates, which will coincide with a counter-trend market bounce, to add further to our position in IEF."

Importantly, we still maintain a long-bias towards equity risk, but that exposure is hedged with cash and bonds which remain at elevated levels. ***(I published an investing resource for you last week: [10 Illustrated Truths About Investing & The Markets](#))***

Looking Forward

Currently, on a very short-term basis, the markets have worked off some of the overbought condition from last month and, importantly, has held support at the Oct-Nov 2018 highs. There is additional support at the 200-dma just below current support at 2775. These are key support levels for the S&P 500 as we head into the summer months and, if the bulls are going to maintain their stance, must hold.



The reason we maintain a more defensive posture is the triggering of the intermediate-term "sell signal" (yellow highlights above) suggest that prices will remain under pressure for a while longer. (Hence the rotation to defensive positioning.)

Let me reiterate four very crucial points **the markets have NOT factored in just yet:**

1. **There will be NO TRADE DEAL** any time soon. (China is buckling down for a long fight.)
2. **Earnings estimates are still far too high** going into the end of 2019 and 2020.
3. **The economy will weaken further as the latest rounds of tariffs**, which take effect June 1st, begin to impact the economy headed into the last half of 2019.
4. **The Fed is unlikely to lower rates**, or increase their balance sheet, prior to a recessionary start or a substantially deep correction in the market. (i.e. more than 20% from current levels)

For now, as stated, the market is working a corrective process which is likely not complete as of yet. **As we head into the summer months, it is likely the markets will experience a retracement of the rally during the first quarter of this year.** As shown in a chart we use for position management (*sizing, profit taking, sells*) the market has just issued a signal suggesting risk reduction is prudent. (This doesn't mean sell everything and go to cash.)

\$SPX S&P 500 Large Cap Index INDX
23-May-2019

© StockCharts.com

Open 2836.70 High 2836.70 Low 2805.49 Close 2822.24 Volume 2.2B Chg -34.03 (-1.19%)



Just one other thing, I don't like market comparisons because no two market cycles are alike. However, price patterns are important because they represent the "psychology of the herd."•The chart below shows the market in the months leading up to the Dot.com crash, the Financial Crisis, and where we are currently.•

S&P 500 Comparison 1998, 2005 & 2017 (Present)



Again, no two market cycles are the same. The drivers which facilitate the bull run, and the catalyst which ends it, are ALWAYS different.

It is just investor behavior which is always the same.

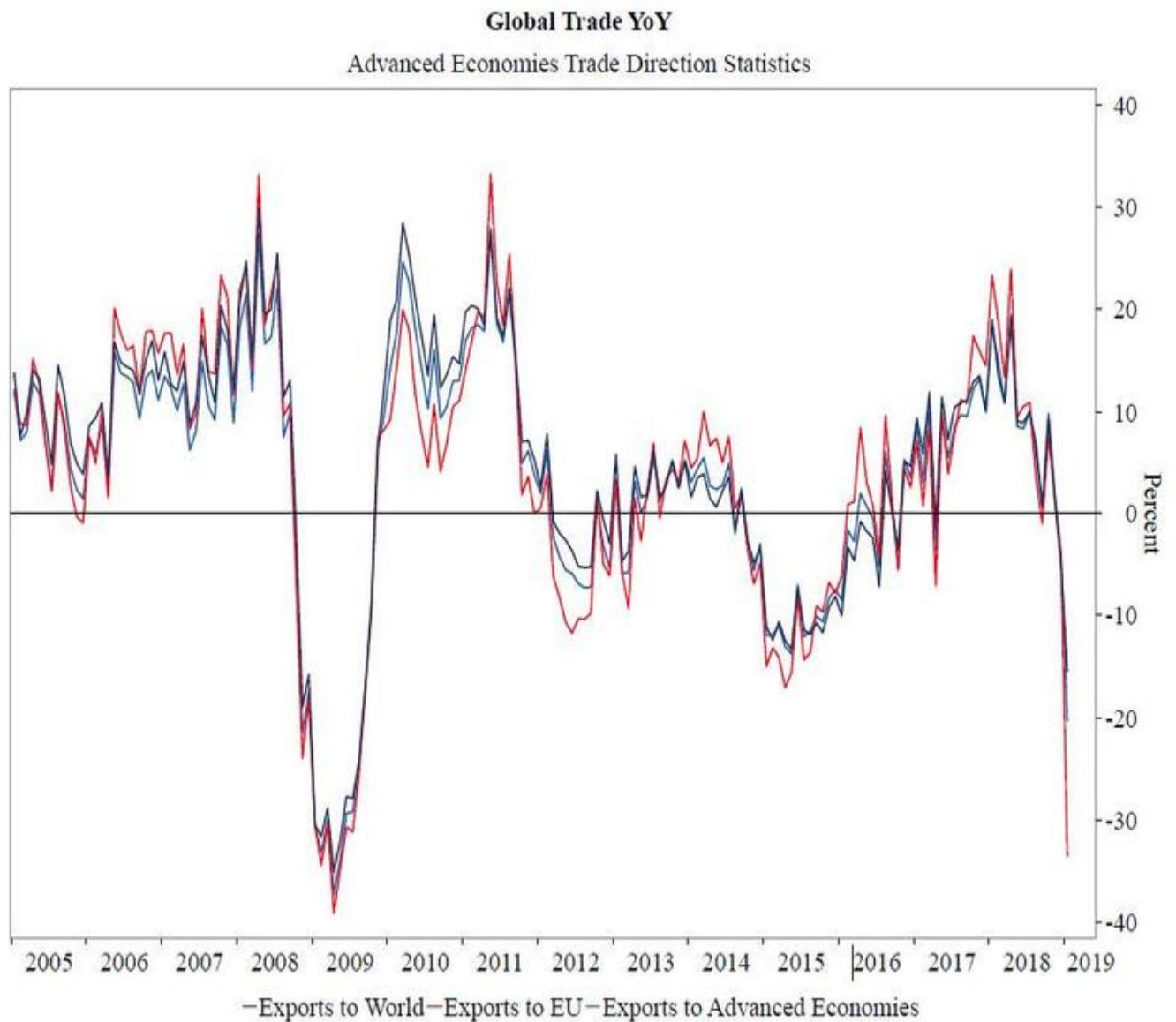
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The Bulls Continue To Bet On The Fed

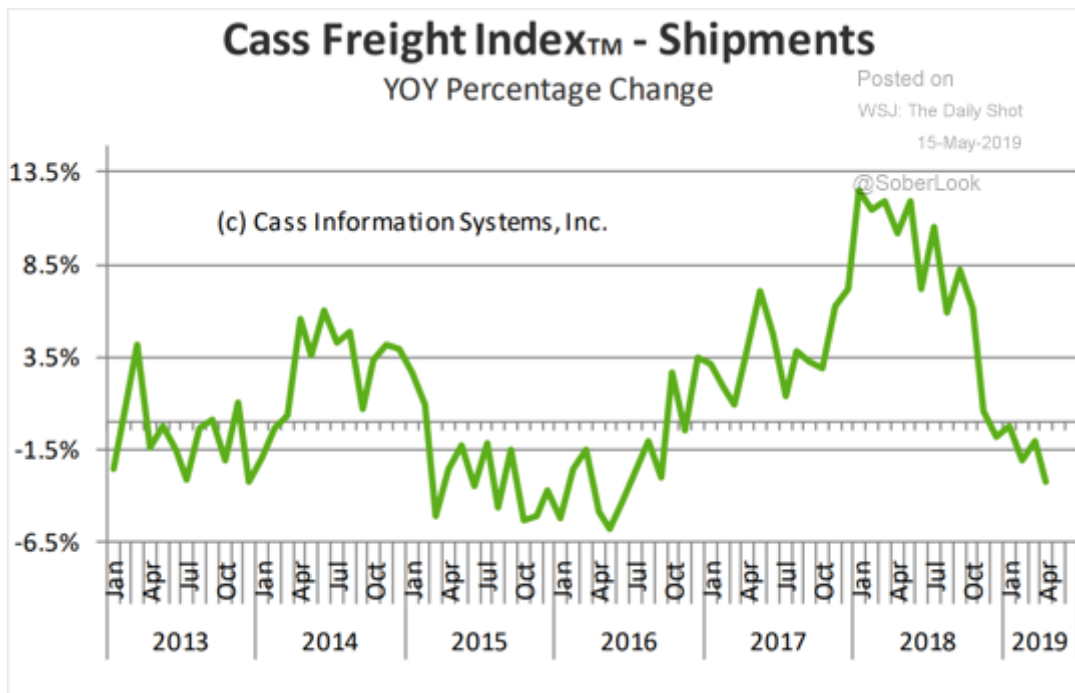
Last week, we noted that the earnings growth story is going to become increasingly difficult to ignore.

*"This is particularly the case given that just this past week economic data continues to show weakness. **As shown in the following chart, global economic trade has collapsed to levels not seen since prior to the financial crisis.**"*



Source: BMO CM & Macrobond

Of course, since almost 50% of corporate revenue and profits are generated from international activity, it is not surprising to see a problem emerging. But importantly, watch what is happening domestically as well. •



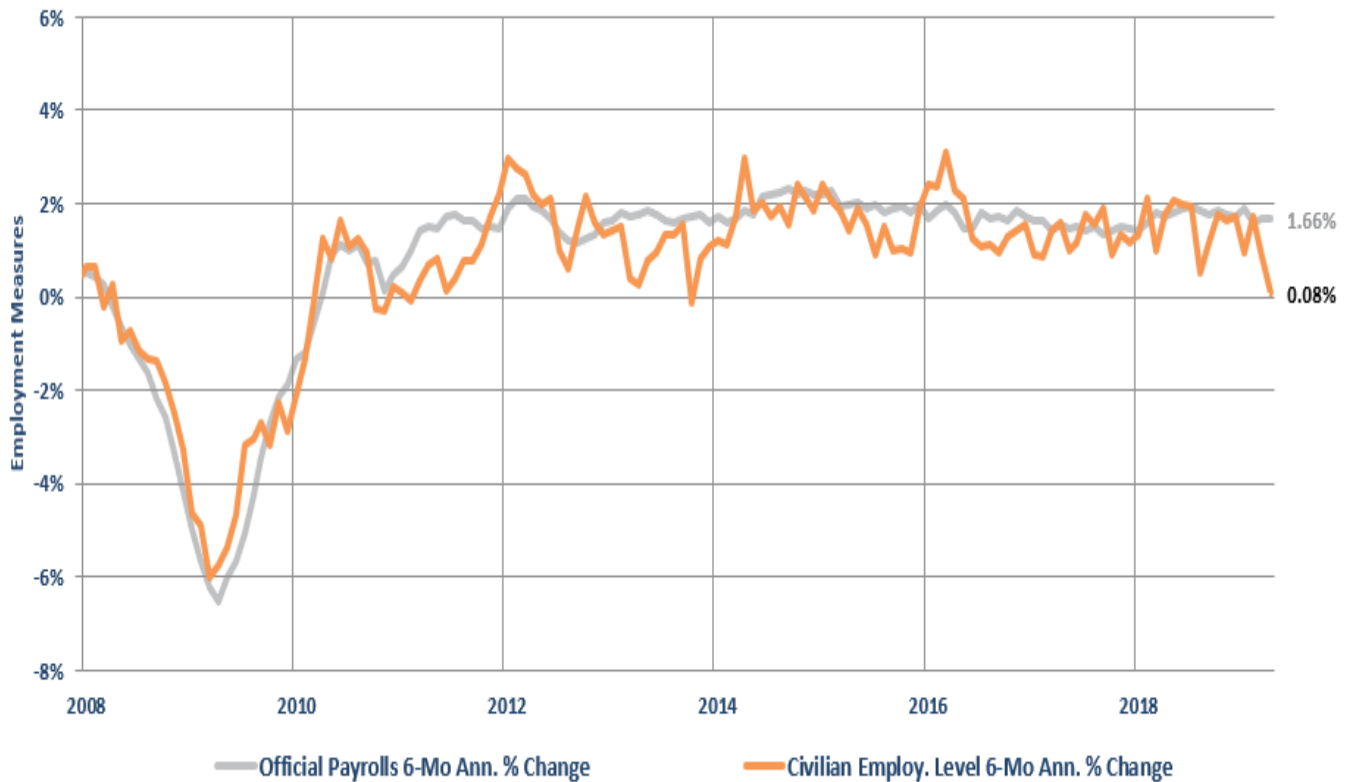
These are early signs of economic weakness.●

"But Lance, employment is still very strong. So what gives?"

The employment number from the BLS is adjusted, tweaked, and mathematically abused. As an indicator, it is one of the worst to watch and is subject to very large negative revisions in the future. Most importantly, the labor market is the LAST thing to turn in a cycle as employees are slow to hire and slow to fire. For a better understanding of employment look at the household survey. It is showing signs of weakening employment which supports [why companies are now laying off workers](#).

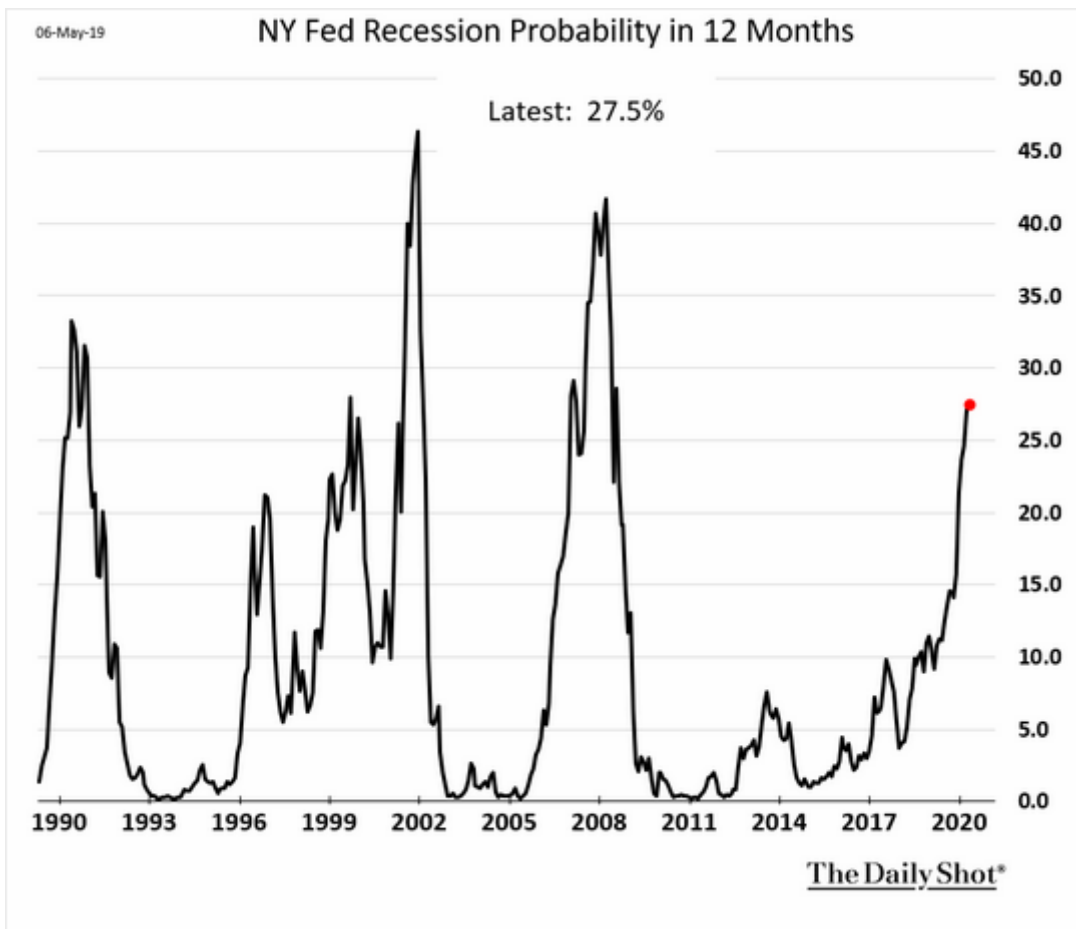
(Also, notice the rate of change in employment has, not surprisingly, run at roughly the rate of actual economic growth. Given that first quarter GDP was 1.8%, when adjusted for inventories and imports, it aligned with the 1.66% rate in employment. Employment is driven by actual economic strength.)

Employment Measures Comparison - 6 Mth. % Chg. Ann.



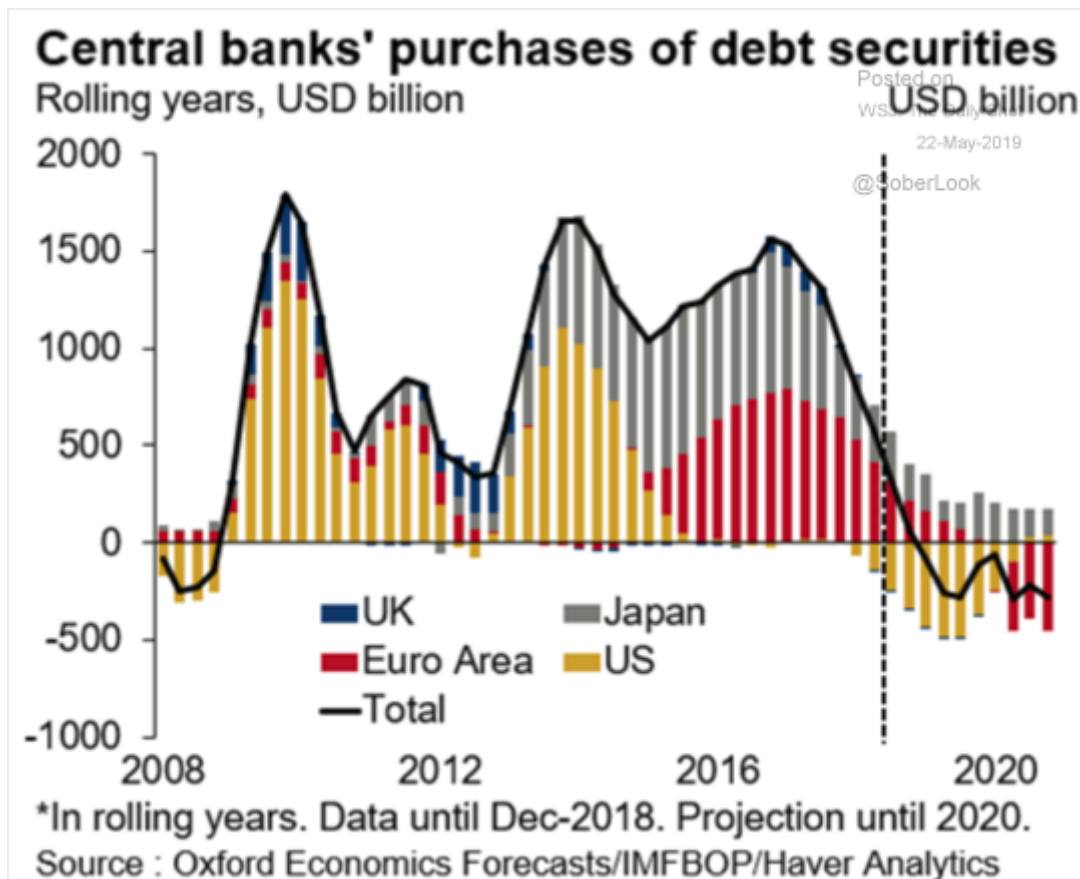
Importantly, the first time the household survey was sitting at 0% rate of change was right after QE1 ended, the economy started sliding and Ben Bernanke launched QE2. The second time was during the 2012 manufacturing recession. As the economy was sliding, Ben Bernanke launched QE3 which pulled forward consumption was again. In both previous cases, however, Fed funds were near zero, the Fed's balance sheet was growing, and recession risks were essentially nil. •

Today, recession risks are the highest seen since 2007.



(Important Note: The graph above is based on lagging economic indicators which are subject to huge negative revisions in the future. Therefore, high current risk levels should not be readily dismissed as the recession will have started before the data is revised to reveal the actual start date.)

But more importantly, the Fed is no longer expanding their balance sheet and the Fed Funds rate is near 2.5%. Also, it isn't just the Fed extracting liquidity, Central Banks globally are curtailing their "emergency measures."



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Still, the bulls continue to operate under the assumption the [Federal Reserve has eliminated the business cycle](#).•

?I don't see a world in which we have any form of meaningful contraction nor any form of meaningful expansion. We have completely taken away the toolkit of how normal economies should work when we started with QE.† mean, the odds that there's a recession anymore in any Western country of the world is almost next to impossible now, save a complete financial externality that we can't forecast.? - Chamrath Palihapitiya on [CNBC last week](#).

However, this is not likely the case as noted by Lakshman Achuthan of the Economic Cycle Research Institute (ECRI):

"A proposition has taken shape the Fed has eliminated business cycles through quantitative easing (QE) and unconventional monetary policy. As a result, we have credit cycles that can prolong economic expansion, in theory, forever."

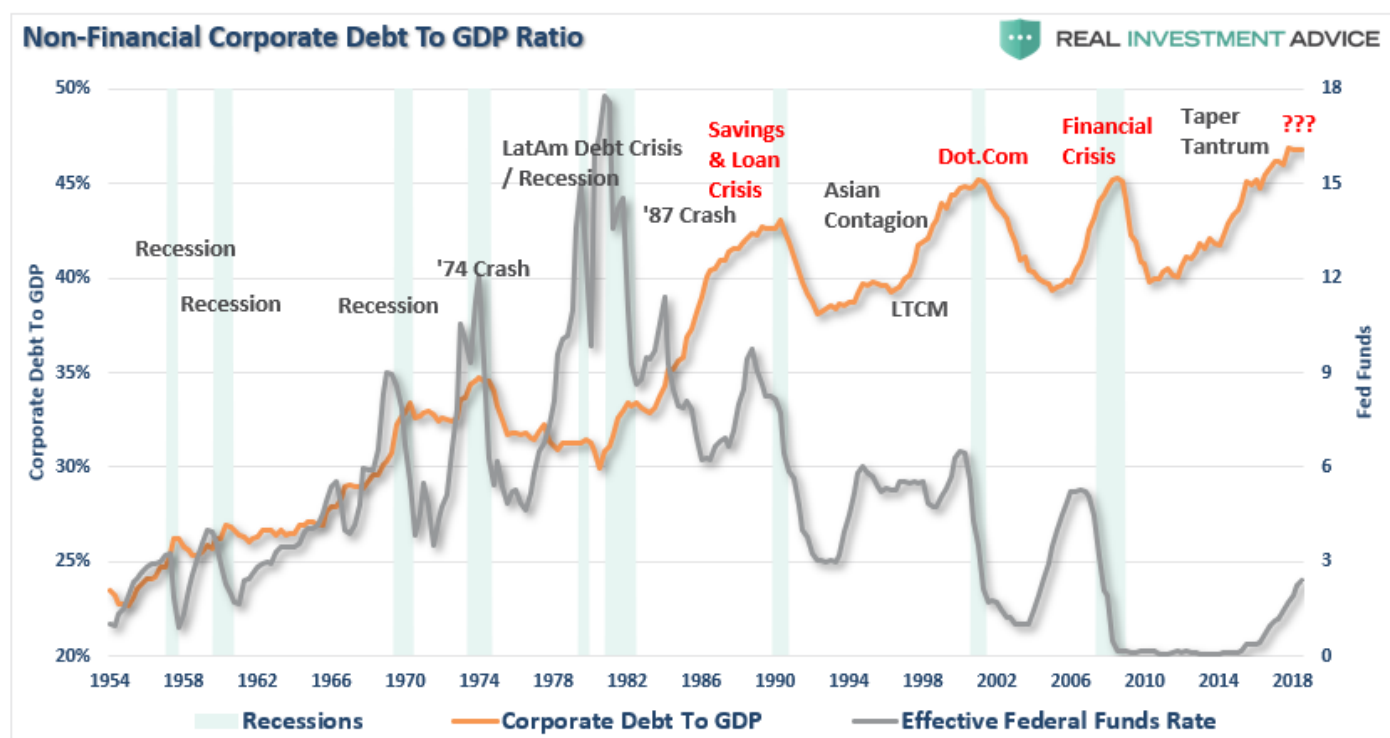
This all sounds so familiar.

"In the late 1990's, during the longest expansion in U.S. history, the idea of the end of the business cycle went practically mainstream, being written up in the Wall Street Journal and Foreign Affairs. Between globalization and the tech boom - which led to dramatic improvements in supply chain management, subduing inventory cycles - the argument went that we had arrived at the end of the business cycle." - ECRI

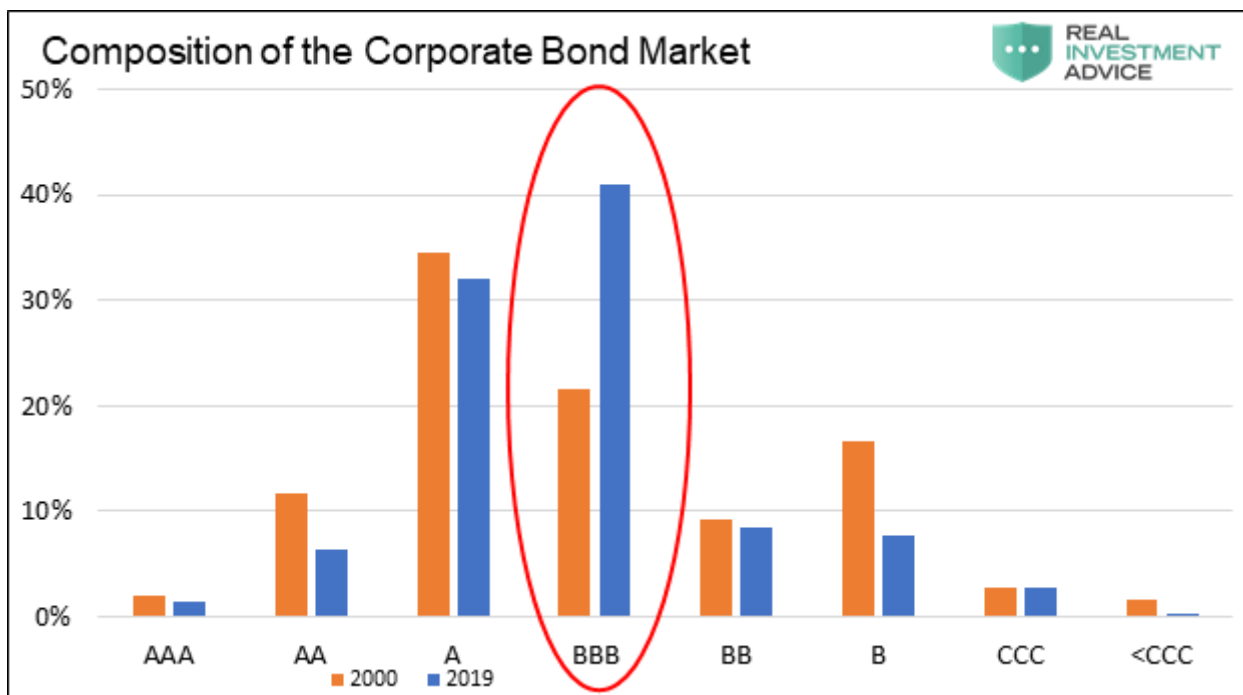
Of course, just a couple of short years later the business cycle returned with a vengeance.

But, here are once again with the latest iteration of why *"this time is different."* The current cycle, which certainly seems never ending, has been built upon on ultra-low interest rates and rising levels of debt. As we discussed last week, the Fed is now tacitly warning about the risks in [corporate debt](#).•

"Officials, for the second time in six months, cited potential risks tied to non-financial corporate borrowing, particularly leveraged loans? a \$1.1 trillion market that the Fed said grew by 20% last year amid declining credit standards. They also flagged possible concerns in elevated asset prices and historically high debt owned by U.S. businesses."

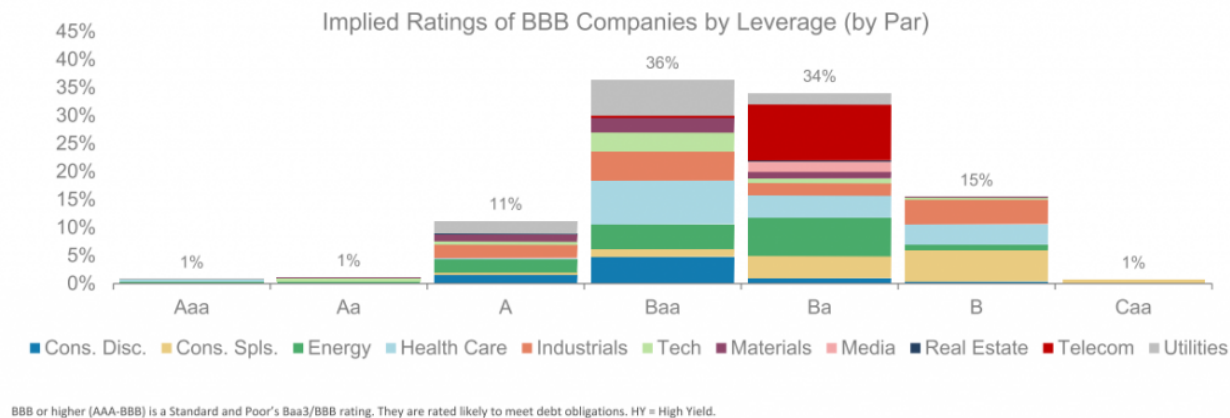


Notice that when the Fed starts hiking rates, historically, combined with corporate debt to GDP at peak levels, bad things have tended to occur...repeatedly. • Furthermore, the amount of corporate debt is stacked up at the bottom end of the *"investment grade"* scale. •



As [Michael Lebowitz](#) pointed out last week:

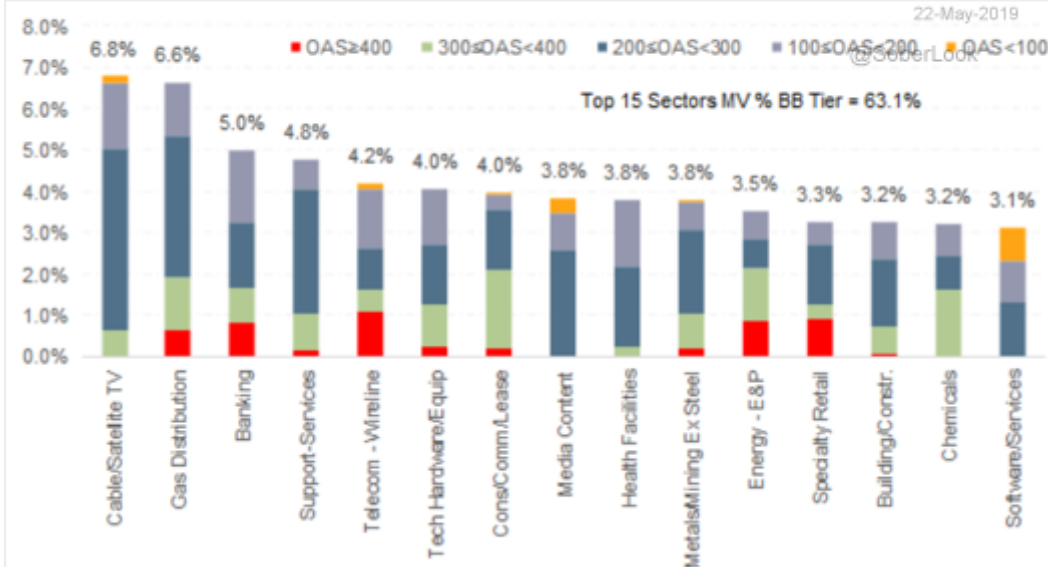
"Given that downgrades are a real and present danger and there is real potential for a massive imbalance between the number of buyers and sellers of junk debt, we need to consider how close we may be to such an event. To provide perspective, we present a graph courtesy of Jeff Gundlach of DoubleLine."



*"If 50% of BBB-rated bonds were to get downgraded, it would entail a shift of \$1.30 trillion bonds to junk status. **To put that into perspective, the entire junk market today is less than \$1.25 trillion, and the subprime mortgage market that caused so many problems in 2008 peaked at \$1.30 trillion.** Keep in mind, the subprime mortgage crisis and the ensuing financial crisis was sparked by investor concerns about defaults and resulting losses."*

Why worry? With just under 2/3rd of the BB (*junk rated*) bonds clustered in the top-15 industry groups what is the worst that could happen?

Top 15 BB Narrow Industries by OAS Band



Source: CreditSights, ICE BofAML Indices data through 5/17/2019

The problem comes if there is a recession. If that occurs, there will be a massive wave of downgrades of BBB to BB, or less, **which means that major pension, institutional, and mutual fund managers will be forced to liquidate their bonds.** Since such an event would most likely occur with the onset of a recession, the real risk comes when the junk bond market, which already has thin liquidity, simply becomes illiquid. •

It won't require much of an economic change to ignite the credit issue which currently exists. **Once the liquidation process begins, liquidity for companies will quickly evaporate leading to forced bankruptcies.** In turn, the stock market will decline as job losses mount and consumption falters. •

This is more commonly known as a "recession."

The ?R? Word

Despite hopes to the contrary, the U.S., and the globe, will experience another recession. The only question is the timing.

As I quoted in much more detail [in the newsletter a couple of weeks ago](#), Doug Kass laid out a decent list of the problems facing investors currently.

- ***Slowing Domestic Economic Growth***
- ***Slowing Non-U.S. Economic Growth***
- ***The Earnings Recession***
- ***The Last Two Times the Fed Ended Its Rate Hike Cycle, a Recession and Bear Market Followed***
- ***The Strengthening U.S. Dollar***
- ***Message of the Bond Market***
- ***Untenable Debt Levels***
- ***Credit Is Already Weakening***
- ***The Abundance of Uncertainties***
- ***Political Uncertainties and Policy Concerns***

- **Valuation**
- **Positioning Is to the Bullish Extreme**
- **Rising Bullish Sentiment (and The Bull Market in Complacency)**
- **Non-Conformation of Transports**

But herein lies the most important point about recessions, market reversions, and systemic problems.

What Chamrath Palihapitiya said above was both correct and naive.

He is naive to believe the Fed has *everything* under control and recessions are a relic of the past. **Central Banks globally have engaged in a monetary experiment hereto never before seen in history.** Therefore, the outcome of such an experiment is also indeterminable.

Secondly, when Central Banks launched their emergency measures, the global economies were emerging from a financial crisis not at the end of a decade long growth cycle. **The efficacy of their programs going forward is highly questionable.**

But what Chamrath does have right were his final words, even though he dismisses the probability of occurrence.

??save a complete financial externality that we can't forecast.?

Every financial crisis, market upheaval, major correction, recession, etc. all came from one thing **? an exogenous event that was not forecast or expected.**

This is why bear markets are always vicious, brutal, devastating, and fast. **It is the exogenous event, usually credit related, which sucks the liquidity out of the market causing prices to plunge.** As prices fall, investors begin to panic sell driving prices lower which forces more selling in the market until, ultimately, sellers are exhausted.

It is the same every time.

While investors insist the markets are currently NOT in a bubble, it would be wise to remember the same belief was held in 1999 and 2007. Throughout history, financial bubbles have only been recognized in hindsight when their existence becomes *apparently obvious?* to everyone. Of course, by that point it was far too late to be of any use to investors who have already suffered a significant destruction of invested capital.

This time will not be different. Only the catalyst, magnitude, and duration will be.

Believing the *"Fed has it all under control"* has historically been a bad bet.

If you need help, or have questions, we are always glad to help. [Just email me.](#)

See you next week.

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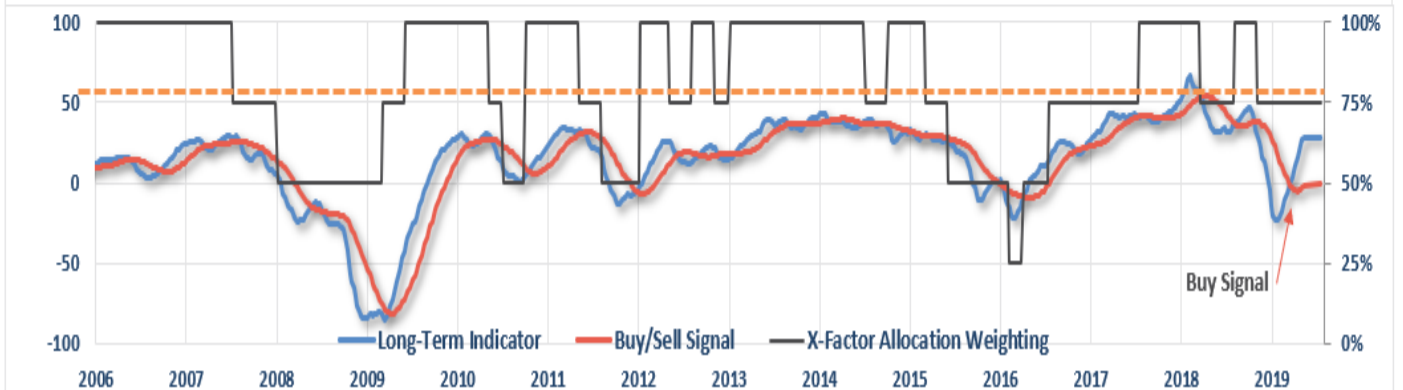
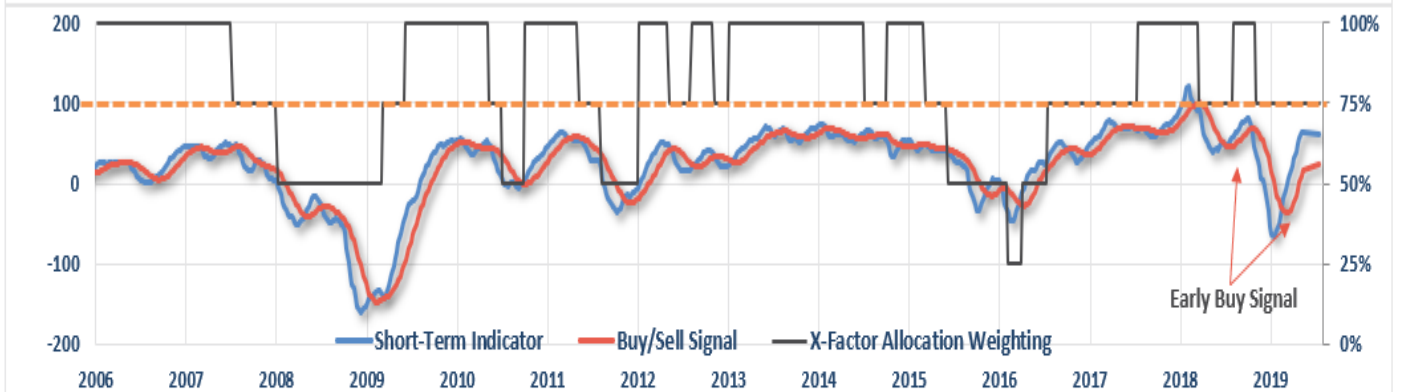
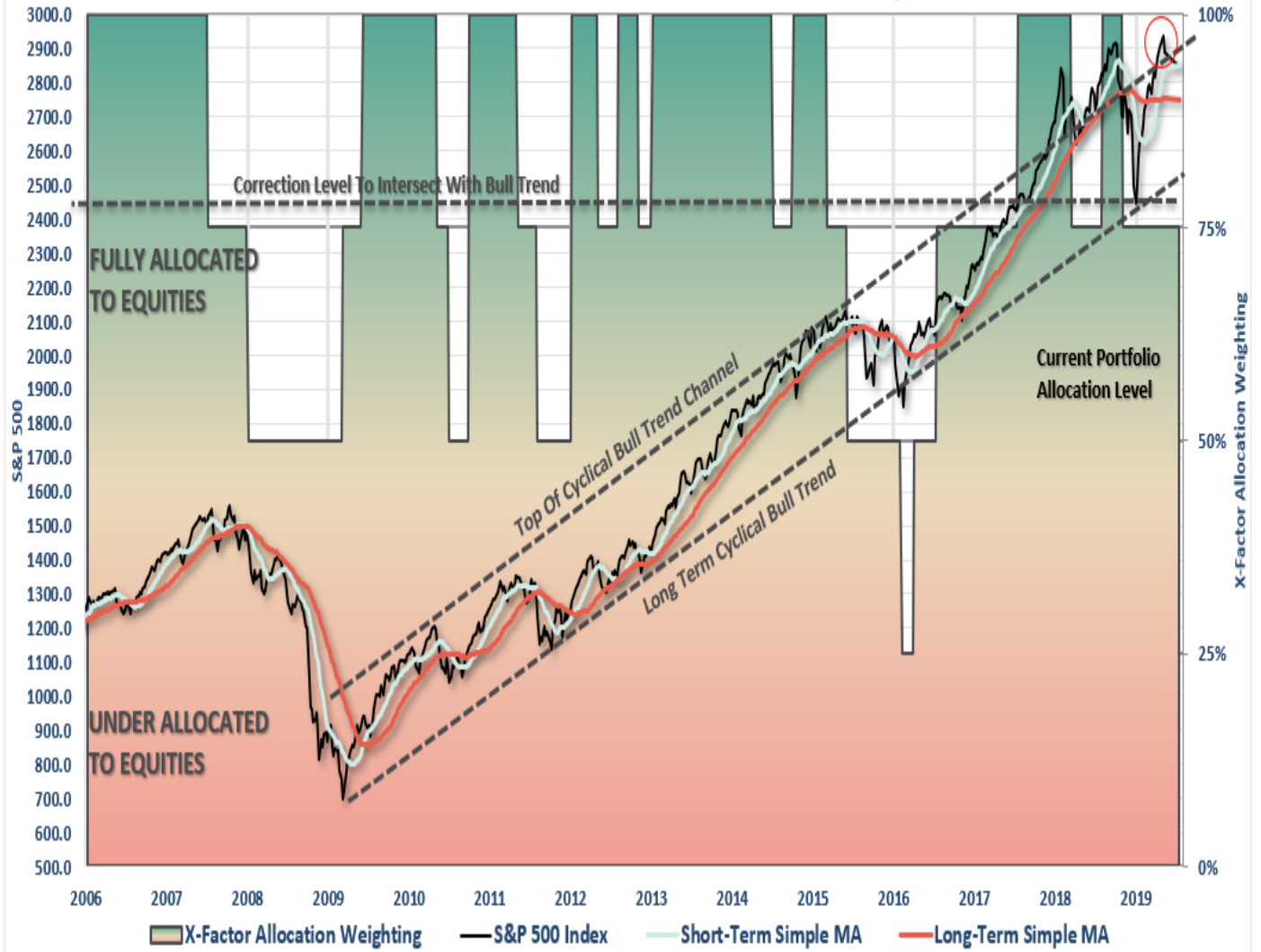
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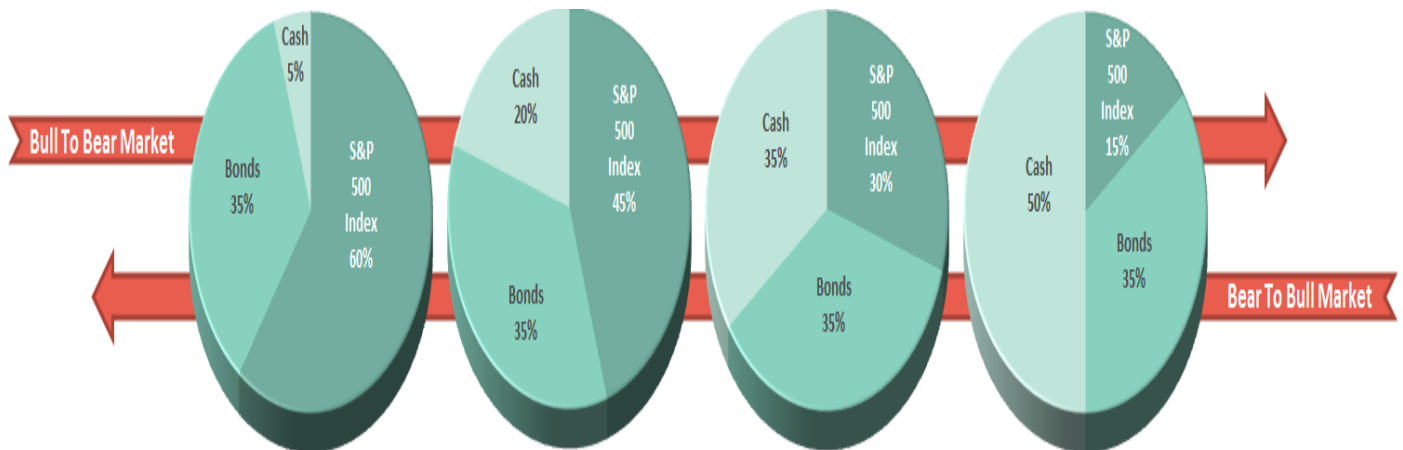
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Risk Management Analysis



There are 4-steps to allocation changes based on 25% reduction increments. As noted in the chart above a 100% allocation level is equal to 60% stocks. **I never advocate being 100% out of the market as it is far too difficult to reverse course when the market changes from a negative to a positive trend.** Emotions keep us from taking the correct action.



Being Patient...Again

As noted last week:

"The market tried to rally last week but failed to hold above the 50-dma which negated our plans to increase equity exposure. • Next week, it is critical for the markets to muster a rally or we are going to wind up retesting the 200-dma."

That rally failed to occur and while we didn't test the 200-dma, yet, we are bouncing along the tops of the Oct-Nov highs. • This support must hold or we are going to see a bigger correction this summer. ••

I would again encourage you to read the commentary above, the bulls, along with the media, are betting on things which have a very low probability of actually occurring. •

Remain patient again this week, and continue to follow rebalancing risk management measures for now. •

- If you are **overweight equities** - take some profits and reduce portfolio risk on the equity side of the allocation. However, hold the bulk of your positions for now. Having some extra cash is not problematic.
- If you are **underweight equities or at target** - remain where you are until the market gives us a better opportunity to increase exposure to target levels.

If you need help after reading the alert; don't hesitate to [contact me](#).

Exciting News - the 401k Plan Manager is "Going Live"

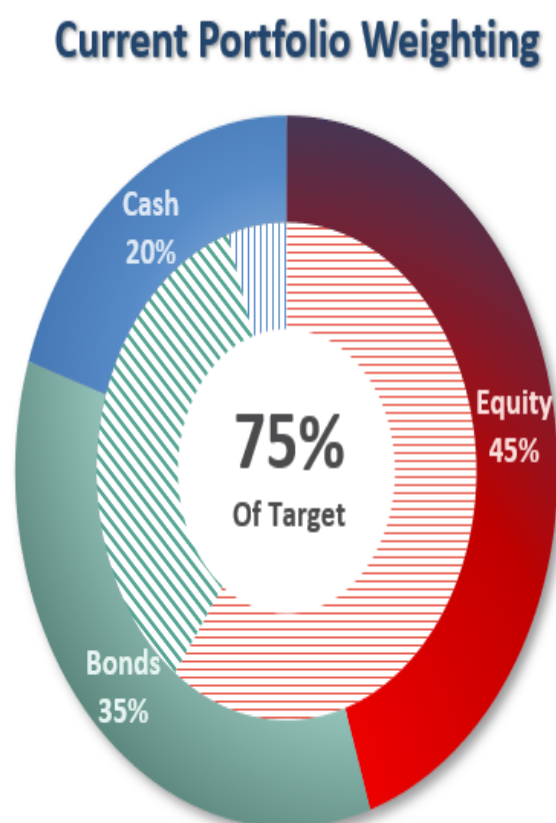
We are getting very close to rolling out a "LIVE" version of the 401-k allocation model which will soon be available to [RIA PRO subscribers](#). You will be able to compare your portfolio to our live model, see changes live, receive live alerts to model changes, and much more. •

This service will also be made available to companies for employees. If you would like to offer our service to your employees at a deeply discounted corporate rate [please contact me](#).

Stay tuned for more details over the next couple of weeks.

Current 401-k Allocation Model

The 401k plan allocation plan below follows the K.I.S.S. principle. By keeping the allocation extremely simplified it allows for better control of the allocation and a closer tracking to the benchmark objective over time. ***(If you want to make it more complicated you can, however, statistics show that simply adding more funds does not increase performance to any great degree.)***



Current 401k Allocation Model	
20.00%	Cash + All Future Contributions <i>Primary concern is the protection of investment capital</i> Examples: Stable Value, Money Market, Retirement Reserves
35.00%	Fixed Income (Bonds) <i>Bond Funds reflect the direction of interest rates</i> Examples: Short Duration, Total Return and Real Return Funds
45.00%	Equity (Stocks) <i>The vast majority of funds track an index.</i> <i>Therefore, select on ONE fund from each category.</i> <i>Keep it Simple.</i> 10% Equity Income, Balanced or Conservative Allocation 35% Large Cap Growth (S&P 500 Index) 0% International Large Cap Dividend 0% Mid Cap Growth

401k Choice Matching List

The list below shows sample 401k plan funds for each major category. In reality, the majority of funds all track their indices fairly closely. Therefore, if you don't see your exact fund listed, look for a fund that is similar in nature.

Common 401K Plan Holdings By Class

Cash	<i>Stable Value</i> <i>Money Market</i> <i>Retirement Savings Trust</i> <i>Fidelity MIP Fund</i> <i>G-Fund</i> <i>Short Term Bond</i>	Equity	
		Large Cap	<i>Vanguard Total Stock Market</i> <i>Vanguard S&P 500 Index</i> <i>Vanguard Capital Opportunities</i> <i>Vanguard PrimeCap</i> <i>Vanguard Growth Index</i> <i>Fidelity Magellan</i> <i>Fidelity Large Cap Growth</i> <i>Fidelity Blue Chip</i> <i>Fidelity Capital Appreciation</i> <i>Dodge & Cox Stock</i> <i>Hartford Capital Appreciation</i> <i>American Funds AMCAP</i> <i>American Funds Growth Fund Of America</i> <i>Oakmark Growth Fund</i> <i>C-Fund (Common Assets)</i> ALL TARGET DATE FUNDS 2020 or Later
Fixed Income	<i>Pimco Total Return</i> <i>Pimco Real Return</i> <i>Pimco Investment Grade Bond</i> <i>Vanguard Intermediate Bond</i> <i>Vanguard Total Bond Market</i> <i>Babson Bond Fund</i> <i>Lord Abbett Income</i> <i>Fidelity Corporate Bond</i> <i>Western Asset Mortgage Backed Bond</i> <i>Blackrock Total Return</i> <i>Blackrock Intermediate Bond</i> <i>American Funds Bond Fund Of America</i> <i>Dodge & Cox Income Fund</i> <i>Doubleline Total Return</i> <i>F-Fund</i>	Balanced Funds	<i>Vanguard Balanced Index</i> <i>Vanguard Wellington Fund</i> <i>Vanguard Windsor Fund</i> <i>Vanguard Asset Allocation</i> <i>Fidelity Balanced Fund</i> <i>Fidelity Equity Income</i> <i>Fidelity Growth & Income</i> <i>American Funds Balanced</i> <i>American Funds Income Fund</i> ALL TARGET DATE FUNDS 2020 or Sooner
International	<i>American Funds Capital World G&I</i> <i>Vanguard Total International Index</i> <i>Blackrock Global Allocation Fund</i> <i>Fidelity International Growth Fund</i> <i>Dodge & Cox International</i> <i>Invesco International Core Equity</i> <i>Goldman Sachs International Growth Opp.</i>	Small/Mid Cap	<i>Vanguard Mid Cap Growth</i> <i>Fidelity Mid Cap Growth</i> <i>Artisan Mid Cap</i> <i>Goldman Sachs Growth Opportunities</i> <i>Harbor Mid Cap Growth</i> <i>Goldman Sachs Small/Mid Cap Opp.</i> <i>Fidelity Low Price Stock Fund</i> <i>Columbia Acorn US</i> <i>Federated Kaufman Small Cap</i> <i>Invesco Small Cap</i>

The above represents a selection of some of the most common funds found in 401k plans. **If you do not see your SPECIFIC fund listed simply choose one that closely resembles the examples herein.** All funds perform relatively similarly within their respective fund classes.