

# JRM Investment Counsel

An Independent Investment Advisor Firm

## Market Commentary First Quarter, 2019

Fear of missing out (FOMO) and fear of loss (FOL) can wreak havoc with investor's portfolios. When stock prices are rising and investors are holding more cash than needed, there is a strong urge to increase risk and buy more stocks (FOMO). Likewise, when stock prices are falling, there is a strong urge to sell stocks (FOL) or get out of the market completely and "go to cash", stop the losses and wait for a better time to invest. Succumbing to these twin fears is one of the primary reasons most investor's actual returns are a fraction of their potential. It is the exact opposite of how rational investors should behave.

When emotions drive investment decisions, rather than rational security analysis, asset allocation and portfolio construction, investors tend to buy high and sell low. Worse yet is when investors "go to cash". They must time the market correctly when they sell, must time the market correctly when they decide to buy, and must overcome the fear of loss to subsequently invest again.

Let's review a chart of the S&P 500 for the period January 1, 2018 through March 31, 2019. The price changes reflect the emotional swings many investors experienced, except market declines generally have twice the emotional effect as market increases.



The S&P 500 peaked at the end of the third quarter, declined 20% before bottoming late December, and since then has moved almost straight up. Short term price changes are usually more about emotional than fundamental reasons, are impossible to predict and often difficult to comprehend. This is true when markets go up and down. We do not know anyone who has been able to time the market consistently.

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We suspect FOL caused many investors to sell securities near the bottom in December and FOMO caused many of these same investors to buy at higher prices this year. Short term volatility may be important for day traders, but has little significance for long term investors.

For comparison purposes, below is a chart of the S&P 500 for the last ten years using quarter end values.



When you change your time horizon from short term to long term and disregard the daily headline news, there is not much to fear. The first rule of compounding is never interrupt it unnecessarily. Time in the market is a better strategy than attempting to time the market.

## **The Economy**

At the beginning of the year, there was much for investors to fret about. The previous month was the worst December for the S&P 500 since 1931, the federal government was partially shutdown, and trade issues and escalating retaliatory tariffs with our major trading partners were threatening the global economy. The Republicans lost its majority in the House of Representatives, the annual federal deficit was projected to exceed \$1 trillion and the Mueller investigation was grinding on with numerous high level indictments, guilty pleas and convictions.

The economic expansion, now in its tenth year, is gradually decelerating. Real GDP growth was 4.2% during the second quarter, 3.4% during the third quarter, and 2.2% during the fourth quarter last year, respectively. First quarter 2019 growth forecast is to slow further to around 1-2%. Outside the U.S., a similar slowdown is occurring.

Our views on the economy have not changed during the last three months. Economic growth will be sluggish, inflation subdued, and monetary policy supportive of the economy and asset prices. Interest rates will remain low and the domestic economy will be resilient in spite of all of the issues and challenges investors fret about. We know a recession will occur eventually, because that is how economic cycles work. Although the odds of a recession increase with the

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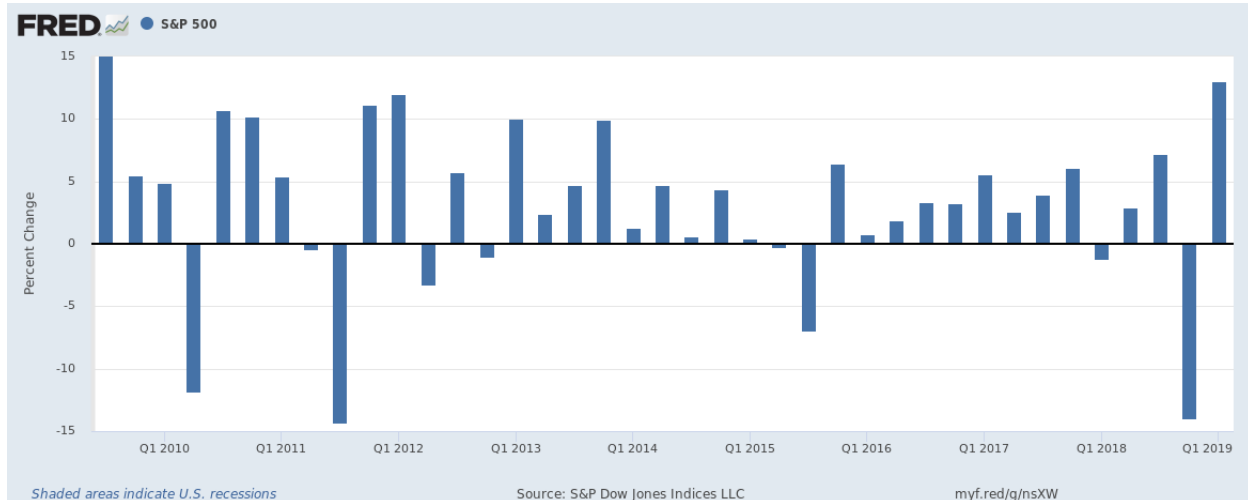
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length of the expansion cycle, it is not calendar driven. Our most likely scenario is the economy plods along at a slow pace this year, barring a significant unforeseen catalyst that tips the economy into a recession.

Investors may have been fretting about a lot of issues, but the markets did not seem to care much about them, as every major asset category produced positive returns during the quarter.

## **Equity Markets**

The S&P 500 increased by 13.6% during the quarter, its best first quarter since 1998. The chart below is the quarterly change in the S&P 500 for the last ten years. When the equity markets start the year this strong, historically there have been additional gains during the balance of the year.



It was not just the S&P 500 that performed well during the quarter, domestic small cap stocks returned 14.6% and international developed and emerging market stocks each returned 10.0%. Domestic equity valuations are close to their long term averages, while foreign equity valuations remain considerably below domestic stocks and their long term averages. We continue to believe it is important to maintain a meaningful allocation to foreign markets.

## **Fixed Income, Yield Curve and Recession**

There is a lot of noise in the financial news about the recent yield curve inversion and how it may be indicating an impending recession. We disagree.

Following its March meeting, the Federal Reserve Open Market Committee (FOMC) abruptly shifted its monetary policy forecast from increasing short term interest rates twice (0.25% each time) this year to no additional interest rate increases in 2019. Shortly after the announcement, the yield curve “inverted” with some shorter term yields higher than longer term as noted below.

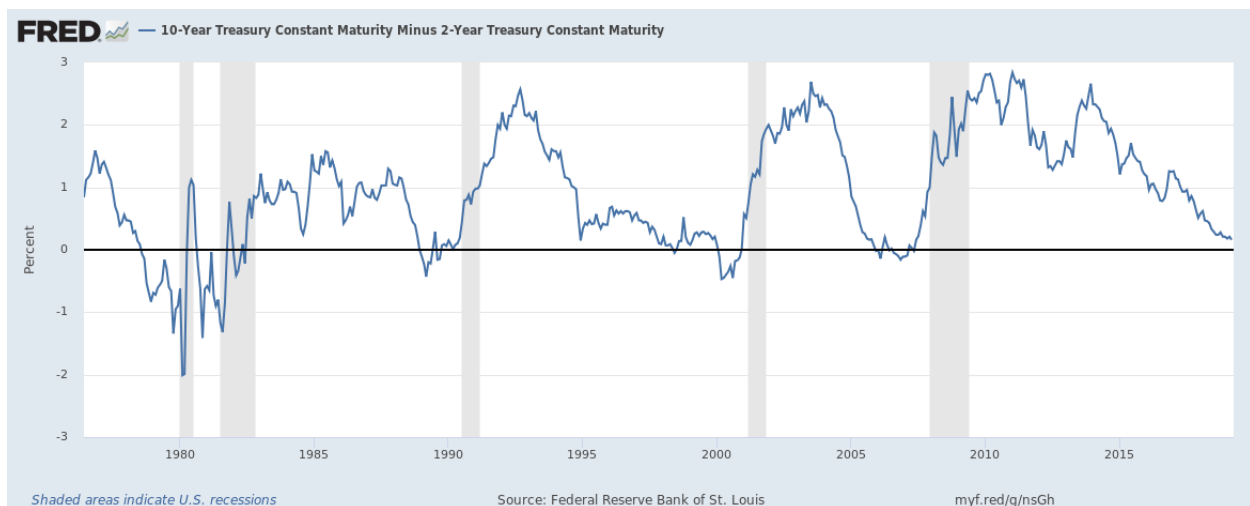
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Yields on bonds with longer term maturities are generally higher than shorter term bonds with the same credit quality because investors expect a higher return for committing their money for a longer time period. When short term interest rates are higher than long term, it is referred to as an inverted yield curve. Inverted yield curves are a good predictor of slower economic growth and lower inflation, and have preceded each of the last nine recessions. However, there have been times when the yield curve inverted without a recession following immediately.

The inversion in the shorter maturities circled in the graph above reflects market sentiment that the FOMC's next change to interest rates will be a cut in its short term target. According to Bloomberg data, the probability of a FOMC interest rate cut in 2019 increased from 0% following its December meeting to 76% following the March meeting.

A better indicator of recession risk is when the 10 year yields are lower than 2 year yields, which is not the case today. The chart below shows the difference between 10 year and 2 year treasury yields during the last forty years, with recessions indicated by the shaded areas. The yield difference is small, still positive (not inverted), and is more likely a reflection of slowing economic growth and low inflation rather than indicating an imminent recession.



It is important to remember that slowing economic growth is not the same as a recession. The FOMC appears determined to use monetary policy to stimulate the economy and avoid a recession. However, there are limits to monetary policy, and only time will tell how effective it will be.

Fixed income performance for the quarter was strong due to the decline in interest rates. The Bloomberg Barclays U.S. Aggregate index and the Bloomberg Barclays Municipal 1-10 year Blend index returns were 2.9% and 2.2%, respectively, during the first quarter.

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## **Alternative Assets and Preferred Stocks**

Finally, returns from alternative assets and preferred stocks were strong during the first quarter. The Alerian MLP, S&P US REIT and S&P Preferred Stock indices returned 16.8%, 15.8%, and 8.0%, respectively. These asset categories provide important diversification benefits to our multiple asset class portfolios.

We are maintaining a slightly more defensive posture with asset allocation, security selection, and portfolio diversification based on current market conditions, valuations, and expected returns. As we have stated previously, our view is returns from all asset categories will be modest during the next few years. We are committed to an objective goals oriented process and know that investment portfolios will compound long term.

Thanks again for your trust and confidence. Should you have any questions or would like to discuss your financial goals and investment portfolio please let us know.

## **Exciting News to Share**

Phil, his lovely wife Katie and big sister Layla welcomed Jackson Patrick McDonnell to the world this week. Baby, Mom and Dad are all doing very well and our families are thrilled. Phil will be out of the office on paternity leave until May 6. Should you need assistance or have any questions during his absence, please contact Lauren or Jack.

Respectfully,

The JRM Investment Counsel Team

*Jack, Phil and Lauren*

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