# Market Commentary

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## State of Confusion

Financial markets don't know if they are coming or going, telegraphing that investors are in a state of confusion. The U.S. stock market is tapping out historic highs, but as we write this, the reality is that the S&P 500 is a scant 2% higher than levels established 9 months ago. Along the way to that meager gain, buy and hold investors endured an agonizing and unrelenting free-fall at the end of 2018 and a sharp 7% loss in value in May.

The uneasy gains should surprise no one. Second quarter earnings are pouring in and results are lower than last year. Rather than earnings, though, stock buyers look to be following monetary policy, hyperventilating over every Fed meeting and Fed governor speech. So yes, the stock market is mostly up, but not with assurance and not with conviction.

At the same time, the bond market is puzzled. A "normal" yield curve translates into one where longer dated Treasury bonds carry a higher yield than shorter maturities. Think about it: if you planned to lend money to your brother (or anyone, for that matter) for the next 3 months, the rate charged would be lower than if that money is lent for 10 years. In fact, the 3 month Treasury bill has remained stubbornly higher than the 10-year Treasury bond for the past two months. Historically, this abnormal behavior has foreshadowed looming recession with alarming accuracy.

As discussed above, the yield curve is "inverted" and this comes against a backdrop of an accommodative Federal Reserve. History shows that an inverted yield curve occurs in front of recessions, but other current economic indicators imply that the yield curve could

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be sounding a false alarm. For instance:

- Leading economic indicators fall year-over-year before a recession, but are still rising.
- The unemployment rate crosses above its 12-month moving average in front of a recession, but it is still below.
- Housing starts and consumer confidence also peak ahead of recession and although below their record highs, these economic metrics are still quite high by any standard.

There is nothing normal about a 3-month yield above 2% and a 10-year yield below 2%. There is also nothing fun about stocks that have taken investors on stomach churning drops for a 2% gain in 9 months. Confusion breeds volatility and investors will likely break out in a sweat all year.  One antidote is to cut off left tail risk. In plain English: a process for minimizing losses is key to any successful investment process.

In this environment, as anytime, weighing upside reward against risk remains a keystone for a successful investment experience. Our quantitative rules-based process is pointing us towards emerging markets debt (EMD). The trend in EMD is to the upside, based on our systems. At the same time, the risks are lower than other asset classes. Over the past year, for example, emerging markets bonds have seen at worst a low-single digit drawdown with emerging markets stocks at three times that level. Regardless, our process incorporates defense against losses by assigning a quantitatively derived sell level to every holding.

Confused markets mean volatility, and volatility means risk. A rules-based sell strategy can help cut off left tail risk, defending gains, and a goals-driven process can orient an investment portfolio despite the confusion.

## Definitions

The Standard & Poor's 500 Index (S&P 500) is a market-capitalization-weighted-index of the 500 largest U.S. publicly traded companies. It is widely regarded as the best gauge of large-cap U.S. equities.

A drawdown is a peak-to-trough decline in a specific period for an investment, trading account, or fund. A drawdown is usually quoted as the percentage between the peak and the subsequent trough.

Investors cannot directly invest in an index and unmanaged index returns do not reflect any fees, expenses or sales charges.

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