Mid-Year Musings: 2019

July is the season when economists and investment advisors reflect upon the first half of the year and give ink to their thoughts about the year to come. These are some of my mid-year musings, which will guide portfolios, investment decisions, and conversations over the coming months.

Overall, it's been a year in which the economy has experienced moderately good performance, despite a few challenges stemming from Washington D.C. and from our social media accounts. This is truly a testament to the strength of the U.S. economy at this point in time. Please feel free to open a conversation about any of these topics.

The stock markets have been very active over the past 6 months. It seems like everyone is talking about how great performance has been at different points in the year. I recently read an article touting that the S&P 500 experienced the best return since 1987. Now that we're past mid-year, we have some of the necessary information to begin to evaluate the state of the markets in the year 2019. Before we journey into some specific discussion of 2019 and the economic factors that have affected returns, two more general concepts are particularly relevant.

Period returns

Understanding how the financial industry deals with returns is critical to looking at our portfolio statements and making good investment decisions. A *period return* is exactly what it sounds like, the change in value (as a percent) over a specified period of time—a day, a month, a year. You see this concept all the time when you look at investment reports and read the listing of your month-to-date, quarter-to-date, year-to-date, and 1 year returns. These numbers are important indicators to us as investment advisors and to you as an investor reading your statements. At the same time, the numbers are often misleading because it all depends on the moment you start and end.

If you take a look at the headline like the one I referenced above, the math is correct, but is essentially irrelevant data. Sure, the S&P 500 started the year at $2476.98 and closed out the month of June at $2941.76. That's a return of 18.8% over just 6 months! But the S&P 500 had just dropped at the end of 2018 and started to bounce back on December 26th. So from September 21st, 2018 the S&P 500 fell all the way to $2346.58 from it's previous high of $2929.67. So if we adjust our period, The S&P 500's 18.8% return becomes 0.41%. That's an astronomical difference!

The impact of using period returns in a calculation is a thing for textbooks, but it has practical implications to each of us because the effect can take many years to even out, and still then, can have some

impact. Looking at this year, the smaller of the two numbers is probably a more useful number to ponder as the 18% return is only the recovery from a corresponding decline. In portfolios used by CoCreate clients, the ultimate goal is to minimize the loss, which will result a less dramatic recovery.

The "Benchmark"

Comparing the returns of your portfolio to a "benchmark" came about in the 1960 as Modern Portfolio Theory (MPT) graduated infancy.

Today, the efficacy of a portfolio is often judged by the way it's return compares to that of the S&P 500, or some other index. One of the many difficulties with the practice is simply that the index looks nothing like your portfolio (unless you're intentionally mimicking the index).[1] The S&P 500, along with most of the indices used, is a representation of the value of the 500 largest publicly traded US companies. They are weighted by the size of the companies, so the largest company's performance has a HUGE impact overall, while the smallest has almost no effect. To give you an idea, Microsoft, Apple, and Amazon make up more than 10% of the S&P while the smallest three companies, Coty Inc, Macerich Company, & News Corporation, are about 0.034%.

Modern Portfolio Theory suggests that the most important thing is the risk/return of a portfolio, which we have interpreted to mean that we can (and should) compare any two things that have a close correlation in the timing of their price changes. A well-constructed portfolio will much more effectively mute the risk of a stock or two, so when Microsoft, Apple, and Amazon cause the S&P 500 to go up and down rapidly, **you should not experience the same thing**. In reality, selection of individual investments has become more important than ever for the purpose of mitigating risks in a portfolio.

Portion of S&P 500 Returns Attributable to Microsoft, Apple, Amazon, Facebook and Google, since Facebook's IPO ("Fab 5")

	S&P 500 Return	Fab 5 Contrib.	*% S&P Return From Fab 5*
2014	13.7%	1.7%	*12%*
2015	1.4%	2.2%	*162%*
2016	12.0%	1.0%	*9%*
2017	21.8%	5.2%	*24%*
2018	(4.4%)	0.5%	*n/a*
1H '19	18.5%	3.6%	*19%*

Source: Horizon Kinetics, LLC

[1] A note to the professional: When you took your licensure exams, or sat through your CFP™ education programs, you learned that a high correlation coefficient meant that that the index and portfolio *are* similar and can be effectively compared. This is only true if the ONLY relevant metric is standard deviation of a portfolio. The challenge, in practice, is that this doesn't take into account the quality of the underlying investments and attribution of returns thereto. Contrary to the academic theory, which works perfectly in a set of imaginary, standardized conditions, the underlying assets determine similarity and not the "r^2". I know this flies in the face of almost all contemporary portfolio construction; however, an ever-increasing number of asset managers are evaluating the mountains of evidence that speak against the practical efficacy of Modern Portfolio Theory and beginning to realize the industry missteps in its unrestrained reliance on the work of Markowitz and Sharpe. At the end of the day you can't paint an apple to compare it to an orange—it's the right color (r^2) but it still looks like an apple, tastes like an apple, and you can't peel it and break it into perfect wedges like an orange.

Accordingly, it stands to reason that that an index is a poor benchmark. Fortunately, more and more financial professionals are remembering that each person's individual goals should define their own benchmarks.

2019: An extended expansion.

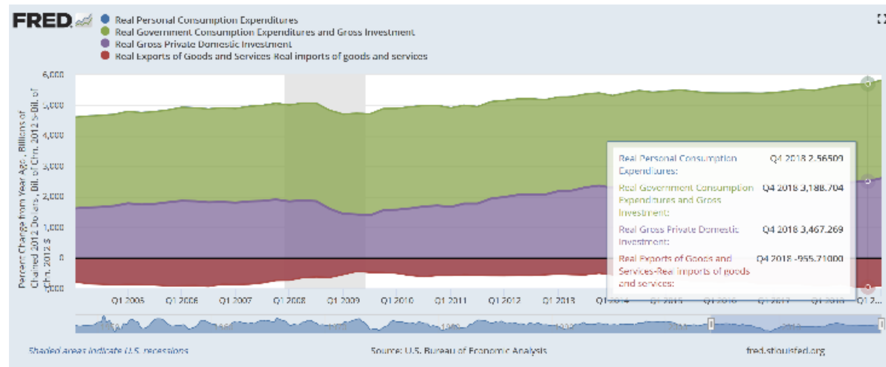
This July, we find ourselves in the midst of the longest expansion in US history, beginning in 2009. Since the beginning of July, a number of people on the news have expressed concern that the end is near. Regardless of present conditions, the timing is ripe for asking the question, "If good times won't last forever, when do we start to brace ourselves for the bad?"

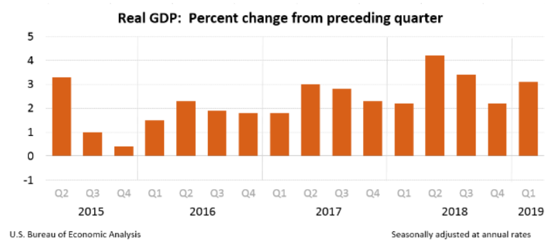
To preface an actual analysis, it is wise to identify some general principles that must guide our thinking.

- *Economic growth isn't timebound.* Neither is decline. The amount of time for which expansion or contraction lasts is a historical metric we can look at, but it is unique to a specific set of circumstances. Though full of its mysteries, Economy never looks at its watch to be on time for the next appointment.

  Some would site that the duration of past expansions has correlated to a number of economic data-sets pertaining to economic growth. Essentially, the shortest expansions have seen the fastest growth, while the longest ones have experienced slower growth. First, correlation is rarely synonymous with causality, and second, there simply isn't enough of a sample to yield statistically valid results to draw conclusions from this correlation, however strong.
- *Multiple business cycles and market cycles take place in during a singular expansion.* This type of activity has certainly taken place over the past decade. Smaller up and down movement can help to prevent bubbles in the market and economy. This means that it is possible to see some recessionary effects, or declining growth in different areas of the economy or in the market and not a major shift in the current expansionary environment.
- *Economic contraction happens when there is significant imbalance.* Imbalance is what we need to be watching for. The easiest and most broad example is when demand exceeds supply to the extent that the consumer is priced out of purchasing and then takes out too much debt to service, a significant imbalance occurs. In this situation, we would be likely to see recessionary effects until economic balance is restored.

So far in 2019, growth has been slower than it could be, but has been riding the tailwinds of a more business-friendly regulatory environment, and the stimulus provided in the Tax Cuts and Job's Act. Real GDP came in at a 3.1% growth rate (annualized) in the first quarter, and it seems likely that the calendar year will finish around 3% growth. This is relatively consistent with GDP growth acceleration in the current expansion. The chart to the right shows the growth of GDP (in categories) over the last 20 years. It's interesting that Government Spending (in green) has grown in lock step with Personal Consumption (blue, but hidden by the green line). In a time of expansion, we would ideally hope to see Government Spending shrinking relative to the rest of GDP. Never-the-less, GDP has continued to grow consistently.





Expect headlines to cover changes to quarterly GDP as they happen throughout the year. These numbers can vary significantly from quarter to quarter. The Second Quarter should come in at around 2%, a number that shouldn't cause too much alarm. The Economy is quite healthy, and as far as the Federal Reserve Interest Rates are concerned, we should see short-term rates at approximately the same level as nominal GDP growth, which is about 4%. Until rates increase beyond that figure, the Federal Reserve is remaining accommodative, even in a good economic environment.

Interestingly, the negatively biased headline topics have been unable to reverse the expansion. The Total Volume of Trade is sitting near a record high. Sure, the trade deficit is growing, but that is simply because we are buying more from other countries than we are selling to them. When you think about it a slowly growing trade deficit is probably a good sign in our present geopolitical climate. Also, the headlines are focused on the tariff wars with China, but we are beginning to see a shift in trade partnerships with other developing nations. So far this year, US imports from China are decreased 12.3% from the same period in 2018, yet they are up 36.4% from Vietnam, 22.5% from Taiwan, 12.4% from South Korea, and 12.0% from India. Companies are starting to shift production out of China. Even before trade negotiations have concluded, we are watching the global economy adapt to a world in which the US and China have a weaker partnership. More importantly, we have been in the midst of an economic cold war with China for many years now. In recent years, they have been working to quietly create economic dependencies around the globe to influence international trade with the United States. China's One Road program is a part of this effort. The global adjustment taking place will strengthen economies of many developing nations as well as the U.S. relationships.

The biggest headwinds for growth in our portfolios have been the increasing costs of labor and the daily uncertainty that comes from Washington D.C. as it pertains to international trade. We can be confident that these challenges will sort themselves out and that good companies will adapt to whatever conditions become normal. However, given the particular nature of these challenges and the potential risks to our economy, it is important to manage portfolios in a manner that will be resilient if the environment changes. To that end, our portfolios at CoCreate Financial will remain focused on capturing profits from mature, stable companies to minimize market risk, credit and default risks, and to create consistent growth into the future.

The Most Significant Risk

A very astute client asked what I saw as the most significant risk to the economy, wanting to hear my perspective, but also offering his own. He brought up an intriguing point about climate change and other environmental factors, including the availability of energy, which is a topic insufficiently addressed (and a topic about which I lack sufficient scientific background to be conversant). His point is something we need to consider. I believe that this is a risk that will have significant impact, but there is another that I believe is of great significance, is immanent, and will influence *every* other issue in economics and also more broadly in society and politics.

Identifying a singular issue among many is a challenging task, one which the question posed inspired me to attempt. Having reflected on the question for some time, it seems the most immanent threat to the economy, first for the US and then abroad, is the extreme polarization of society and the inability to hold intelligent conversations among good and intelligent people. The general paradigm for political engagement has become a simple four-step process:

1. Align with a singular political idea and the group that claims to as well.
2. Read a bumper sticker, a tagline or a tweet.
3. Repeat, repost, and shout bumper sticker, tagline or tweet.
4. Before anyone can engage in an honest conversation, call them a name and levy a serious accusation against them unless they agree without reservation.

We can't even begin a conversation about policy issues when the entire political game is the smoke and mirrors of ad homonym attack. It's up to each of us to STOP IT.

The death of tolerance and collaboration in the United States has been largely driven by social media, poor education as it pertains to critical thinking, and a number of other factors. Regardless of root-cause, the economic impact is extreme. As we approach the next presidential election, this becomes our greatest topic of concern over the coming years. Here are a couple of ways our collective refusal to have respectful, intelligent, tolerant, and engaged conversation can cause significant damage to the economy.

- Uncertainty for corporate and consumer spending.

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- Open opportunities for other countries to weaken the US
- Poor government policy and implementation leading to excessive government waste and an economically crippling regulatory environment.

This is a risk we can control by seeing our neighbors as people who have a profound story and immeasurable value. We know we won't agree, but we can hear one another because we recognize each other's value, and we know that the world is more complicated than post on social media.

Despite all the chatter, the economy is strong. We should be able to look forward to sustained growth over the next year. As long as we remain watchful for changes in the geopolitical climate and long-term shifts in U.S. policy and law which could alter the current direction of growth, our portfolios will continue to focus on investing in high-quality, mature businesses that pay steady cashflows to those of us who own them.

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