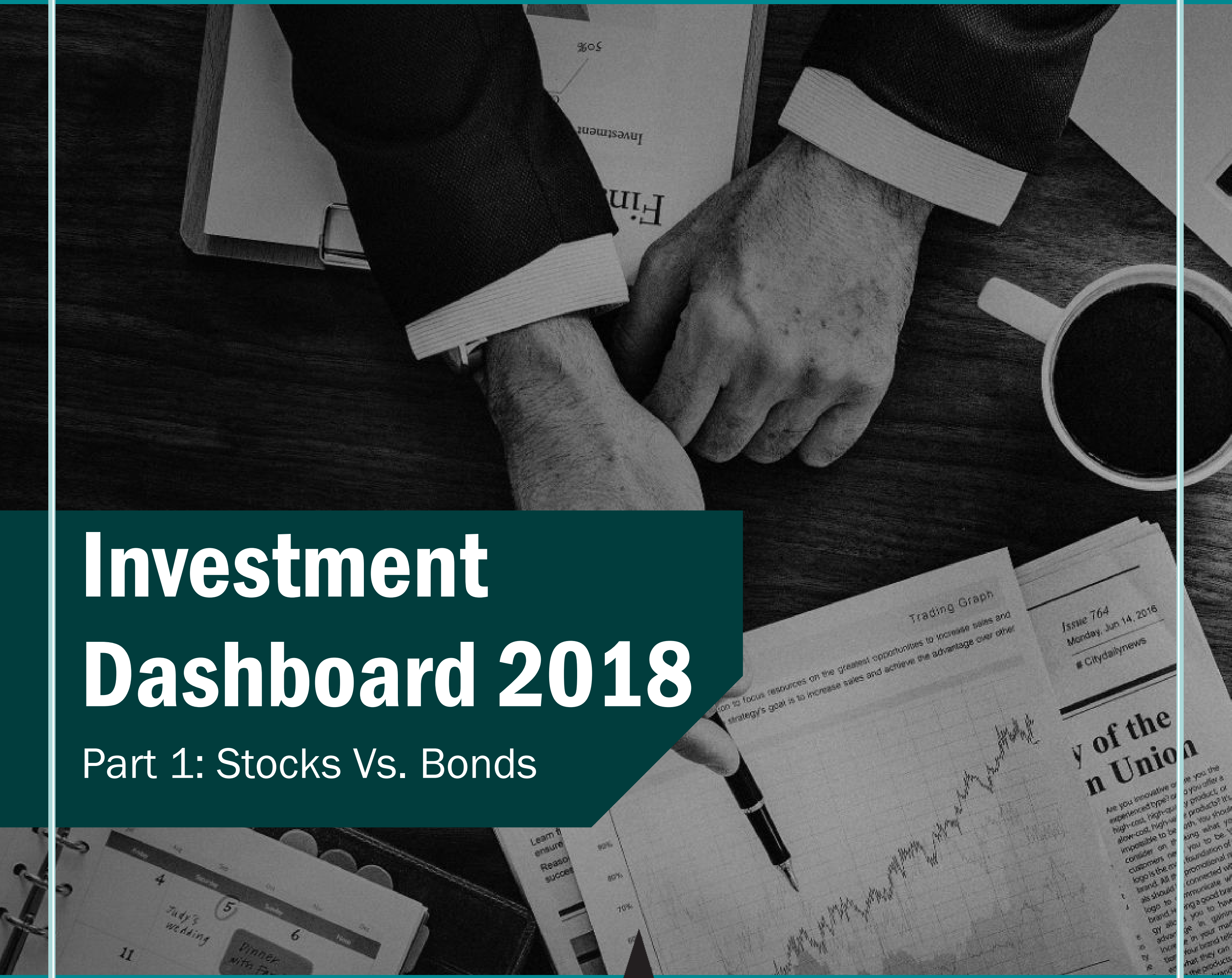
# Investment Dashboard 2018

## Part 1: Stocks Vs. Bonds

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AMBASSADOR
Wealth Management

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# Market volatility

## A picture (often) is worth a thousand words.

In that spirit, this blog begins a new series of occasional, short articles to help you understand how we think about your investments.

| | Historical S&P 500 Performance after "Low Vol" Years (Since 1945) | | | | | | |
|---|---|---|---|---|---|---|---|
| Calendar Year | Year Drawdown | Year Performance | | Calendar 1 Year Later | 1 Year Later Drawdown | 1 Year Later Performance |
| 1954 | -4% | 45% | | 1955 | -11% | 26% |
| 1958 | -4% | 38% | | 1959 | -9% | 8% |
| **1961** | **-4%** | **23%** | | **1962** | **-26%** | **-12%** |
| 1964 | -4% | 13% | | 1965 | -10% | 9% |
| **1972** | **-5%** | **16%** | | **1973** | **-23%** | **-17%** |
| 1991 | -6% | 26% | | 1992 | -6% | 4% |
| **1993** | **-5%** | **7%** | | **1994** | **-9%** | **-2%** |
| 1995 | -3% | 34% | | 1996 | -8% | 20% |
| 2013 | -6% | 30% | | 2014 | -7% | 11% |
| 2017 | -3% | 20% | | 2018 | -11% | ??? |

*Source: Strategas Research and Ambassador Wealth Management.*

Entering the new year, we communicated that markets could be in for a rougher ride entering 2018. (Market Pullback blog) Thus far in 2018, markets have corrected -11% from the peak after enjoying strong returns and a smooth ride in 2017.

## Should we be worried?

The table above shows the history of periods when markets have experienced "low volatility" – and what has happened one year later. One way to measure volatility is by measuring market drawdowns. The term "drawdown" measures the extent of a market decline during the year from the last peak to the last trough. (This chart looks at the S&P 500 as a proxy for stocks. Clearly, individual sectors or stocks potentially have more volatility.) Drawdowns occur in bull and bear markets. It is common to see drawdowns of anywhere from 10% to 20% over the course of a bull market. However, it is rare over the course of a calendar year not to experience drawdown of a magnitude of 6% or less.

Since the end of World War II in 1945, there have only been 10 years where drawdowns (and volatility) have been so low (defined as having drawdown of 6% or less). Each of these calendar years has come with positive market gains. Does a year of calm in the markets precede higher volatility? Does a calm year portend only a more volatile year ahead or something worse (such as an actual market decline)?

The data suggests that only once out of these 10 years did we have a year of low drawdown (1992) followed by the next year again with a low drawdown (1991). Although volatility stayed low and consistent, market returns were modestly positive the following year (+4%).
The other 9 years in question saw an increase in market volatility. This highlights that the past often is not a good indicator of the smoothness of the future (at least the near term).

However, there is some good news in this data. Although volatility in the other 9 years picked up, many years still resulted in positive gains for the market. 6 out of 9 years yielded both higher volatility and a higher market.

## So, what about the 3 years where markets declined in the face of higher volatility?

- 1994 (market down a modest -2%) was a year where the Fed aggressively boosted interest rates in the wake of strong economic growth (including bank lending). It triggered a bear market in emerging markets (see the Mexican Peso devaluation and crisis). The S&P 500 treaded water but mostly held steady.
- 1962 (market down -12%) resulted from a spike in interest rates and concerns about rising inflation. Higher bond yields hit the stock market that year.
- 1973 (market down -17%) followed the consequences of the Arab Oil Embargo in 1972. Gasoline prices spiked from 25 cents to 1 dollar a gallon. Other prices also rose. Again, interest rates rose in fear of higher inflation, and stocks tumbled.

## What can we draw from the lessons of the past for 2018?

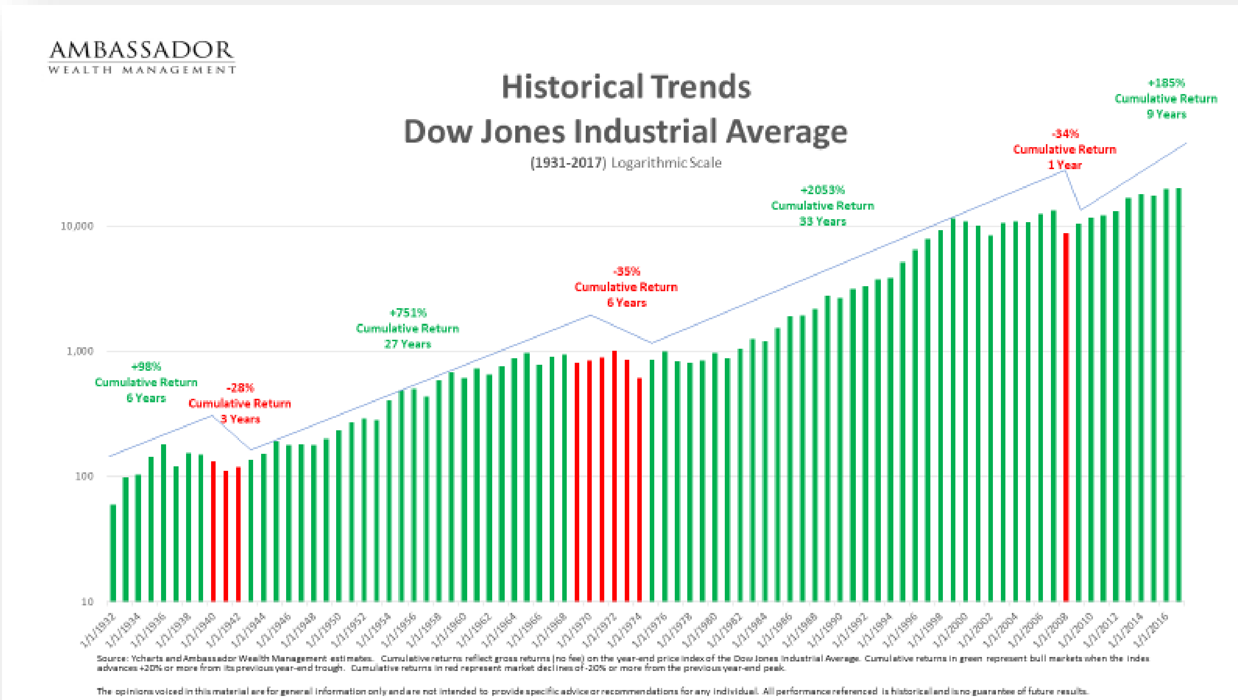
- Volatility is likely to (and has already) rise in 2018 after a smooth year in 2017.
- The Federal Reserve is raising interest rates, which could also contribute to higher volatility and perhaps dampen future market returns.
- This is not sufficient to prompt a protracted market decline, so long as inflation remains contained, and bond market participants agree.

We are monitoring these developments and managing your investments accordingly.

# Long-term View of Equities

## What insight can history give us for today?

Read below about what one chart on 86 years of history of the Dow might tell us about where we are today.




*Source: Ycharts and Ambassador Wealth Management estimates. Cumulative returns reflect gross returns (no fee) on the year-end price index of the Dow Jones Industrial Average. Cumulative returns in green represent bull markets when the index advances +20% or more from its previous year-end trough. Cumulative returns in red represent market declines of -20% or more from the previous year-end peak.*

*The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. All performance referenced is historical and is no guarantee of future results.*

Even with the market washout in 2008, the stock market generally has been a good place to be in the last decade.

The chart above measures returns for the Dow Jones Industrial Average, a proxy for large blue-chip stocks domiciled in the US.

Green bars represent years when the market has advanced 20% or more from its bottom of the previous year. Red bars represent declines of -20% or more from the previous peak.

*Ambassador Wealth Management, LLC is a registered investment adviser.*

Using these measures over the course of 86 years since 1932, the midst of the Great Depression, most of the bars have been green. Stocks have generally provided positive returns in most years when viewed over a long-term trend.

However, bear markets have been fast and furious when they do occur. In fact, 2008 was even faster and just as furious as the previous 2 major bear markets during this time period.

In only one year, the 2008 correction wiped out as much capital (nearly one-third) from peak to trough as the other 2 multi-year bear markets in this study (1940-2 and 1969-74).

## What are the takeaways from this chart?

- The Dow Jones has generally traded upward over the last 86 years.
- Market corrections can be steep and quick.
- Recoveries can also be quick.

Looking at the current bull market, the numbers might suggest that it is shorter (9 years) and less exciting (185% cumulative return) than prior bull markets (simple averages of 22 years and 966%).

## However, 2 words of caution:

- Past performance is no guarantee of future results.
- We are starting from a higher valuation base in this current market than other bull markets.

Each family's situation is unique. Other factors beyond "chasing the market" should play into how your family should be invested.

Help us to help your family position appropriately for the future.

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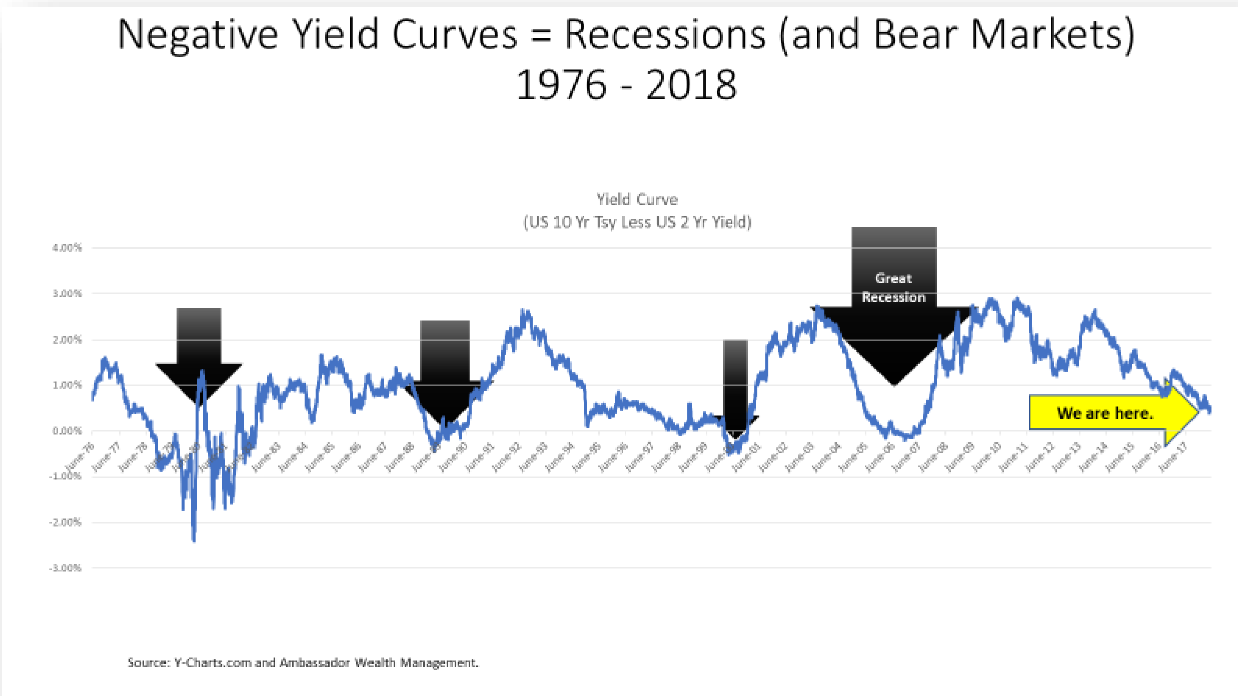
# What Can Bonds Tell Us About the Economy?

"The stock market has predicted 9 of the past 5 recessions."

Paul Samuelson (Nobel Prize winning economist in 1966 *Newsweek* article)

There is a better weathervane than stocks to forecast if the economy has hit the skids.

Watch Treasury bond yields, not stocks, to know when to worry.




*Source: Ycharts and Ambassador Wealth Management estimates*

Yields on major bonds issued by the Treasury have done a pretty credible job of signaling economic recession in the last half century.

The chart above displays the slope of the yield curve in the US Treasury bond market. The "slope" is defined as the difference between the yield provided by Treasury bonds with a stated maturity of 10 years ("10 Year yields") vs. the yield provided by bonds with a maturity of 2 years ("2 Year yields"). This difference is also known as "spread".

When the slope is positive, or greater than zero, that has typically indicated a growing economy. When the slope goes to zero or turns negative, that has been a near perfect indicator that the economy is shrinking or slipping into recession.
The performance on your investments is directly related to the performance of the US economy.

"Risk on" assets, that is, investments that benefit from economic growth, tend to rise in price over time when the economy is growing. Stocks, high-yield corporate bonds, and many commodities are examples of "risk on" assets.

"Risk off" assets, investments that attract investors in times of fear and uncertainty, tend to do better than "risk on" assets when economic growth turns negative. Gold and Treasury bonds with long maturities are examples of "risk off" assets.

Since 1976, the slope of the yield curve has turned negative 4 times (1978-1982, 1989, 2000-1, 2007). (Refer to the black arrows, including the large one marked "Great Recession".) Once the slope turned and stayed negative, "risk on" assets sold off and performed poorly relative to "risk off" assets. In all 4 cases, the US economy soon fell into recession and posted negative growth.

The good news is that the slope of the yield curve has been mostly positive over the last 5 decades. "Risk on" assets have benefited with positive returns for most of this time period.

## But when the yield curve turns negative, all bets are off.

What about today? (Refer to the yellow arrow "We are here".)
The yield curve currently has a modest positive slope of less than one half of one percent. This reflects expectations for the US Federal Reserve to influence rates upward for bonds with shorter maturities. Long term yields are still greater than yields on bonds with shorter maturities, but the gap has reduced from a couple of years ago. This reflects that market participants have some concern that the Fed runs the risk of raising interest rates too quickly and might potentially cause a future recession.

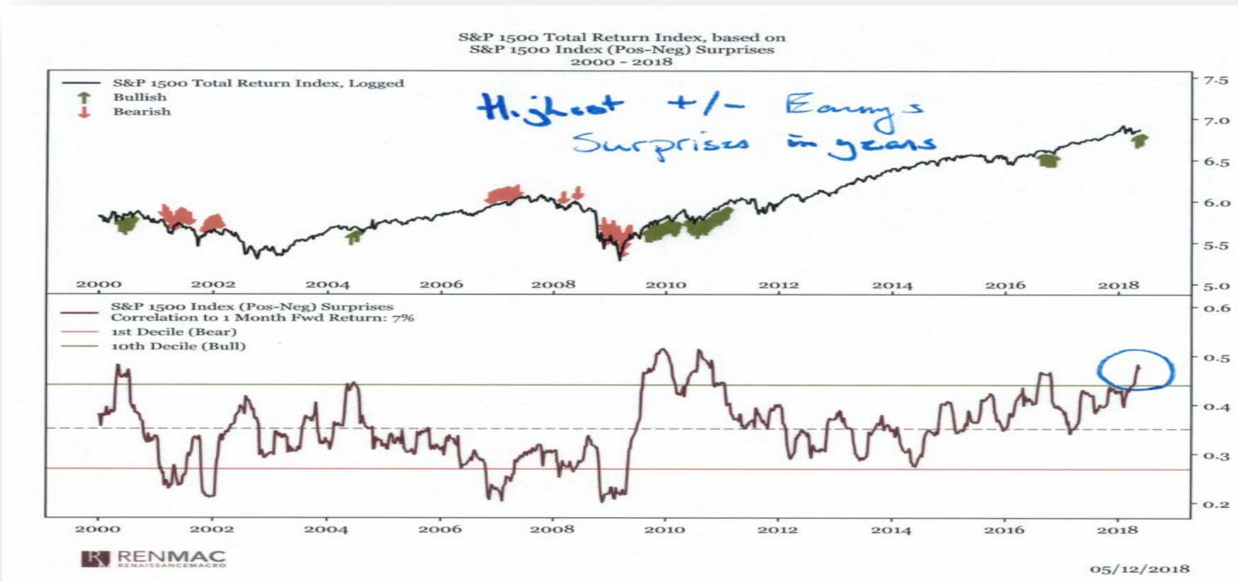
However, there might be an historical precedent of a narrowly positive yield curve persisting for some time: 1995-2000. This was also a time of strong returns for "risk on" assets. It eventually led to a brief bear market and recession to start the new century. However, this took several years to play out.

We monitor the yield curve as one important indicator of where we are in the economic cycle.

# Corporate Earnings – Fuerte![i]

## US corporations are posting some of the strongest earnings results in years.

Is it sustainable?  What does it mean for your investments?




*Source: Renaissance Macro Research.*

Prior to the pause in 2018, many stocks have risen strongly over the past couple of years.  Investor sentiment has been a main catalyst for price appreciation.  Yet another catalyst has been the strong performance of corporate profits, particularly relative to market expectations.

The chart above comes from research house Renaissance Macro.  The data show the level of actual quarterly earnings achieved by companies of all sizes found in indices compiled by Standard and Poor's.  The data include earnings from large, mid, and small cap companies.

The data measure the ratio of positive to negative surprises of actual earnings vs. forecast earnings estimated by Wall Street analysts.  The line at the bottom of the chart shows the aggregate performance of actual vs. expected earnings.  When the line is moving up, that means more companies are beating expectations than missing them.  When the line moves down, that means more companies are missing Wall Street estimates.

Current earnings are strongly beating estimates. (See the part of the red light to the right and circled in blue.) In fact, the level of positive earnings surprises is the highest in 7 years.

While earnings in 2018 have been given a boost by tax reform, other factors might explain the current level of positive earnings surprises. Fiscal stimulus in other areas, such as accelerated depreciation for certain capital expenditures, might also be helping profits and even revenues in limited situations. Higher commodity prices and interest rates have helped the energy and financial sectors. Additionally, solid if not spectacular US economic growth has helped profits. Economic recovery overseas and a weaker US Dollar has also helped sales and earnings. (For example, every $4 of $10 of revenue of large companies in the S&P 500 come from overseas, according to Strategas Research.)

Continued robust performance in earnings might help to ignite further gains in stocks. Conversely, any deterioration could take the sizzle off earnings surprises. (Higher oil prices, for example, might help the energy sector, but they can also hurt other sectors of the market, such as consumer stocks in that input costs might rise and thus hurt profit margins.)

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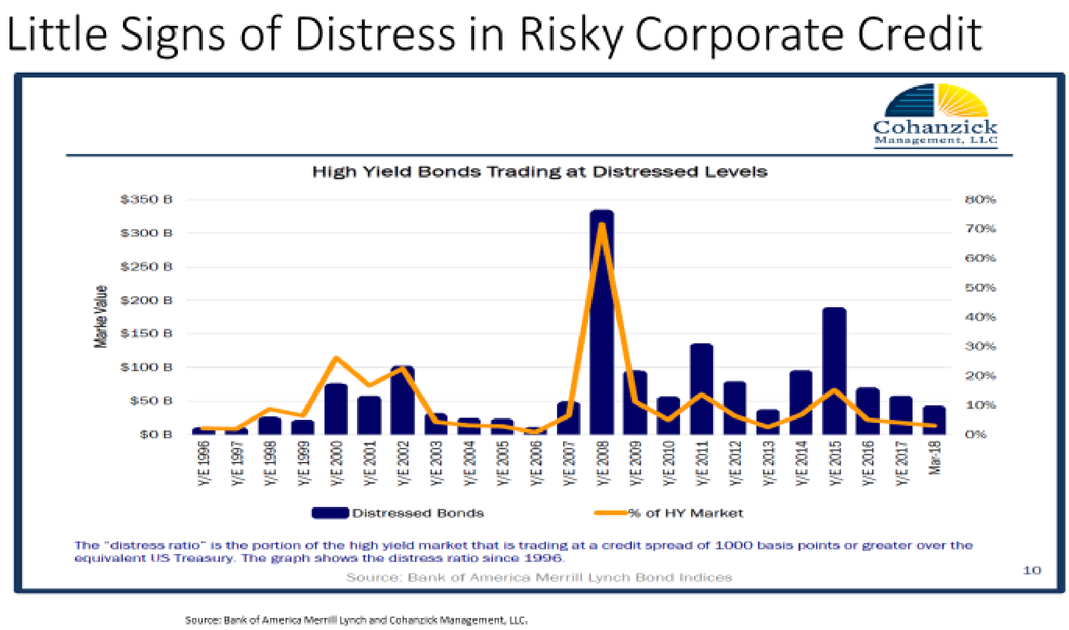
# High Yield Corporate Credit: Don't Worry, Be Happy?

## The US high yield corporate bond market is pricing in benign news for future credit defaults.

How credible is this message?  How might this impact other parts of your investments?




*Source: Bank of America Merrill Lynch and Cohanzick Management, LLC.*

The above chart suggests high yield corporate bonds are enjoying calm weather.

Data compiled by Cohanzick Management, a New York based asset manager, and Bank America show the amount of US high yield corporate bonds[ii] priced as if they were going to default in the near future. The data include corporate bonds that trade 10% or more (1,000 basis points) above the yield of the equivalent US Treasury bond. Such bonds appear to sport high yields, but they do so with a reason: fear that the company could choose not to pay bondholders back and default.  Think Toys R Us as one recent example of a company that eventually went bankrupt.

The blue bars represent the absolute level (market value) of bonds priced for bankruptcy for a given year.

The yellow line shows the percentage of the total high yield market that is priced as if it were going to default.

Whether an issuer priced as distressed actually defaults or not depends on the situation. Often the market is correct about such dire prospects. Sometimes, the market overly panics, and the company manages to find a way to bail itself out. What matters for this discussion, though, is this: **what message is the high yield market sending about the US economy overall?**

Currently, the level of bonds priced for default is about 3% of the total US high yield market. This is close to the lows set earlier this century. While this number appears good for the moment, there are also reasons to be concerned.

Defaults at this level are likely to get worse, not better, based on past history. Two historical precedents for a bear case going forward might include:

- 1999: TMT[iii] on the eve of the dot com bubble bursting, when the Fed also had just been hiking interest rates aggressively after pumping in excess liquidity to stave off contagion from the Russia debt default/emerging market crisis to the US. High yield defaults were concentrated mainly in those sectors, but the economy later turned into recession, and stocks corrected.

- 2006: The housing bubble was about to burst. The Fed was raising interest rates while oil was over $100 a barrel. It took another 2 years before we finally entered the Great Recession. Numerous sectors experienced high defaults. Stocks corrected.

A more benign case might consist of something like 2003. Interest rates remained quite accommodative for a long time. Steady economic growth and reasonable interest rates prolonged a benign credit cycle for years. Eventually, however, it gave way to asset bubbles particularly in the housing and debt markets.

# What lessons might we learn for today?

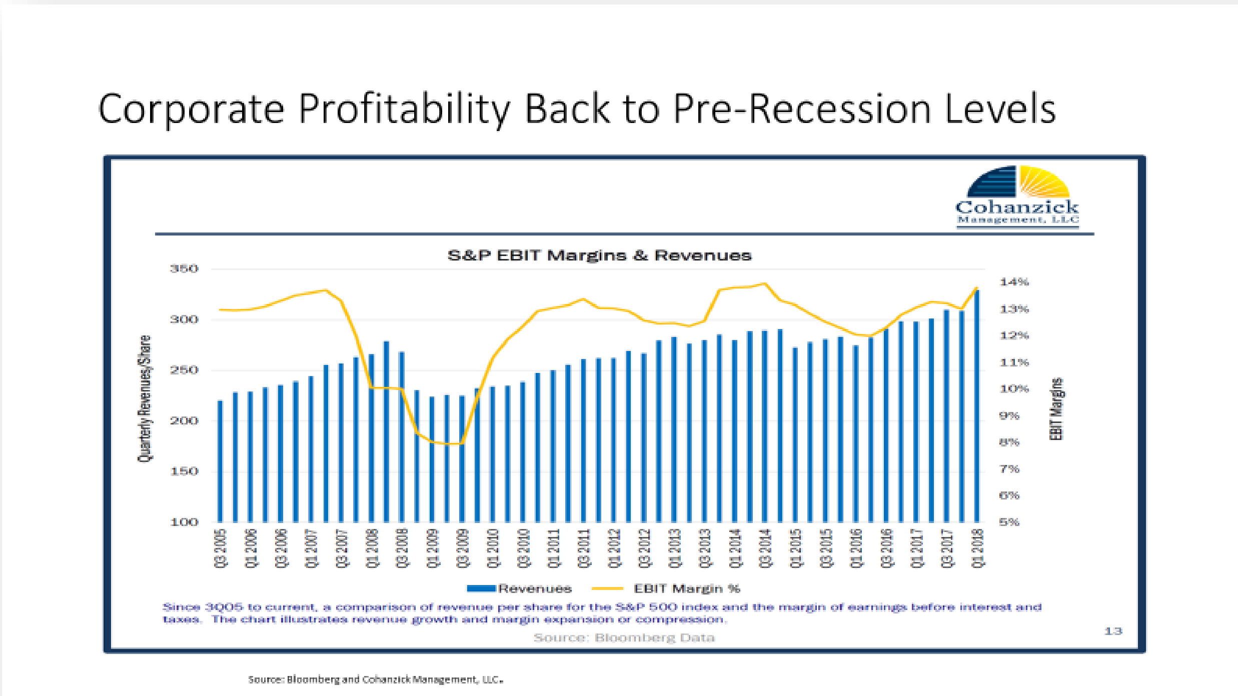
Economic recovery, while the second longest on record, has also been tepid, as evidenced by the weakest level of growth in recorded US history. The hangover from the financial crisis has allowed central banks to keep interest rates low even after recent rises. Additionally, low inflation has also resulted in robust profit margins for many companies.

However, any change in inflation might make central banks tighten short-term interest rates more aggressively. Cost pressures from either wage or input price inflation might weaken corporate margins.

A combination of these two issues might put pressure on certain issuers in the high yield market. That might send a warning signal to corporate credit and adversely impact other assets, including equities.

# US Companies Are Minting Money – Will It Continue?

Public companies in the US are showing strong profit margins with record sales.  Why does that matter for your investments?




*Source: Bloomberg and Cohanzick Management, LLC.*

American public companies are rolling in the dough.

Data compiled by Cohanzick Management, a New York based asset manager, and Bloomberg examine sales and profit margins for companies included in the S&P 500 index.  They include profit margins and sales going back nearly 13 years.

Corporate profit margins, defined as operating profits excluding interest expense and taxes, are nearly at all time highs in spite of a slight pickup in inflation.  Profits reported in the first quarter of 2018 are at levels similar to the levels attained in 2005 and 2006 (before the housing bubble popped and brought in the Great Recession of 2008-9).

Though companies made great gains in improving productivity (more sales and profits achieved by fewer employees and less capital expenditure), benefits from technology have also contributed to the improvement in profits.  This has come in spite of headwinds from the weakest economic recovery in recorded US history, depressed commodity prices, and price competition in a number of sectors.

Going forward, it would not surprise us to see margins hold steady, if the economy were to continue its recovery. Economic growth might lead to further gains in sales. Offsetting the help from sales, however, is the need for companies to reinvest in capital expenditures as well as incremental cost pressures from raw materials and wages.

Revenues (adjusted for number of company shares outstanding) are above the peak in 2008. The high level of revenues per share partially reflects economic recovery. However, this metric also reflects companies' willingness to buy back their own shares. (Remember that years after 2008, in spite of the market's recovery, many retail and institutional investors were still selling stocks. We believe this trend ceased only a couple of years ago in 2016.)

In the future, it is possible that sales will continue to show growth. While many companies might continue to buy back shares of their own stock, it is difficult for us to see them accelerating such a trend. Corporate balance sheets have more debt leverage now than they did prior to 2008. Additionally, the greater the confidence companies have in the sustainability of the economic recovery, the more likely they might increase capital expenditure. More capital expenditure might help the economy, but it also drains cash flow that might otherwise have been used to buy back more shares.

If this outlook were correct, it might suggest that US companies might still enjoy reasonable sales per share and profit margins. However, it might be more difficult to see significant expansions in either without a significant improvement in economic growth.

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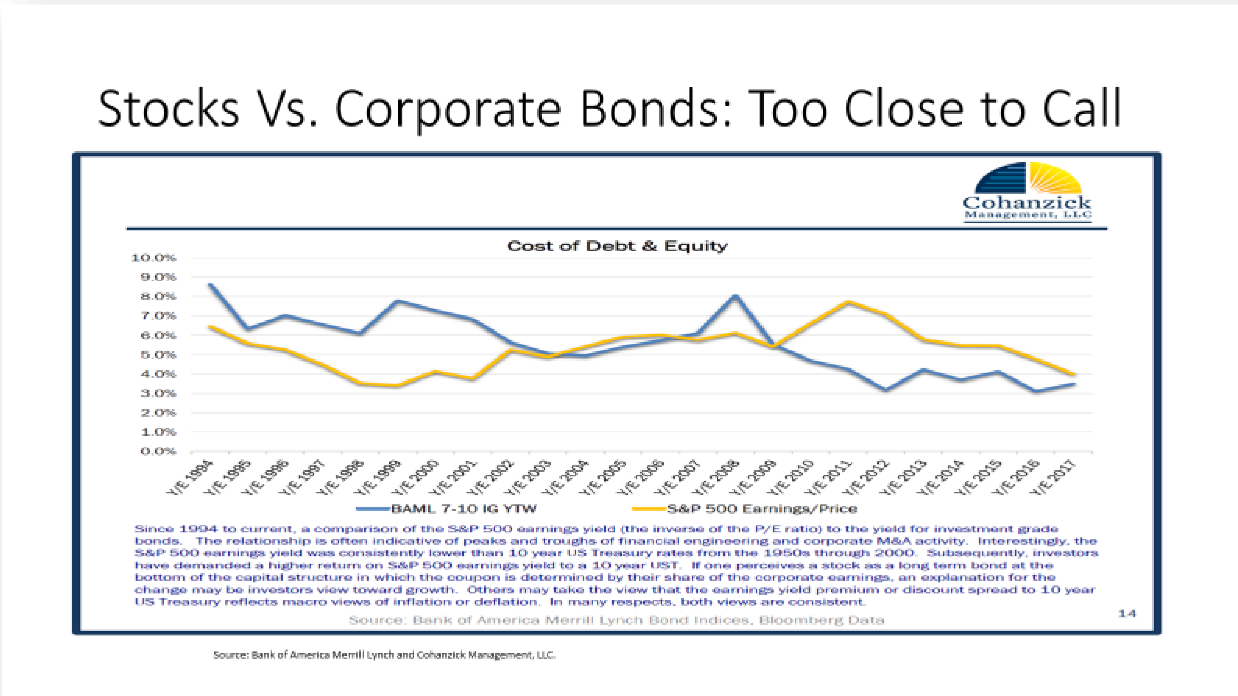
# Stocks Vs. Corporate Bonds: Too Close to Call

## What is the market signaling about the price of stocks versus corporate bonds?




*Source: Bank of America Merrill Lynch and Cohanzick Management, LLC.*

For the first time in nearly a decade, it is a close class as to whether stocks or corporate bonds are the better value.

Data compiled by Cohanzick Management, a New York-based asset manager, and Bank of American analyze values for US stocks and corporate bonds. The data run back 23 years to the early 1990's.

The blue line represents the yield on bonds of US corporations rated investment grade by the rating agencies. The yellow line represents the earnings yield of companies include in the S&P 500 index.[iv]

When either of the lines is sloping upward, that means investors demand higher return for that asset compared to the past. Either they sell down the price or else earnings (or interest service) is rising, but investors are not paying up for it.  Conversely, a line sloping downward indicates either investors are bidding up prices for the asset or else earnings or interest coverage are deteriorating.

Since 2008, bonds (the blue line) have appreciated in price dramatically.  Investors became quite bullish on an extended period of low interest rates and the health of corporate issuers to pay their interest.

In contrast, stocks from 2008 to 2011 became cheaper.  Stocks declined in price in 2008 due to the Great Recession.  However, stocks appreciated from 2009 to 2011.  So, what happened?

Earnings growth outpaced that of stock price appreciation.  However, investors had not bid up stock prices to keep up with that earnings growth.  Apparently, stock markets were skeptical of how sustainable these earnings actually were.  (Remember this in the context that bond investors were much more sanguine about corporations' ability to service their debt.  They still bid up corporate bonds!)

As a consequence, a wide valuation gap opened up between the stocks and bonds of US companies from 2008.  Bonds were valued more richly than stocks.

Corporate executives were more optimistic about their own stocks than investors.

Companies viewed bonds as a cheaper way to finance their operations than issuing stock.  Additionally, many companies had shrunk their debt leverage because of the 2008 crisis.  Executives saw room to issue bonds at attractive low rates.

These companies also issued debt at cheap rates to buy back their stock.

In 2012, the gap between bonds and stock started to shrink.  The yellow line started to move down, while the blue line was flat.  Stocks outperformed bonds.  Investors recognized a greater supply of bonds and a shrinking amount of stock.

## Where does that leave us today?

The clear valuation gap between corporate stock and bonds no longer exists.

The implication is that companies have less incentive to buy back stock by issuing more debt.  Rising interest rates also reduce this incentive.

On the surface, this might imply that stocks are no longer a great value compared to a few years ago.

However, longer term history might suggest that stocks still might outperform bonds, if that were to repeat itself.

Cohanzick points out that recent history is an anomaly.  Bonds were cheaper than stocks from the 1950's up until the year 2000.   Bonds and stocks traded nearly in line with each other up from 2000 to 2007.  Only in recent history have bonds traded more expensively than stocks.

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[i] “Fuerte” means “strong” in Spanish.

[ii] “A high-yield bond is a high paying bond with a lower credit rating than investment-grade corporate bonds, Treasury bonds, and municipal bonds. Because of the higher risk of default, these bonds pay a higher yield than investment grade bonds. Issuers of high-yield debt tend to be startup companies or capital-intensive firms with high debt ratios.” Source: Investopedia, https://www.investopedia.com/terms/h/high_yield_bond.asp accessed on May 17, 2018.

[iii] “What is the ‘Technology, Media, and Telecom (TMT) Sector” on https://www.investopedia.com/terms/t/technology-media-and-communications-tmc-sector.asp accessed on May 17, 2018.

[iv] Earnings yield is defined as the inverse of the Price to Earnings ratio for the aggregate of companies included in the S&P 500 index.

***Life is complicated, let's simplify it.***
*Building relationships to help you navigate life with purpose.*

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