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# THE TEMPO VANTAGE

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## Pot Hole or Sink Hole?

The way the markets were falling in the fourth quarter of 2018 you would think we are headed for the next Great Depression, or at least the next Great Recession. We are not.

For the quarter large cap U.S. equities (S&P 500) were down 13.5% and international stocks lost 12.5%. And these were among the better sectors! Small-cap stocks were down 20%, mid-cap stocks were down 16%, and technology stocks were down 17.5%.

From peak to trough here is how various equity markets fared:

S&P 500 -19.8%
Small-Cap Stocks -27.2%
Mid-Cap Stocks -21.5%
NASDAQ -22.0%
International Stocks -24.2%

Seems like just about every market has experienced a bear market with the exception of the S&P 500. Of course the S&P 500 is what most pundits look at in determining bear markets. Time will tell if they will round the 19.8% loss up to 20% and declare this a bear market.

Bonds have had a tough time recently as well. About the only thing that made money in the fourth quarter was intermediate-term bonds, which were up 1.6%. But short-term and long-term bonds were relatively flat and most other categories lost. Inflation bonds (-1.0%), bank loan bonds (-3.4%), high yield bonds (-4.3%), and convertible bonds (-9.0%!) all had terrible quarters.

OK, Traub, time to put up or shut up! Last quarter I said that "I'd gladly suffer a 20% decline or two to gain more than 800%." We'll, we've now had a 20% drop, so how do I feel?

Pretty good. Let me tell you why as we look at some key economic metrics:

**Inflation:** After peaking at 3.23% (Nov 8) the 10 Year Treasury rate has fallen to 2.73% as of this writing. Inflation rates are still low by historical standards and the Fed has slowed the pace of rate hikes. Inflation is not a major issue at this point.

**Yield Curve:** The yield curve is a chart of short-term to long-term interest rates. We prefer to have a positively sloping (long-term rates higher than short-term rates) yield curve which indicates confidence in the economy today and in the future. What we don't want to see is a

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negative yield curve (short-term rates higher than long-term ones). While the yield curve has been flattening (not much difference between short-term and long-term rates) it has not yet inverted. Nor do I expect it to invert as the Fed has slowed the pace of rate hikes. Still, worth keeping a close eye on.

**Earnings:** The market has been falling as if earnings are going to decline. They are not. Earnings are growing at a slower rate. This was inevitable. Last year earnings were up 20% year-over-year (yoy) in large part due to the decrease in the corporate tax rate. A yoy bump in earnings due to a tax decrease happens once. Next year earnings are more likely to be up about 7%.

What's wrong with 7% yoy growth? Nothing.

Yet there is no doubt the decrease in earnings expectations was a factor in the recent stock market decline. One could even argue that the slowing of the growth rate of earnings warranted a decline in the stock market. Fair enough. But that doesn't mean we are going into a recession.

**International Trade:** This could go either way. The negative scenario has tariffs and Trump's negative posturing continuing into the foreseeable future. The longer that continues the more you will see companies lower earnings guidance based on reduced sales in China (as Apple did on 1/2/19).

The positive scenario posits that the markets have been held back in large part due to trade disputes. Notice that the market rallies every time there is a hint of resolution. If there is an actual resolution that could spark a sustained stock market rally.

**Sentiment:** Sentiment is the overall attitude of investors toward a particular security or financial market. You might think of it as investor emotions - fear and greed. In the short run emotions can and do move markets in directions not justified by underlying market fundamentals. That may very well have happened in the fourth quarter as investors' fear of a bear market contributed to the decline.

But the interesting thing about sentiment is that at extremes it is a negative indicator. The worse sentiment is (more bears as compared to bulls) the more likely the stock market will rise. Right now bearishness is at a fairly high level, which is good for stocks.

Where does this leave us? The decline in equities is overblown. That doesn't mean stocks won't decline more. They could. Maybe sentiment will get worse before it gets better pushing stocks clearly into bear market territory.

I believe that there is a path to more stable (and profitable) markets if we follow my grandmother's simple advice: All things in moderation. We want the economy to grow, just not too fast or too slow. Too slow and we risk recession. Too fast and we risk inflation.

We want interest rates to normalize, but not rise too fast. We want fair trade, but not at the expense of extended trade wars.

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## Tempo Financial Advisors' 4th Quarter Investment Performance

Tempo's investment programs were having a decent year going into the fourth quarter. And then, well, the fourth quarter was not kind to Tempo's investments.

**Tempo Dynamic Income** was positioned for continued higher (or at least not lower) interest rates and a relatively stable environment. Our models were caught off guard in the fourth quarter as all the positions that had benefited accounts the past few years suddenly were among the worst places in the fixed income markets: Bank loan bonds, high yield bonds, and worst of all, convertible bonds.

Tempo's -5% return for the quarter was 5% worse than our benchmark and nearly 7% worse than the benchmark for 2018 as a whole. We have had a worse year on an absolute return basis (2008), but not a worse result as compared to the benchmark. Let's hope this doesn't happen again for another 10 years... or ever!

Dynamic Income accounts have been rebalanced for the first quarter of 2019 with positions in intermediate-term bonds, global bonds, and high-quality corporate bonds to go along with utilities and a market neutral fund (alternative investment). As I write this Dynamic Income accounts are up about 1% at the start of the first quarter.

**Tempo Dynamic Growth** was correctly positioned at the low end of our equity allocation (40%). Unfortunately half of that allocation was in small caps, which underperformed the overall market. Another 20 percent of accounts was invested in commodities (which I consider an alternative). As it happens commodities behaved more like equities and fell double digits. The result is that Dynamic Growth declined more like a portfolio with 60% equity than one with 40% equity.

In the end our return of -10% for the quarter was about 2.5% worse than our benchmark which means we trailed the benchmark for 2018 by a little over 2% as well.

Dynamic Growth portfolios have also been rebalanced for the first quarter. As before we are at the low end of equity exposure. But commodities have been sold in favor of more conservative investments such as intermediate-term bonds, corporate bonds, and global bonds. Accounts are also up about 1% early in the first quarter.

**Tempo Lifestyle** had the worst absolute performance among our three strategies but the best performance relative to benchmarks. Accounts were down between 10% and 12.5% for the quarter with conservative accounts falling less and aggressive accounts falling more. This was a little over 1% worse than benchmarks, which means that our performance for 2018 was also about 1% worse than benchmarks.

Part of the reason for the underperformance is something we've written about numerous times in the past. For diversification purposes we always own mid-cap and small-cap stocks (in varying amounts). The benchmark does not. When these categories underperform as they did in the fourth quarter (see above) it can be difficult to overcome.

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The other reason for our underperformance is that our fixed income holdings, which have served us quite well for a few years, are geared toward success in a flat to rising interest rate environment. That is not what we had in the fourth quarter.

Double-digit declines are more common in Lifestyle than the two Dynamic Programs. Twice (2Q, 2010 & 3Q, 2011) over the course of the bull market we had declines of 10%. I'd gladly suffer a 20% decline or two to gain more than 800%. Where have I heard that before?

Lifestyle accounts have begun the New Year on positive note with accounts up 3% or so in the early going.

You may have noticed I did a significant amount of tax loss harvesting in taxable Lifestyle accounts in December. Tax loss harvesting doesn't change my overall convictions for the markets. We were simply making lemonade (realizing losses to save taxes) out of the lemons (a negative stock market) we were given.

I also made a few tactical changes in the fourth quarter. After the Democrats took control of Congress I sold defense and aerospace in favor of healthcare, reversing the trade I made in the wake of Trump's election. Both moves were motivated by what Trump may or may not be able to accomplish in these sectors based on who is in control of Congress. Over the course of our trade, defense did in fact outperform healthcare by about 10%.

We also sold our overweight position in financial stocks. A flat yield curve is not good for banks, which profit from the difference between short-term rates (where they borrow) and long-term rates (where they lend). In their place we bought utilities, which was one of the bright spots in our portfolios in the fourth quarter.

I often espouse the virtues of diversification. Not only between stocks and bonds, but among investment strategies as well. This is why Tempo has three investment programs.

We could very well see diversification in action in the first quarter of 2019 among Tempo's three investment programs. Dynamic Growth and Income are both conservatively positioned and will outperform if the market continues to struggle. Lifestyle, as always, is positioned for the longer term and will outperform if the markets turn around as they have been in the early going.

**Reminder**

Please contact us if there has been a change in your financial circumstances that would warrant a fresh perspective on your portfolio.

Daniel J. Traub

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