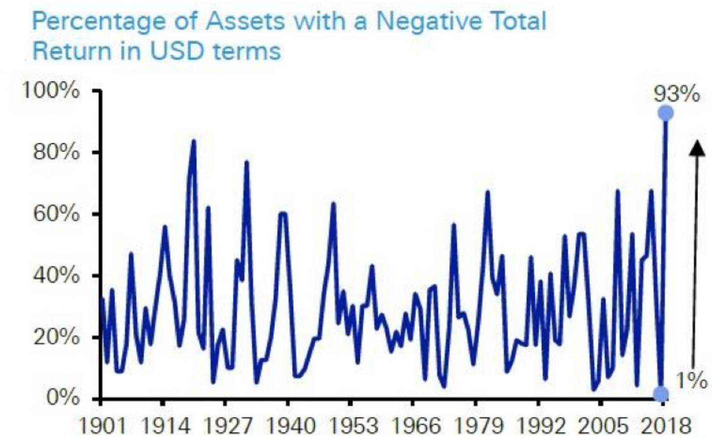
SECURITY NATIONAL BANK
WEALTH MANAGEMENT
Sioux City • Dakota Dunes • Sioux Falls

Winter 2019
Economic & Market Commentary

Nowhere to Run...

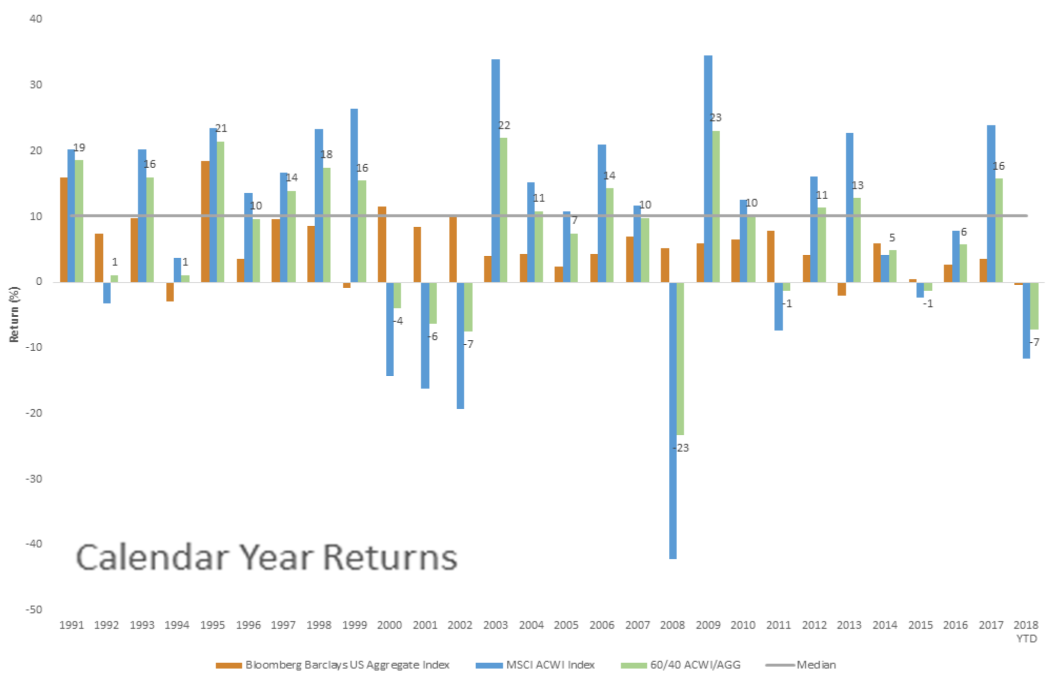
Martha and the Vandellas were a vanguard of the 1960s Motown sound. Eclipsed in popularity by Diana Ross and the Supremes, the group nonetheless is remembered for its portfolio of chart-topping singles. One early hit was 'Nowhere to Run', with its opening line, 'Nowhere to run to, nowhere to hide...' Martha and the Vandellas were inducted into the Rock and Roll Hall of Fame in 1995. They're leading contenders for the 2018 Most Accurate Market Forecast award.

Everything was rosy entering 2018. Goldman Sachs' expectation for a 'synchronized global expansion' was intact. Inflation remained under control, here and abroad. The Tax Cuts and Jobs Act signed in late 2017 produced immediate boosts in corporate profits. Of course, the Federal Reserve expressed its concerns, but investors shrugged off the risks. Most equity valuations were in the upper quarter of their long term ranges. High expectations were priced into most financial markets.



Source: Deutsche Bank

The late economist Herbert Stein once noted, 'If something cannot go on forever, it will stop.' Global growth started to diverge early in the year. Tariff concerns exacerbated the uncertainty. International markets -- particularly those of emerging economies -- tumbled and stayed firmly in negative territory for the remainder of the year. Bond prices fell as interest rates rose, and quality spreads widened alongside growth concerns. U.S. equity markets gave way in December.



Source: Morningstar Direct, Michael List, CFP®

How challenging was 2018? In terms of absolutes, it was manageable -- nothing like the bursting of the dot.com bubble or the more recent credit crisis. At the same time, the widespread declines were unprecedented. Deutsche Bank tracks seventy different financial assets, from stocks and bonds to currencies and derivatives. Through mid December, over ninety percent were negative for the year, a record one-sided cascade dating back to 1900 (when only thirty indices existed).

The second chart ignores the more non-traditional categories and focuses on a prudently diversified mix of global stocks and bonds. Again, we faced one of the few negative returns for balanced portfolios in three decades. The magnitude of the price decline was limited compared to most bear markets, but the declines were sharp and broad. Indeed, there was no place to run to and no place to hide.

Late Stage is Not End Stage

Global economies reached their nadir ten years ago. The subsequent recovery and expansion is approaching the longest and most powerful in modern times. But, as noted above, cracks are showing. Global growth is slowing. Brexit is creating chaos in the EU. Trade wars may (or may not) be on the horizon. While rhetoric has somewhat softened, central banks continue to unwind the stimulative policies that kept interest rates at record lows for so long. We are clearly in the late stage of this cycle.

These facts, and the rising volatility of financial markets, are ramping up business in Wall Street's busiest industry -- predicting the next recession. So where do we stand?

Economic momentum in the U.S. remains positive, but warning signals are present here as well. Near-record low unemployment is a two-edged sword. Consumer spending is exceeding expectations, but national output will taper as worker shortages are not offset by improved immigration policies and productivity advances. Interest rates will continue to rise, creating issues for rate-sensitive sectors of the economy. On the plus side, the Powell Fed is signaling a more data-dependent approach to rate hikes. With inflation running consistently at the low end of expectations, we are likely closer to the peak of this rate cycle than the trough. Last, energy independence is a massive long term positive for the U.S.

In sum, the U.S. economy is unlikely to fail in the near term. Cycles are part of economic life, but there remains sufficient momentum to produce favorable GDP reports through 2019. The Fed's subtle shift toward data dependency affirms a less programmatic approach to monetary policy. The chances of a damaging policy 'overshoot' are somewhat lessened, even as the unwinding of the Fed's balance sheet continues. Headlines will be mixed with an emphasis on the negative. Markets will remain unsettled, but a recession is not around the corner.

Late Cycle Turbulence: A Last Gasp For Risk Assets?

Protracted Bear Market Unlikely Until Recession Imminent

ANNUALIZED REAL RETURNS (%) PRIOR TO RECESSIONS	MONTHS PRIOR TO RECESSION 13-24 MONTHS	1-24 MONTHS	7-12 MONTHS	1-12 MONTHS	1-6 MONTHS	NON-RECESSION MONTHS
S&P 500						
AVERAGE RETURNS POST-1950s	14.2	6.8	8.0	0.1	-7.8	10.1
JUL 1953 - MAY 1954	21.9	12.0	17.8	2.0	-13.8	14.7
AUG 1957 - APR 1958	15.8	7.1	-17.0	-1.6	13.9	19.3
APR 1960 - FEB 1961	31.3	16.8	6.6	2.2	-2.2	15.8
DEC 1969 - NOV 1970	13.4	-1.3	-11.0	-15.9	-20.7	5.8
NOV 1973 - MAR 1975	16.9	4.9	-11.3	-7.0	-2.7	6.2
JAN 1980 - JUL 1980	0.5	2.2	6.8	5.4	4.0	3.1
JUL 1981 - NOV 1982*	...	...	32.2	10.5	-11.2	4.0
JUL 1990 - MAR 1991	14.3	13.1	22.2	11.9	1.6	14.0
MAR 2001 - NOV 2001	8.9	-0.7	20.0	-10.3	-40.6	12.5
DEC 2007 - JUN 2009	11.6	7.6	13.6	3.6	-6.3	4.0

Returns tend to be strong in the late stage of the business cycle...

...but don't overstay your welcome

In more recent business cycles, investors have reaped strong returns in the 7-to-12 months prior to the recession

* FIRST 2 COLUMNS OMITTED DUE TO OVERLAP WITH PREVIOUS RECESSION PERIOD.
NOTE: MONTHLY RETURNS ARE ANNUALIZED AND DEFLATED BY THE CONSUMER PRICE INDEX; CALCULATIONS ARE BASED ON TOTAL RETURN INDEX.

Source: BCA Research

Investment Implications

Portfolios under our management will remain fully invested. First, predicting the onset of a recession months or quarters ahead is a futile gesture. The statement that 'the stock market has predicted nine of the last five recessions' is history, not satire. Second, as shown in the table from BCA Research, the latter stages of an economic cycle often produce stellar results. Becoming too cautious, too early can lead to a significant shortfall in meeting long term goals.

At the same time, as shown, there are risks in overstaying the welcome. Our solution is a middle path. We rarely make major asset mix changes, but we will adjust our risk parameters -- conservative when appropriate, more aggressive as opportunities permit. This philosophy has served our clients well and we expect it will continue to do so.