Investment Commentary

HANOVER ADVISORS

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Monetary Policy Dominates the Economy and Financial Markets in 2019

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In the fourth quarter of 2018, rising interest rates and the signs of decelerating economic growth crashed the richly valued stock market. Large U.S. stocks lost 13.8 percent of their value, and small U.S. stocks gave up 20.2 percent. However, this correction has brought the stock market from its historically high valuation down to more reasonable levels, and may even set the stage for a market rally in 2019. It is even possible that momentum investors could push stock prices to a new record level. Despite this, the issues of rising interest rates and decelerating growth are eventually going to resurface. When they do, it will be against a backdrop of very expensive financial assets. As a result, the U.S. stock market remains vulnerable to significant fluctuations.

Much of this uncertainty can be attributed to the staggering amount of debt that has been generated in the last decade. After the financial crisis of 2008, the Federal Reserve embarked on a decade-long policy of historically low interest rates in the hope of reflating the economy. The policy succeeded in stimulating economic activity, resulting in economic expansion, and driving the unemployment rate down to the low single digits. This post-recession economic expansion was fueled by debt though, and debt is now increasing more rapidly than economic growth.

The problem with excessively low interest rates is that they stimulate borrowing, and much of that borrowed money has inflated the price of financial assets. A recent study by Deutsche Bank found that a combination of global stocks and bonds may be at the most elevated prices since 1800.

The world has taken on immense amounts of debt in the past decade. Much of this borrowing has found its way on to corporate balance sheets and has been used to push stock prices higher, via share buybacks and corporate acquisitions. In recent years, corporate debt has increased by approximately 60 percent, while corporate earnings have increased by only 27 percent. According to the Federal Reserve, U.S. corporate debt has climbed to an all-time high and now equates to nearly 46 percent of GDP. As interest rates continue to rise, servicing these debts will become more costly for corporations, a problem compounded by the prospect of an economic slowdown weakening profits.

The Federal Reserve now faces the challenge of normalizing interest rates without precipitating a sell-off of financial assets. The long-term benchmark interest rate will have to increase from the current rate of 3 percent to a yield of 5 percent to get back to the level it was at before the 2008 financial crisis. If history is any guide, the Federal Reserve is unlikely to strike the right balance.

U.S. Stocks Valuation models such as the cyclically adjusted P/E (CAPE ratio) and the market cap/GDP ratio show, despite the recent sell-off, that the stock market remains extremely expensive. At the time of writing, the total market cap, as tracked by the Wilshire Total Market Index, to GDP ratio stands at 131 percent.

The only time the market has been more overvalued was just before the dotcom bubble burst in 2000. Equity analysts, on the other hand, prefer to use forecasted earnings as a method to determine the attractiveness of stocks. Many expect earnings to increase by 9-10 percent in 2019 and believe the stock market returns will be very rewarding. Should earnings fail to live up to expectations, and with valuation models already stretched, there would be little support for stock prices at current levels. Equity analysts may be correct, but they are facing strong headwinds from increasing signs of global economic deceleration (not recession) and rising interest rates. In this environment, it would be prudent for investors to be cautious. Allocations to stocks should be consistent with investors' time horizon and risk tolerance. Various hedging techniques, such as "covered call" writing and "protective put" option buying, are justified for conservative investors. Possible events such as a reversal of the Federal Reserve's stated interest rate policy or the settlement of trade disputes would be a boost to the market. This would be an opportunity to harvest some gains and rebalance portfolios.

In a year that will likely see spikes of volatility and uncertain earnings, we prefer stocks from companies with strong balance sheets and low leverage.

Bonds

With a growing sense of unease about economic growth and increasing volatility, the relative security of the bond market becomes more appealing. The Fed's recent rate increases, and their later eye toward moderation, have resulted in higher yields and a flatter curve. In this environment, we believe short-to-medium term bonds, such as U.S. Treasuries with maturities between 3 and 10 years, are likely to generate income while serving as a ballast against the possibility of a recession or equities sell-off. U.S. Treasuries are highly sensitive to interest rates, so if the Fed does decide to sharply raise rates, it could have a negative impact on returns. The risk of this remains relatively low though, and we feel that Treasury bonds will remain an attractive way to diversify your portfolio, navigate equity volatility and generate income.

In the corporate bond market, we recommend balancing high-quality investment-grade bonds with a modest allocation of high yield bonds. It is important to note though that investment grade does not mean what it once did. Investment grade bonds are those rated between AAA and BBB-, with those closer to AAA being safer. In the debt-fueled economic recovery of the last decade, the BBB bond market has rocketed from $686 billion to $2.5 trillion. More than half of all investment grade bonds now sit just above the threshold of being considered high yield, or "junk." This could mean that these lower tier bonds will exceed their average performance and return higher yields. There also exists the possibility that, if the economy slows, these bonds could see a credit downgrade, triggering a sell off, resulting in big losses. It is important that your allocation of corporate bonds aligns with your level of risk tolerance.

Municipal Bonds

For those in high tax brackets, one option to diversify your portfolio and guard against volatility in the equity markets is to include municipal bonds. Municipal bonds are generally tax exempt at the federal level, and exempt at the state and local level if the investor lives in the state where they are issued. For investors in lower tax brackets, higher yields can be attained with other fixed income investments like corporate or treasury bonds.

While the Russel 3000 was down more than 5 percent last year, the S&P Municipal Bond Index saw a gain of 1.36 percent, and 2019 is expected to continue apace. The coming year is expected to see a negative net supply for muni bonds, meaning that the total number of new issues is lower than the number that are called or reach maturity. A negative net supply generally means increased performance. The Fed's recent pivot to a more moderate stance regarding interest rate increases lowers the interest risk that can come with muni bonds.

Though municipal bonds generally have strong credit ratings, there are some areas of risk in certain municipalities, such as a lack of economic diversity, poor demographic trends, or underfunded pensions, and there is the possibility that a major infrastructure bill could result in an increase in new muni bond issues, hindering performance. Despite these potential risks, municipal bonds may be an attractive way to diversify in 2019.

International Markets

The tail end of 2018 saw several economists predict a slowdown in global economic growth, and we expect this year to bear that out. The IMF recently cut its forecast for world economic growth to 3.5 percent in the coming year. This marks the third consecutive quarter in which they have lowered projections.

In the developed markets, Europe is expected to have slow earnings growth and has several impediments to the region's economic momentum. The region faces policy issues such as tight regulations and labor laws, as well as political issues like Brexit and Italy's budgetary problems. The area is also under-represented in growth areas.

Japan will benefit from accommodative fiscal policy, strong corporate fundamentals, and relatively cheap valuations, but there is little indication of sustained outperformance. There will be another increase in the value added tax later in the year, which may negatively impact business conditions, and the nation's economic growth may peak this year.

Emerging markets will face headwinds from the strength of the American dollar and concerns about trade. Currency concerns could moderate if U.S. economic growth slows relative to other nations and the dollar weakens.

China's economic momentum has decelerated recently, facing trade disputes with the U.S. and slowing economic growth. If growth continues to lag, policymakers will likely alter fiscal policy to spur growth, but a severe slowdown or escalated trade war could pose a risk to the entire Asian region.

Looking Ahead

2019 will be a year of uncertainty. Economic growth is expected to slow and it is unclear how the Fed will direct monetary policy in the coming year. This is occurring at a time when global assets values are extremely high. The aforementioned Deutsche Bank report concludes that "while there are no obvious triggers for historically high global asset valuations to correct, while they remain this high there is always a risk of a sudden correction that could be destabilizing to a financial system and global economy." While there may not be an obvious catalyst for a major crisis, a correction of some size is likely based on where we are in the economic cycle.

The Economic Cycle Research Institute (ECRI) tracks the natural cycles of economic growth as it accelerates and decelerates. ECRI's leading growth indicators indicate that we are in a growth rate cycle

(GRC) downturn. ECRI notes that in all four of the GRC downturns since 2008, there has been a correction in the equities market of 10-20 percent. The risk of another correction remains until the leading indicators show an upturn in growth.

In the current environment, it is important for investors to assess the level of risk they are comfortable with, and consider ways they can protect their portfolios. One method would be to allocate more of your portfolio to U.S. Treasury Bonds. Treasuries historically have a low, or even negative, correlation to the stock market, meaning that as stock prices drop, Treasury bonds can be expected to hold their value or even see an increase. In 2008, at the height of the financial crisis, the total return for the stock market was about -37 percent. Long term U.S. government bonds, on the other hand, saw a total return of +27 percent. U.S. Treasuries are also backed by the full faith and credit of the U.S. government, so the risk of default is exceedingly low.

Another method of protecting one's portfolio would be to implement covered call writing and protective puts. A covered call is a stock option in which an investor agrees to sell shares of a stock that they already own if the stock rises to an agreed upon price. The buyer pays a premium for this option, allowing the investor to increase the income earned on assets they already own, and offsetting potential losses if the stock's value falls. Protective puts are essentially insurance on stocks, allowing an investor to set the lowest price they are willing to let a stock drop to before putting it off on a buyer, protecting them from additional losses. These options, when used conservatively rather than speculatively, can help your portfolio maintain its value amongst the fluctuations of a volatile market.

Hanover Advisor Bulletins

Special Reminders to all Hanover Clients

- **New enhancements to our portfolio reporting system**. All Hanover clients have free access to our internet-based reporting system known as Black Diamond. This robust system provides comprehensive performance reporting, asset allocation and risk assessment on clients' portfolios. The system will have a new look and major enhancements starting this fall. Our office is available to assist in accessing and utilizing the Black Diamond system.

- As a reminder to our clients, Hanover Advisors, Inc. now has an office in Greenville, SC. Meetings can be scheduled at either the Greenville office or our conference facilities at Concourse Parkway in Atlanta. Please see our website, HanoverAdvisorsInc.com, for detailed contact information.

- We want to invite all clients to contact our office to schedule a portfolio review. We would be happy to coordinate a sit-down meeting, a conference call, or an online meeting at your convenience. Please call our office to schedule an appointment.

- Tax season is here, and we want to inform you that the 2018 1099 Tax statement drafts are available. The final revised copy will be mailed out in the upcoming weeks. If you have any questions or concerns about tax statements and documents please call our office.

- Please see our quarterly review of the financial markets on our website at HanoverAdvisorsInc.com. Please click on "Insights" and then "Video/Presentations" to find the quarterly reports.

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