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THE ADVISOR

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With the Yield Curve Fully Inverted, Is the Clock Ticking Toward Recession?

After hitting new record highs in late July, each of the major stock market indexes started August with a drop. The market regained some of those losses only to drop again the following week, then repeated the cycle as the month ended. While another escalation in the Trump-China trade war was partly to blame for the volatility, many other factors are likely to continue making Big Investors nervous that the next recession and major market correction may be just around the corner.

Shortly before the G7 Summit in mid-August, President Trump and Chinese President Xi Jinping both announced plans for more tariffs, and on the same day the Dow Jones Industrial Average dropped 623 points, while the S&P 500 closed about 6% off its record high.[1] More significantly, at around the same time, the U.S. yield curve became fully inverted. While we've been discussing the significance of a flat or inverted yield curve for several years now, most of the financial media has only begun to pay attention to it recently.

It started making headlines on December 3 last year when the yield on the 5-Year note fell slightly lower than the 3-Year note. But that was only the beginning. The inversion culminated in mid-August when the yield on the 10-Year Treasury fell below the 2-Year note, and the 30-Year bond closed below 2% for the first time ever.[2] The 10-Year yield was already lower than the Federal Reserve's benchmark short-term interest rate despite the Fed lowering rates to 2.25% at its July meeting.

In a normal yield curve, short-term bills yield less than the long-term bonds, and investors expect a lower return when their money is tied up for a shorter period. When a yield curve inverts, it's because investors have little confidence in the long-term economy. That's why an inverted yield curve is said to be one of the most accurate indicators of a coming recession — and history bears out that accuracy. According to studies, an inverted yield curve has preceded every domestic recession since 1955.[3]

Will This Time Be Different?

Nonetheless, there are always some economists who make the argument that "this time will be different." When the curve inverted prior the Great Recession in 2008, for instance, the Fed tried to explain it away by saying a "global savings glut" was pushing excess cash into U.S. treasuries, driving down yields and creating an unreliable recession indicator.[4] Obviously, they were wrong.

One of the arguments some economists are making for why this time will be different is that this inverted yield curve is not really being caused by a projected major slowdown in growth for the U.S. economy, but by the global economic situation. Many countries across Europe also have inverted or partially inverted yield curves now, and even in coun-

Continued on page 2

When Should You Sell?

Most information about stock investing seems to discuss buying, but to actually profit from a stock investment, it must be sold. For many investors, selling a stock is the most difficult decision.

The reason selling is difficult for some investors is the fear of missing out on future profits. Let's say an investor purchases a stock at $30 per share and decides to sell when the stock reaches $35 per share. But when the stock reaches $35, the investor thinks it is doing so well that it will surely rise more. The stock then drops to $31 and the investor decides to wait until it reaches $35 again. Then the stock takes another tumble

Continued on page 3

With the Yield Curve

Continued from page 1

tries where the yield curves aren't inverted, such as Germany, interest rates are still in negative territory. Some economists say this is the real force pushing down U.S. interest rates, more so than a slowing demand for goods and services that will trigger a recession.

While there is some merit to that argument, it overlooks a key point: an inverted yield curve isn't always just a symptom of recession; sometimes it's a primary cause. The real damaging part of the inversion isn't that investors have little confidence in the economy, but that banks and other lending institutions suffer real fiscal consequences when the yield curve inverts. With long-term interest rates lower than short-term rates, banks have to pay depositors more than they get back from borrowers. They lose their financial incentive to lend and end up tightening their underwriting standards and approving fewer loans. That affects home sales, car sales, business start-ups, and a host of other areas crucial to economic growth.

So we disagree that "this time will be different." At the end of the day, even if U.S. growth were to remain strong but other economies around the world continued to struggle, we would ultimately feel the impact. Even if you're the "cleanest dirty shirt" in the hamper, you're still going to collect dirt off the other shirts. The bond market (which is said to be smarter than the stock market) knows this, and that's just one reason why its most reliable recession warning signal — the inverted yield curve — is flashing red.

Ahead of the Curve

With all of this in mind, we're in a "sweet spot" right now for investors who haven't yet reduced their stock market risk by switching their strategic focus from growth to income. Although the market has been volatile and trading sideways since early 2018, it still hasn't started that major sustained drop that is likely to coincide with the next recession. There is still time to reduce your market exposure and avoid getting caught in the next downdraft. How much time? No one knows for sure, and the market may even eke out another new record high before the recession begins. But is it worth risking a major loss in hopes of getting a minimal gain?

As mentioned in last month's newsletter, the current environment also creates a good opportunity for Income Specialists to demonstrate why investing-for-income is a sound strategy regardless of market conditions. While overall low interest rates do make it challenging to get good competitive yields, rest assured that advisors who specialize in active management are making the strategic adjustments necessary to meet that challenge on behalf of our clients. That's the beauty of the income model: it isn't based on crossing your fingers and hoping for growth; it's based on real strategies that can be modified and amended to keep you ahead of the curve — even when the curve inverts!

[1]"Five Things to Know Before the Stock Market Opens Monday," CNBC, Aug. 26, 2016

[2]"30-Year Treasury Yield Falls Below 2% For the First Time, CNBC, Aug. 14, 2016

[3]"Inverted Yield Curve and Why It Predicts a Recession," The Balance, Aug. 27, 2019

[4]"This Time is Not Different for the Inverted Yield Curve, CNBC, Aug. 28, 2019

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Learning Lessons from the Stock Market

If you pay attention to the stock market, you can learn some valuable lessons:

- **The market tends to revert to the mean.** When the stock market has an extended period of above or below average returns, it has a tendency to revert back to the average return.
- **Don't chase performance.** Investors often move out of sectors that are not performing well, moving money to investments that are currently high performers. But the market is cyclical, and often those high performers are poised to underperform, while the sectors just sold are ready to outperform. A classic example is technology stocks in early 2000.
- **Avoid strategies designed to get rich quick.** The stock market is a place for investment, not speculation. When your expectations are too high, you have a tendency to chase after high-risk investments.
- **Don't avoid selling a stock because you have a loss.** When selling a stock with a loss, an investor has to admit that he/she made a mistake, which is psychologically difficult to do. When evaluating your stock investments, objectively review the prospects of each one, making decisions to hold or sell on that basis.
- **Make sure an investment will add diversification benefits to your portfolio.** It's common for investors to keep adding investments that are similar in nature. This does not add much in the way of diversification, while making the portfolio more difficult to monitor.
- **Check your portfolio's performance periodically.** Compare your actual return to your targeted return. Now honestly assess how well your portfolio is performing. Are major changes needed?
- **No one knows where the market is headed.** So don't pay attention to gloomy or optimistic predictions. Instead, approach investing with a formal plan so you can make informed decisions with confidence.

When Should You Sell?

Continued from page 1

to $24 and the investor just lost all the profit, plus some of the initial investment.

If selling is dictated by emotion rather than a well-thought-out plan, it is very likely to play out as described in the example above. A good selling decision may leave some profit on the table, but it should be determined by a rational analysis of valuation and price. The most successful investors do not focus on market timing by trying to sell at the highest price; instead, they focus on buying at one price and selling at a higher price.

If you have a difficult time with selling, you should consider using a limit order. This type of order will automatically sell the stock when it reaches your target selling price.

When to Sell

You should decide when to sell a stock at the time of purchase. Following are examples when you should consider selling based on your personal financial situation, as well as warning signs with the companies you are invested in:

- If you are losing sleep over a particular investment, it may be worth reducing your emotional distress to sell even at a small gain or loss.
- If you need money in the next three years to purchase a home or send a child to college, you should pull the money out while you know you have it.
- To help reduce tax payments, you may want to look for investment losses to offset other gains.
- If your portfolio is shifting from your original asset allocation, you will want to rebalance it to get back on track.
- Watch your stocks for a high price/earnings (P/E) ratio, which compares the company's recent earning to its stock price. If the P/E ratio is high, it can be an indicator that the stock is overpriced.
- Keep an eye on the company's competitive advantage. If others have come up with a new product or technology, they can erode their market share.
- If the company makes a drastic change in direction or management, it may indicate a problem with its business model. Research the changes and follow your instincts about the company's future.
- If a company's sales are falling, it may be signaling a problem. While all companies will go through slumps, if other competitors are experiencing growth during the same time period, it may be time to sell.
- When there is a trend of shrinking profits, it means the company's expenses are rising faster than its revenues, and it's having a hard time keeping profits up.
- If a company cuts its dividend payment, it may be a signal that it is expecting lower earnings and less growth.

Please call if you would like to discuss this topic in more detail.

Principles of Stock Diversification

Diversification is a practice that investors use to reduce risk and maximize returns by investing in various industries that will most likely react differently to the same event in the market.

When investing, there are two types of risk one faces:

- **Undiversifiable** — Also known as systematic or market risk, this is risk that all companies are exposed to and includes inflation, interest rates, exchange rates, political instability, etc. This risk is just the price of doing business, as all investors must assume it.
- **Diversifiable** — Also known as unsystematic risk, this is risk that can be specific to a company, industry, market, or country. Diversification can help manage and reduce this risk.

How to Diversify

Most experts agree that diversification is extremely important to reaching long-term goals while mitigating risk. A properly diversified equity portfolio should hold stocks from different industries, company sizes, valuations, growth rates, and countries to help reduce volatility and limit exposure to a permanent loss of capital.

The more uncorrelated the stocks in your portfolio are, the more you are limiting your risk exposure.

Let's say you have a portfolio of only automotive stocks and it appears there will be a strike. Most likely, all of the automotive stocks will experience some drop in their share prices, and in turn, you will see a noticeable drop in value.

However, if you have stocks in other industries that are performing well, you will be able to offset some of that loss and some of the mental anguish that goes along with it.

How Many Stocks Should You Own?

While there is always debate about how many stocks to own in a well-diversified portfolio, most experts agree that 15 to 20 stocks across different industries is optimal. This portfolio size is manageable, yet it allows you some room for losses.

The other extreme is overdiversification where investors hold too many stocks, which makes it almost impossible to know the companies well. Not being knowledgeable about your stock investments can lead to making irrational decisions, which will negatively impact your portfolio returns. The key is to strike an appropriate balance.

Another impact of overdiversification is that an investor can become indifferent regarding his/her investment decisions. If you're holding over 100 stocks, any individual stock might represent only a small percentage of the total portfolio. If the stock turns out to be a loser, it won't cost you very much; but if it provides great returns, you won't reap the benefits either.

Diversifying your stock portfolio will help you manage the risk of the price movements of your assets, but it can't completely eliminate risk and volatility. Please call if you'd like to discuss diversification in more detail.

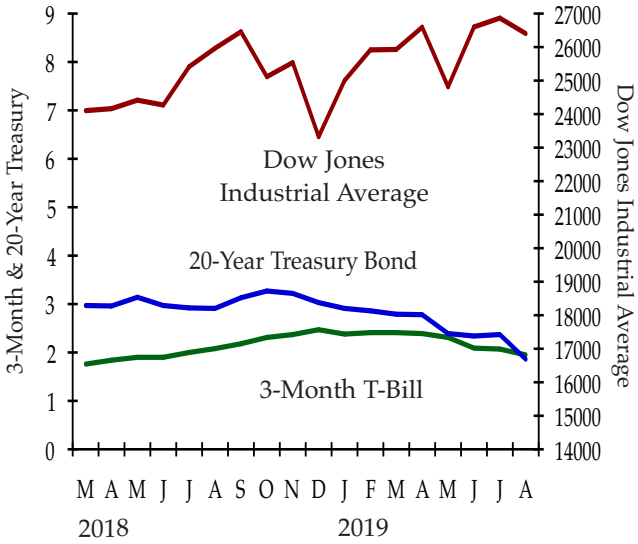
Business Data

Indicator	Month-end Jun-19	Jul-19	Aug-19	Dec-18	Aug-18
Prime rate	5.50	5.50	5.25	5.50	5.00
3-month T-bill yield	2.09	2.07	1.95	2.47	2.08
10-year T-note yield	2.05	2.07	1.58	2.89	2.83
20-year T-bond yield	2.34	2.37	1.86	3.03	2.91
Dow Jones Corp.	3.22	3.21	2.86	4.40	3.84
GDP (adj. annual rate)#	+2.20	+3.10	+2.00	+2.20	+4.20

Indicator	Month-end Jun-19	Jul-19	Aug-19	% Change YTD	12-Mon.
Dow Jones Industrials	26599.96	26864.27	26403.28	13.2%	1.7%
Standard & Poor's 500	2941.76	2980.38	2926.46	16.7%	0.9%
Nasdaq Composite	8006.24	8175.42	7962.88	20.0%	-1.8%
Gold	1409.00	1427.55	1528.40	19.3%	27.1%
Unemployment rate@	3.60	3.70	3.70	0.0%	-5.1%
Consumer price index@	256.09	256.14	256.57	1.8%	1.8%

— 4th, 1st, 2nd quarter @ — May, Jun, Jul Sources: *Barron's, Wall Street Journal*
Past performance is not a guarantee of future results.

18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield
March 2018 to August 2019



How Much of Your Portfolio Should Be in Stock?

One of the most often asked questions is how much of a portfolio should consist of stocks. It's a good question, and one that doesn't always have a clear-cut answer. The amount of stocks you should have in your portfolio will vary depending upon a number of different factors, including your age, current net worth, and penchant for taking risks. Still, there are a few basic rules of thumb that are worth adhering to, which should make fleshing out your portfolio less stressful.

If you're saving for retirement, most financial planners will recommend that the younger you are, the more of your portfolio should be allocated to stocks. Stocks are a relatively risky and volatile form of investment. When we're young, taking risks tends to come along with less catastrophic consequences than when we're nearing retirement age. If formulas work for you, the general idea is to subtract your age from the number 100 to wind up with a safe percentage of stocks versus other investments. For example, 30-year-olds will often do well by allotting 70% of their portfolios to stocks, while 60-year-olds may want to reduce this percentage to 40%.

Of course, age is just one factor that influences portfolio allocations, and there are more aspects that need to be taken into consideration. The best way to ensure your portfolio is properly divided is to work with a financial planner who is fully aware of your situation and can make educated suggestions. After all, a formula can only get you so far, and personal recommendations will always be more valuable than guesswork. FR2019-0522-0102

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