

## Left Behind

Because of the market's remarkably strong, sustained bull-run, it is no surprise that some investors have become a bit complacent about doing any difficult or time-consuming due diligence regarding market research. After all, hasn't just about everything gone right with portfolios since last September? Intoxicatingly, investors have come to believe that every cloud has a silver lining.

But a deeper look at "*everything going right*" reveals that not everything is in proper order, nor are economic signals completely convergent with definitional understanding of what is "consequential" to our overall economic well being.

Obviously, no one knows for sure whether the bull will continue or collapse by the weight of its own success. What we do know, however, is that there are uneven probabilities ahead for capital appreciation given the wide diversity of economic news and its impact upon each sector individually.

Interesting, for example, that even as the averages are peaking near all-time highs a significant proportion of sectors are lagging in their performance. The best performing groups are the most defensive (utilities, non-cyclicals, basic materials).... typically a sign that money is seeking safe-haven versus randomly aggressive speculation. Will the market capitulate as a result? Once again, no one can say categorically. What we can do is read the tea leaves and respond to the probabilities as laid out before us accordingly.

It is also irrefutable that sentiment indicators as well as anecdotal evidence indicates that the public is far more skeptical, albeit hopeful, of this bull market than one might expect in a prototypical bull market run the magnitude of which we are currently experiencing.

Why is this so? In part because investors have no choice but to buy stocks knowing that interest rates are so low. Savings accounts and time deposit purchases are no alternative to equities at these levels. Thus, when or if a panic were to set in a pullback might be more enhanced, deeper and swifter, with the potential to inflict more damage to the "average" portfolio than if it were suitably diversified by asset class.

This is why, in our opinion, television news and 24 hour accesses to current events have become disproportionately influential. Depending upon which extreme point of view you hold, you're either *winning* or *losing*....in politics, investing, and life!! This kind of absolutism is no way to build long term portfolio success. Lacking a comprehensive discipline and failing to have a macro global view of things in general usually leads to panic when things don't go exactly as you had planned. Dogma and hyperbole are simply too short-sighted from our point of view, and a recipe for portfolio disaster. Sometimes, a subtle bit of patience yields a more optimal result.

In this author's judgment anything which leads to upside *or* downside knee-jerk responses raises the probability of affecting exactly the opposite outcome than expected.

Our research has screened and correlated a number of economic statistics and has come to the conclusion that, despite resounding stock market advances, a large percentage of the world's population are actually falling behind financially, are being left in the wake of market momentum, or are feeling disassociated from economic events that are happening around them. The wealth gap is widening as more and more money is being localized into fewer and fewer nexuses.

Moreover, the tenor of economic conversation is becoming more harsh, more adversarial. It seems that the dialogue is more "*us versus them*" in tone...as if those with financial advantage have something to protect. Their greatest fear, one assumes, is becoming like those they detest. In that type of environment the barrage from daily business news channels becomes either an affirmation of one's largesse or a 24 hour constant reminder of warning shots being fired across the bow. Mankind is losing what is human and humble about the acquisition of wealth.

Unquestionably, we still see overall metrics as strong and likely to provide further validation for equity exposure and growing economic output. But it is becoming increasingly more difficult to ignore the widening gap between those who have benefited from the market's good fortune and those who have failed to "keep up" for reasons related to technology, geography, corporate accounting, ethnicity, education, or otherwise. We truly have lost a sense of "oneness" as a culture. The pursuit of wealth is supplanting a pursuit of life's deeper meaning. To be fair, this is not an either/or discussion, but no doubt the equilibriums and imbalances of rich/poor, young/old are shifting over the generations.

## Markets

A difficult quarter lies ahead as the markets try to digest a dominion of political, fundamental, economic, and current events. Against the backdrop of a market rally already long-in-the-tooth we must position portfolios to defense against any unforeseen negative occurrences while still holding sufficient capital in abeyance should the opportunity for one-off purchases occur.

Given the complexity of this intersection, we opt for caution over aggression while the world processes Brexit, terrorism, political discord, and highly charged institutional debate. We do not foresee a calamitous event bringing the market to a halt, but rather a natural recoil of *any* cycle that measures at the apex of its time line. It is not at all unusual to expect that a "linear upside rally" be followed by a cyclical capitulation.

We reaffirm that global economic fundamentals are improving. Demand for energy, food, housing, medicine, tangible materials, and human resources has been increasing to near pre-recession levels. There are no indications...at least as of yet...that the cost of money (interest rates) has become prohibitive. In fact, low interest rates serve as an ardent reason for predicting stock market and economic rallies.

Still, we don't want to appear to be abandoning all logic or scientific reasoning. The Federal Reserve and global central banks have recently given strong indication that they are ready to reverse stimulus in favor of a more restrained monetary policy, giving us every reason to anticipate higher interest rates and a reversion back to historically equivalent monetary valuation. The "bubble" will not burst, as Fed Chair Yellen said last week, but a period of tighter money might have a disquieting effect in the near-term upon stock speculation.

With global monetary policy uppermost in our focus, we nevertheless are still waiting for US fiscal (government-related) action on important issues such as healthcare, infrastructure, and taxation. Thus far we are duly unimpressed, seeing no indication that these debates will lead to funding and action that births meaningful outcomes. Cooperation between the political parties is at a stalemate. The impasse has the potential to exacerbate any vulnerabilities within the financial markets, particularly in those sectors that rely upon legislative certainty.

After a very strong first half of the year, we worry that stocks will moderate their pace of acceleration, perhaps even falling in absolute terms for the current quarter by as much as 3 to 7 percent. How else to justify runaway upward spirals without pause or contraction for over 6 months?

Against this backdrop, and with the unusual inert political overlay of our times, we prefer investment in companies that have strong and consistent earnings, that perform in a variety of market circumstances irrespective of current events or political suasion. A new market up-leg might indeed materialize as there seems to be no slowdown in the appetite for portfolio ideas. But those sectors into which we choose to allocate reside at the "back-end" of an economic cycle rather than at its initiation. You and I are becoming much more circumspect about how and when we select to buy something, and that is likely to continue, and to reverberate throughout a tenuous marketplace.

There is also a fertile opportunity to begin anew at punctuating portfolios with fixed income products. In a climate where policy initiatives have pushed interest rates to historically low levels, one has to expect that increased economic output will also lead to a gradual redirection of the cost of money. "*Lower rates*" does not mean "*forever* lower rates". Eventually the correlations between stocks and bonds will neutralize to nominal levels. So, too, will the balance between *requiring* taking too much risk and *choosing* to do so. We seek a balance between short-term risk-taking and longer term reward in time deposits. Laddering maturities with careful due diligence is another portfolio option going forward.

## Conclusion

Markets are likely to be handcuffed by an unfortunate conjunction of political discord and excessive stock valuation. Ultimately, our political institutions control the ending to the story. Assuming even a modest compromise between the opposing sides, this quarter...this year...has enormous potential to yield a healthy rendition to the bull rally. Those endeavors, however, which are perceived domestically or worldwide as political chicanery, unilateral power grabs, or deconstructive to social and moral values are doomed to disrupt economic forecasting, financial estimates, and personal expectations about one's aspiration to the next rung up the ladder.

## Suggested Balanced Account Asset Allocation, Q3, 2017

**Equities: 50%**  
**Fixed Income: 23%**  
**Cash: 27%**

Arlington Econometrics is a quantitative market tool. Utilizing proprietary algorithmic equations, AE offers solutions for market-timing, asset allocation, and macro economic analysis. Using historical time-series measurements, Arlington Econometrics optimizes the analytical process and forecasting coefficients to make economic forecasting more objective.

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