KEEN ON RETIREMENT

July 2019 Market Update Webinar
With Matt Wilson

Welcome to Keen on Retirement
With Bill Keen and Steve Sanduski

Bill Keen: Hello everyone. Bill here. I wanted to take a moment to introduce our podcast today. We have a special treat in that we are releasing the audio portion of a recent market update webinar conducted by the chief investment officer of Keen Wealth Advisors, Matt Wilson. Now Matt takes a look back at what happened in the second quarter of 2019 in the markets, in the economy. And even more importantly, he takes a look ahead at what may be in store for the remainder of the year. We talk a lot in our episodes about understanding how to separate the news from the noise. And Matt does a wonderful job in providing you the information that we think you should be looking at, if indeed you have an interest to try and stay up with what's happening in the markets and the economy.

Now this information is on the keenonretirement.com website in webinar form, meaning that if you go there, you can watch this presentation and see all of the slides that Matt so deliberately puts together and walks through. While I believe that's the better way to consume this information, if you choose to just listen to this podcast, I think you will garner some wonderful bits of information as well, to help you consider what may be coming down the road. And remember, we always say that the investments are just the engine to someone's total plan. The financial planning, having a plan, being thoughtful, being intentional, making sure that the investment portfolio is structured in a way to support that financial plan is always what's most important. It's always the why behind what we're doing when we're helping people manage their investments. So with that in mind, I hope you enjoy this episode.

Matt Wilson: Welcome, everyone. I'm excited to get started today. Thanks for attending our market update webinar. As always, I have a lot of great information for you. And we will take questions at the end of the broadcast, but feel free to just type those in as they come up throughout the presentation. And then I will address those at the end, time permitting. And if we don't get to those at the end of the webinar, I'll reach out to you personally and kind of discuss those questions with you. But yes, as I mentioned, I have a lot of great information. This is our update, kind of a midyear update. We're halfway through 2019, and yeah, feels just like we had New Year's, and now we're at just past July 4th, so this next half of the year will probably go by just as quick, if not faster. And a lot of good things, though, to look forward to.

Now my goal with these presentations is to just help you understand what's happening in the economy. There is so much information out there, and a lot of it doesn't matter. And when I say it doesn't matter, it doesn't matter in the sense that it impacts stock prices. So what I'm going to focus on is the information that matters, that impacts investments, impacts stock prices. And so we'll kind of talk about the different dynamics with that today. But I'll start with just some information on where the market's at today, what we've gone through over this last several years, and even taking it through what we expect to happen for the rest of the year, looking at the Fed, and earnings, and some of the other components to the investment landscape.

It'll be kind of interesting then. Where do we go from here after such a strong start to the year? With the stock market, I'm going to start with that, and some of these bullet points that I have on here about stocks have Powell protection. And Jerome Powell is the chairman of the Federal Reserve. And I'll show you what the impact that his policy stance, and that with the Federal Reserve Committee, what the impact that that has on stock prices, and what we expect things to look like here. This is going back to 2016, and a lot of different headlines here, lot of different data on this chart. But what I want to point out is, I've got my cursor just highlighted over this, this is the September, end of September, early October high in the market of 2018. And what followed was a significant pullback down to the bottom in the market in December of 2018, which was about a 20% drop from the high, which for all intents and purposes, that's considered a bear market, at least in my eyes.

Then we had a large rally, very strong rally, through the end of Q one, had some volatility in Q two, but finished Q two strong at all time highs. And we're basically sitting still at all time highs again today. And the reason is because the economy and the fundamentals that drive the economy are strong. But we also have had some headlines here from Powell and others that have driven some of the recent rallies, I believe. We've got here, Powell, he kept saying back then that we're a long way from neutral, and we're going to continue to raise rates. And they did in October. And then they did again in December, significant drop there. And then after the first of the year, they took an about face, they basically admitted that they were wrong and that they aren't going to raise rates up to 3%. They're going to keep them where they're at. And they may actually reduce rates. And that's what the pursuing rally confirmed.

Now then in May, we had some tariff issues, full blown, or potential full blown tariffs in the China case, and then also some from Mexico. Brought the market back down, and then again, Powell came out and said they will act as appropriate to sustain the expansion. And so markets are rebounding on some of that news. Now I show this chart, this goes back to 1957, and the reason I show this is because the volatility, what we just went through, all the different reasons, those will change from time to time. They will always be different. Powell's saying this today. We have the China issues today. We have global growth issues, different things today that are impacting stock prices, but we've gone through different things historically. This goes back again to 1957. And you can see some of the major headlines around the stock market back then.

And the market continues to grind higher. And this is actually just a trend line that I drew, which is right around 7% per year. Now this is on a price return basis. This does not included dividends. And dividend yields, if you add that back in, gets you very close to that 10% long-term return that we talk about. Now I show this trend line because the other thing to take away from this is, we're right on trend. This is looking back to 1957 to where we're at today. We're not significantly over or undervalued as compared to this trend. Look back here in the late '90s, markets were way overvalued against this trend. And then in 2008, 2009, way undervalued. And so the recent rally over the last decade has just gotten us back to trend line. So I think that's important to kind of take that long-term perspective and kind of see that data.

But why do stock prices continue to grind higher? Well, stock prices are just a function of corporate earnings. That is what they are. And I think this displays this very well, very easy to see. This is the earnings of the S&P 500, so S&P 500 is just a benchmark for the US market. It's the top 500 largest companies in the US. And this is their earnings on a year to year basis. You can kind of see how that trends higher. I've got the boxes up here for 2019 and 2020. That's the estimate for earnings for the rest of this year, and then going into 2020. Now overlaid with that is now the actual value of the stock market in the black line. You can see it. It trends very closely. There's a very high correlation with earnings and stock prices. Again, in the late '90s, stock prices were significantly higher than earnings were, and that led to the big crash in the early 2000s.

Now in '07, '08, stock prices actually weren't significantly overvalued as compared to earnings. There were other factors that caused that correction. But you can see where we're at today. Now I'm going to show this. Actually, I have data to support this. But two things that were consistent, so the reasons for the sell off in the early 2000s, and the sell off in '07, '08, were different. This one was earnings weren't keeping up with stock prices, and so there was a lot of over valuation, less an over valuation, more leverage in the system. But what was happening in both of these cases where we had the economy start to weaken, both of those cases, that was happening. And so I'll show you the data that tells us. Okay, well, is the economy continuing to grow and expand? Or is it going to maybe start to peak here, and roll over and start to weaken? Because that is what we're concerned about because the causes of the next recession or the next major market meltdown, it's hard to say exactly what those will be.

They'll be different every single time. But there will be some key indicators within the economy to help us identify when those happen. Now let's look at the economic environment. Where are we at today? The economy, it is slowing. Now it's not going negative, it's just not growing as fast as it did compared to 2018. And we're seeing a lot of slow growth in the manufacturing index, that's where purchasing manufacturing index, and there's other surveys that look at manufacturing companies, and they're definitely signaling some weak demand. Some of that is due to the issues with the tariffs and also some just global slowness across the world. And also, we have the leading economic index, which is a ... It's a composite of 10 different indicators that look at the data points that lead the economy.

That's things like average workweek, and initial jobless claims, and the stock market is one of them, and interest rates and things like that. And it tells us if this composite index is starting to roll over, that signals that there's going to be, most likely, a recession in the next 12 to 13 months. That's about the lag time that it gives us. Right now, it's not rolling over. It's just flat. And it's been flat several times over the last decade, so that isn't necessarily a cause of concern, but it is something that we pay attention to. Now moving forward, these are all the things that are actually going well within the economy, so that's why I don't believe that the weaker PMI or the flat leading economic index is going to roll over and lead to a recession because we have all of this additional data, which is very, very strong right now.

Now let me just touch on the trade war for a minute here. The president, the administration, they have instituted the trade war. It's not full blown yet. They did put a pause on that. But I think the reaction to the news on whether we're having a trade war, or if the trade war's going away, is a little bit overdone. And the reason is because our trade with China, while a large number, is not very large as a percentage of our total economy. So this very first column, this is US GDP, and this is everything that we produce here in the US in a given year, so the total value of all the goods and services. And it's $19.4 trillion. And then down the line, I've got our imports, exports, and then broken out to what we have with China specifically.

And the key to this is that our US exports to China, they only comprise 1% of GDP. Now China's exports to the US are significantly higher, and that's why the tariffs hurt the Chinese economy much worse than it hurts the US. Now of course, there's going to be industries that are impacted by this much more than the economy as a whole here in the US and different businesses and what have you. But there has been a lot of different research done on this, and the estimates, if we have a full blown tariff. It's not even where we're at today, but if the full blown tariffs come out, Goldman Sachs and other institutions have said they would expect that to reduce GDP growth. So in the previous slide, I showed that we were growing 3% on a year over year basis at the end of Q one, we're about 1.5% for Q two. It would shave off about .15 percentage points, so not even a quarter percent. And that could be on the high side, a quarter percent. They give us a range, .15% to a quarter percent.

But that's the impact that the tariffs would have on the US economy, so not recession inducing. That's really the key because media and what have you talking about the trade wars and the impact that it's had, the worry is that it's going to kick us into a recession. It's going to slow down the economy enough, that it's going to cut back spending and cause some layoffs, and then slow down the economy. And that data would not put us into recession. Now those are estimates because what you don't know is: Once they are instituted, will people continue to just still buy Chinese goods, even with the extra tariff? Or would they substitute for another good? We don't know that until after the fact, how consumers will actually behave. But the data doesn't cause us to be alarmed by where the tariffs are at.

Now with all that being said, tariffs aren't good for anybody. As a global economy, they end up hurting everyone, essentially. The people who benefit are the industries that the tariffs are on in the domestic country. That's who benefits the most, so those industries benefit. And typically, it's the producers of the goods. It's the owners of those companies because they're able to raise prices and what have you, and kind of get some extra profits out of the consumers that did not exist because there were no tariffs previously.

But once the tariffs institute that, that kind of sets prices higher, and they can benefit from that. And so when you look at it from just an economic standpoint, tariffs do end up just kind of hurting all the consumers here in the US and in the international space as well. Hard to say how long these will last, but do know that both sides are very wanting to, very willing to get a deal done, and potentially before the election as well because that would be, I think, a nice win for the administration going into all of the debates and what have you that we're going to start to ramp up here over the next 18 months.

Now let's kind of look at the US GDP in a little bit more granular basis. 19.4 trillion economy. Well, how do we ... What is made up of that? Well, 70% of it is consumption. That's 70% of the GDP, the $19.4 trillion is consumers buying goods and services. The next highest component is business investment, so businesses buying goods and services. Now we have then the government is the next largest piece. And then we import more than we export, so that actually takes away from GDP. So we have a net negative trade balance here. And so the key is when we're looking at the direction of the economy and the future of corporate earnings, is to focus on the consumer because our economy here is driven by the consumer. And we want to make sure that the consumers are doing well, because if the consumers are doing well, the economy will do well because the consumer will spend money. And because the economy is doing well, corporate earnings will do well, which would lead to higher stock prices.

That's kind of simplistic kind of circle of the economic machine here. That's why I focus on these things. It's because this is what drives stock prices. Now of course, I always say with the caveat, there's going to be volatility. Any given year, there's going to be events that are going to drive markets higher or lower based on the different dynamics that those have. But if we have the economy doing well, we expect those things to be short lived, and the recoveries to be fairly quickly. Exactly what we've seen over the last 18 months. We had the pullback in Q four of 2018, and then we had the recovery in Q one and Q two. And that is to be expected when we have such a strong economy.

So how is the consumer doing? Well, what this is, this is a graph of real disposable personal income. And this is per capita, so this is all of the people within the United States. So we take all the income. We net inflation out of it, so that's what real means. It means after inflation, and divide by all the individuals here in the US. And disposable income is after taxes too, by the way. So this is money they actually get to spend. This is after taxes, kind of what hits their bank account after their paycheck and what have you, after they receive their investments or distributions from their retirement accounts, after the taxes are paid. This is what they have left to spend.

And what we're concerned about is: Does this line continue to grow and expand? And it has. We had some stagnant periods here, especially coming out of the great financial crisis in '08, '09, going sideways. But since then, since about 2015, we've been on a nice trend higher. And just compared to the previous recovery, we're on pretty much a very similar growth rate as we were back then. And so individuals have more money to spend, net of inflation and net of taxes, so I think that's important. Now what do they spend the money on? Well, this is where this flows through to the economy. Now some of it though is debt service, financial obligations. And that's what this is. This is the financial obligations ratio. And it's extremely strong right now. Going back to 1990s, you can see how this has kind of ebbed and flowed over the years. But since the mid '90s, basically ticked higher up until 2007.

And what that means is that consumers are getting more levered up. They're taking on more debt, and they have more debt service payments relative to their income. Now interest rates are low, and consumers have been able to capitalize on that, meaning they've been able to refinance mortgages and other types of debts, and/or pay them off quicker because the interest expense is not as high. And so the financial obligations are much lower as percentage of income than they've been over the last 30 years. And I'll tell you this, debt levels aren't expanding at all. I mean, they peaked back in '07, '08, and they've come down since then as well. So it's not like consumers are just taking advantage of low interest rates and piling on a bunch of debt. That is not the case at all.

And not only that, the existing debt that's out there is not delinquent either. There's always little pieces that move higher and lower, but as a whole, delinquency ratios are not moving significantly worse in a bad direction. So consumers, from a balance sheet standpoint, are doing well. They have more income than they've had in previous years. And they don't have a lot of debt service, so that is good for the economy. Now what's the outlook for consumers? Well, we can measure that by the jobs market because the jobs market's going to tell us. Do consumers have the potential to keep this going? Because if the job market's weak, then we would expect the data that I just showed you to start to weaken, meaning consumers' debt ratios are going higher, and they're starting to default, and financial obligations are getting behind, which is then going to hurt the economy.

Let's look at the job market. And there's a lot of different components to the market. But I'm going to focus on some key pieces right here. Right now we're at full employment here in the US, by every measure. This is a lot of ups and downs here, but this is actually job creation, so these are the changes in payrolls every single month. So it goes back to mid '90s here. You'll see job growth, job growth, job growth. Then we start to see jobs decline. This gray bar represents a recession, and so anywhere you see a gray bar in any of my graphs, by the way, that represents a recession. And one thing you'll notice is that, yes, we have pretty robust job growth leading out of a recession. It starts to peak, and then taper off before the next recession.

This was a lagging kind of indicator. It doesn't peak until after things get worse. But looking forward, or looking over the last decade, you can see job growth has been very consistent. And it's not showing signs of dropping off, which would us to expect that we're headed for a recession. Now in addition to this job creation, I also look at what's called the initial jobless claims, so that's when folks just get laid off, and they file for unemployment claims. And that will be a very early indicator that a recession's on the horizon, is when we start to see an uptick in that over a sustained period of about six months. Again, that is at extremely low levels.

Now superimposed over this, I've added now where the unemployment rate is at, 3.7%, continuing to tick lower. Some people might ask, "Well, how much lower can it get?" Well, there's still actually a good amount of slack in the labor market. So the labor market is defined by everybody that is employed and unemployed. That's the definition of the labor market. But it doesn't include people that have dropped out. So if you've stopped looking for a job, you're not included in the labor market. But more people are being brought into the labor market because incomes are higher, they're getting paid more. There's more job openings, and the prospects for them are much better than they were over the past decade, so they're being pulled back into the labor force.

And we have a labor force participation rate of about 63%, 64% right now in the US. It peaked in '07, was about 70%. And it bottomed out in the low 60s, about 62 in '08, '09. And so there's still room for that to grow, to move higher, which would help the economy continue to move forward as those folks are coming into the workforce, in addition to the millennials and the younger generation coming into the labor force as well. I mentioned the jobs market is tight, so this is the number of job openings here in the US, so that's what we have in ... Now what I've added to this then is what we have here in unemployed folks. So we have more job openings than unemployed individuals, and this hasn't happened before, so this ticked over back in 2018, and it continues to stay that way, which is good for the labor market. This is a very good sign for labor and for jobs and for consumers in the years ahead.

As I mentioned, this unemployed individuals, this is bringing more unemployed people into the number, so that's a good thing. That's what we want here in the US. I showed real disposable income earlier. This is average hourly earnings, and this again is net of inflation. And this is for all employees, so this includes the executives all the way down to manufacturing and the blue collar workers as well. And you can see it was flat for quite some time coming out of the global financial crisis. But we've also had some nice growth here over the last several years, so things are looking good on the employment front.

Now people ask, "Okay. If that includes all the executives, well, what about everyone else?" Well, this is production and non supervisory individuals. Again, very same pattern, flat for a number of years, and then continuing to grow. And they're actually growing on a year over year basis faster than the all employees graph that I just showed. This is at a 1.9% on a year over year basis. The previous chart was 1.6%, so production and non supervisory individuals, wages are growing faster, which is good. That's a good sign. And overall, household net worth here in the US, continuing to grow and expand. This is net of all the debt, but this is going back to 1990, so we have all the assets, and then you subtract all the debt, and this gives us net worth. And this black line is just the trend line going back from 1990.

Now as common with the stock market, you can kind of see how it got overvalued relative to trend, net worth did, with some of these peaks before the recessions. But we're just right back to where we were on trend line here. This is actually the Q four selloff here in the stock market, and now the subsequent rebound, which puts us right back up there. This is important because there's a concept called the wealth effect. And basically what that means is that as people are wealthier and feel wealthier, so as their investments are performing better, they actually spend more money. So it's a good sign when we have the net worth statements among consumers here in the US continuing to grow and expand.

Now let's look at the Fed policy because I pointed out several things with the market over the last nine months that were impacted by what the Fed was saying and what the Fed is doing. And we actually have coming up next week a Federal Reserve meeting, where they're expected to announce their rate cut. That is the expectation, to at least cut rates by a quarter percent, if not higher. But the expectation's at least a quarter percent cut. And I'll show you why they're cutting and what that means because sometimes the thought process is, well, if things are going well, they should raise rates because the economy is going well, and the economy can support it, which is true. And if they're cutting rates, does that mean the opposite? Does that mean the economy is not performing well, and we need to start boosting it via some of this monetary stimulus? We cut rates, that makes loans cheaper, and that makes borrowing a little bit easier. And it provides more credit, more access to capital. That's why they cut rates.

Well, that's not the case. It's at least the case for why the Fed will be cutting rates in addition to the justification for it as well. We've had a significant recovery since the great financial crisis in '08, '09, and as I mentioned in my market commentary that came out earlier this month, that records are made to be broken. And so we just surpassed that here in the US. We have the longest expansion ever. This says post world war, at 121 months, but actually going back to 1900s. This is the longest expansion that we've ever had here in the United States. But it actually hasn't been that good of an expansion. Now the Fed, though, they are committed to keeping this moving forward indefinitely. This is a statement that Chairman Powell made back last fall. And I pointed this out during my last webinar, I don't believe this, that they can't ... Maybe this is some wishful thinking on the Fed's part, that they can keep the US economy out of recession forever. That's basically what he said, and I don't think that's possible.

And I don't necessarily know if that's a good thing either. Recessions do provide some benefits. They're not fun to go through, but they do kind of bring things back in check when they do happen. Now I mentioned, this isn't the strongest recovery on record. And so here's what I've got here, a lot of info on here. These are all the recoveries in a different format. But on the right hand side, what I've got is the strength of previous economic recoveries. And this is some data that we get from JP Morgan. And the steepness of each of these lines is the cumulative GDP growth. So you've got to see how a lot of them follow very similar trajectory. They have a very strong recovery in the years after the recession, and some go longer than others, until the next recession. That's when the line stops, is when that recession's over.

Well, this is the recovery since '08, '09. And it is so much weaker than the other recoveries. And because of that, I mean, just the weakness in and of itself does tell us there's a lot more room for this to expand, relative to what other expansions have done on a historical basis before we get to the next recession. So while I wouldn't say, agree with what Chairman Powell said about not ever having a recession again. I still think we can go a lot longer than what most people think because of there's a lot more room in this economy to move forward compared to historical norms. Now a lot of different things will impact that, but still interesting to see how this compares on a historical basis.

This is some text I highlighted from the Federal Reserve, from a statement that they gave in a press release back in June of 2019. And the highlighted areas, what they've got is that basically, they're pointing to expansion of economic activity, strong labor markets, and inflation near the committee's symmetric 2% objective, so I'm going to talk about inflation here in a minute, is the most likely outcomes. But uncertainties about the outlook have increased. They're saying, "Hey, the economy still looks good. The data we have points to it continuing to expand and improve. And inflation's not an issue." But these uncertainties that they're pointing to, the trade war and the global growth slowdown, those things are what they're pointing to. And we'll act as appropriate to sustain the expansion, so that's a key comment there, is that they're committed to making the economy here grow and expand. I mean, they don't want to force us into a recession, which they kind of did, or at least were getting closer and closer to doing that with the yield curve, which I'll show here later in the presentation.

But interesting to hear them. And one of our mantras here at Keen Wealth, especially on the investment side, is that we don't want to fight the Fed, meaning if they're committed to doing something, that's in our best interest to follow along with what they're doing in the sense that they're going to pump liquidity in the markets, meaning they're going to make credit cheap, and they're going to allow people access to it, and that's individuals and corporations. And those are good things for stock prices. Liquidity is a good thing. When liquidity dries up, or when credit gets more expensive and harder to come by, that doesn't bode well for stock prices. That leads to recessions, and I'll show you our measure of liquidity, what we look at, and able to analyze where that's at.

Now I mentioned inflation. And they said here that committees 2% objective. Well, the funny thing about the 2% objective, so they're basically saying they want inflation to be at a sustainable 2% rate, which the purpose of a sustainable inflation rate is it's easier for businesses and individuals to plan for. It's not as disruptive from a shock or a supply standpoint. If inflation is way out of whack in the sense of if it's growing at double digits a year, that's not good for an economy because then it usually leads to crashes on the other end, similar to what we saw in the '70s and early '80s. But the 2% objective is actually just something they kind of created out of thin air. They just made up and have been using that ever since.

If you think about: What's the most stable? It's zero inflation. But asset prices tend to improve at low levels inflation, so we like to have some level of inflation here in the US. Now one thing they look at is this concept called the Phillips curve. And they comment, they talk about the Phillips curve. And this is actually, this is an image from a textbook. If you remember back to econ 101, or as best you want to remember to econ 101, we've essentially just kind of got a supply and demand curve here. But what we're pointing to is the relationship between the unemployment rate and the rate of inflation. And essentially what this graph is saying is that as more people get jobs, as the unemployment rate goes down, the rate of inflation increases. So we've got unemployment here, as that gets lower and lower and lower, inflation goes higher and higher. That's the definition of the Phillips curve.

And the problem is, it doesn't work. And this is one of the tools that the Fed uses. One of their models is the Phillips curve, and it doesn't work. This is the preferred measure of inflation that the Federal Reserve uses. It's personal consumption expenditures. And they just look at the growth rate over that on a year over year basis, and it's just gone sideways for almost 20 years. You can see some spikes in there, but really hasn't done much of anything. And this is the unemployment rate. I mean, if the Phillips curve were to hold true, or even had some sort of inverse relationship, we would expect to see inflation pick up, especially as the unemployment rate has come down, and that just is not the case at all.

And so I know they know this data, and so part of the reason they can justify a rate cut is because inflation is not there. It is not running wild. The Fed has a dual mandate. They want to have full employment, and they also want to have inflation under control, and they've said 2%. That's their under control value. Their measures of inflation are well within those metrics, and so inflation's not out of control, and things are good on that front.

This is going back to 2010, and the red line is just that same personal consumption expenditures. It's their method of inflation. And you can see the growth rate over the last nine years. And it's been at 1.5% a year. That's the compounded growth rate. And if they were targeting 2%, you can just kind of see the difference because they're targeting 2%. They want it to be up here, and it's not there, and a lot of different reasons for that. Some of it's different dynamics around businesses and employment and what have you. But I've mentioned that wages are going up and people are spending more money. And as the Fed and the government have provided stimulus over the last decade, the expectation is that, that is inflationary. That's been one of the key things that many economists have gotten wrong over the last decade, is they've expected inflation to increase. And most of them expected it to increase significantly, especially with the different types of stimulus packages that came out, and it just hasn't happened.

And so different measures of inflation here, this is consumer price index. This is what the government uses when they provide you with Social Security benefit increases on an annual basis. They use this CPI. They exclude food and energy. This is the version that's exclusive of food and energy. This is the version that includes food and energy, so the red one. And this is why, now just to explain to you why they exclude food and energy is because it is more volatile. And you can see that in that graph. You can see how much larger the swings are between the red and the gray bars, gray lines. And it's true. I mean, food and energy do have ... Energy is a big component of that. But it does smooth it out. And you can see this is just going over the last 12 months. CPI X food an energy at 2%, including food and energy is actually a little lower. So a couple different measures of inflation here.

Now inflation though is very closely tied to employment costs. And this still though isn't showing any signs of future inflationary pressures down the road. But why is that the case? Well, if employment costs go up, so if a business has an employee, and their costs go up, whether it's wages, benefits, taxes, what have you, typically that's going to be funneled through the business and passed onto the end consumer. Prices will rise to offset these higher employment costs. And so that is a very good measure. It's one of the measures we look at for future inflation expectations. And we are seeing the employment costs index starting to up a little bit, little bit faster than the other inflationary metric that we look at. And there are some potential pressures down the road. But you can actually stave off some of this passing through, through the economy and through to the consumer, through productivity gains.

And this is kind of a messy graph, just in the sense it's a lot of movements up and down. But this is the measure of business output per hour, so it's a measure of productivity. And you can see here this dark line that I've plotted in here, that's the five year moving average. So if the current measure is below that, that's going to bring the long-term five year average down, and it's going to signify that productivity is getting worse. And over the last few years, we are starting to see that creep up because that has been a concern. Productivity, it's been hard to measure, and the sense is: Is this even the best measurement because it's like, how is productivity going down, considering the advances in technology that we've had? But using this as a historical measure, this is showing that productivity has gone down over the last 20 years, but seeing some improvements here over the last several. And so as productivity goes up, that actually offsets some of those employment costs that I just showed.

The companies have the ability to not have to pass through all those additional costs through the consumer because they're getting more out of their workers. So that's again, a little in the weeds there on some of this metrics. As I mentioned, the Federal Reserve, they have a mandate of inflation. They want to keep it in check, and they also want full employment here in the US. And their key lever, the thing that they control is the yield curve. And how they control the yield curve is through what's called the overnight lending rate. And that's just the rate that the Federal Reserve controls. And that is the rate that banks have to borrow from the Federal Reserve to lend out money. Right now, that rate is 2.4%. Well, the yield curve, what that is, is when we plot out what loans cost ... For example, if you were to loan your money to the government, you would buy US treasuries. If you loan money to a bank, you're buying CDs, certificates of deposits. If you loan your money to a government, you're buying corporate bonds.

And these are various maturities, so if you loan your money from one month all the way down to 30 years. Those are all the maturities that are out there. And the structure of the yield curve typically, as you would expect, short-term rates to be the lowest, and the longer term rates to be the highest. And it's because, yes, there's some risk there. There's future inflation. We don't know what that is. So I need to be compensated for that. If I'm going to loan you money, I expect to receive more than if I loaned you money for 30 years, I'm going to receive more than if I loaned it to you for one year because there's a lot of unknowns down the road, and I want to be compensated for those.

This, so I've got three different measures on here. This is 2018. This is the yield curve in 2018, short-term rates here. Basically, this is the Fed rate right in front of that, all the way out to 30 years. You can see that is an upward sloping yield curve, a steepening yield curve is some of the terminology. And that is what we like to see. Well, the red is where we're at today. So short-term rates are higher than some of the long-term rates. You can leave your money in money market, receive 2.4%, roughly. It's going to be different for each institution, but that's the Fed funds rate, 2.4%. You could buy a US treasury, loan it to the government, which is considered the safest investment there is because the government's never defaulted. And you will receive less than 2% if you do that for five years. So I can leave it in cash, make 2.4. I can give it to the government and only receive 1.75.

If you go out to 30 years, you can get a little higher, two and a half. But this an inverted yield curve. That's what that means. It's the opposite shape of what we like to see. Very similar to March of '07. You see this is the yield curve in March of '07. Rates were higher back then. You can see up here, five and a quarter or so. But it went inverted back then. And why is this important? As I mentioned, lenders borrow short and lend long. So if a bank's cost of funds is more expensive than the loan that they're providing, they're going to lose money. And so they're not going to do that very long. So they're going to do one of two things. They're either going to stop lending money because they're not making anything on it, or banks are going to raise the rates that they're willing to lend money at because they need to make a profit. And so this is what was happening in Q four of 2018.

The Fed was raising rates even though the intermediate and long-term rates weren't going up. And they don't control that rate. That's all set by supply and demand within the market, so they don't control long-term rates. They only control the overnight lending rate. And so the market was saying to the Fed is that, if you continue to do this, you're going to push us into a recession, and that's not good. We don't want to go into a recession because you're going to put a big break on credit activity, on lending. And that's going to hurt the economy a whole lot worse than other factors. So this is going back to '83, this is the yield curve. This is just plotted out every month here. And this is where we're at right now. So we actually did go negative. The yield curve went significantly negative, as I showed. And previous presentation I gave, we weren't there yet. But now we have gone negative. There's the last rate hike. You kind of see where that went.

But just because we've gone negative isn't necessarily mean that a recession's on the horizon. So this is where it went negative and preceded a recession. So there's '07 here, late '06, '07. Here's 2001. And then you can see the gray bar followed. That's the recession. Here's '89 leading into the recession into 1990. Now two other things I've pointed out though, in '95 and '98, and there's been other times in the past too, where the Fed was seeing that we were going inverted in '95, and then in '98 it actually did go inverted. And then they cut rates. And we didn't have a recession. And that's where I think we're at today. I think we're in a situation where they are going to cut rates, but we're not going to have a recession.

I'm going to share with you then how the markets perform because it's performed significantly different when we cut rates and don't have a recession, versus when we cut rates and have a recession. So those are kind of two different outcomes that could happen. Little bit longer term data here on the yield curve. A lot of folks remember this. This was when you could leave your money, this is late '70s, early '80s, doesn't even show up in my graph. But this is where you could keep money in money market and make almost 20% a year in money market rate, and then your mortgage, 30 year mortgage, was 13%. So a very inverted yield curve. And then what happened after that was kind of a deep recession, things like that, so something that we do follow very closely.

Now here's what I've got. This is that yield curve chart going to 1983. And then what I've added is the stock market performance because this is why I'm talking about this, it's because stock market performance is very strong before we have a recession. And once we have a recession, that's why I focus so much on that, is because stock returns are significantly worse when we have a recession. And so you can kind of see the performance of the stock market. This is late '90s, early 2000s, peaked here, had the yield curve inverted, led to the recession. Stock prices fell off a cliff there. And then we had another movement higher in stock prices going back to '07. Yield curve inverted down here. Led to another deep recession.

This isn't the end all, be all, though, in the sense that the recession or the yield curve inversion, while is does signal that there could be a recession on the horizon, it doesn't necessarily ... There's some lag time there. You can see this one, there's about 18 months or so. Other ones are shorter. But it's about at least a year from an inversion until we have a recession. But that's only if the economy is starting to falter because we've had these inversions in the past where it did not lead to a recession, and we had a nice rally here. Again, this is the S&P 500. This is the federal funds rate, so this is the rate the Fed controls. And all the movements in here are all based on the Federal Reserve increasing or decreasing the rate. So you can kind of see these different rate cuts that we've had outside of recession. See, the gray bars are recessions. So we've had periods like this where the Feds reduced rates, and we didn't have a recession.

Again, I've said that several times. That's where I believe we are at today. There are no signs of recession because consumers doing well, corporate America's doing well. Those aren't leading to recessionary signs. And that's what was happening here. Late '90s, employment started to go down, earnings growth started to go down, and then we went into the recession. Same thing, 2007, 2008. Earnings started to go down, employment started to go down, led to the recession. We just don't have those signs today to point to that. What does this mean on the investment side? Well, we talk a lot about diversification. And part of the reason that diversification makes sense is, well, it's rooted in science. I mean, there is a modern portfolio theory, which is all about being diversified, and then optimizing the portfolio based on risk and return trade offs.

So that gets a little technical. We look at things called standard deviation and correlation coefficients and things like that. And then we rebalance the portfolio. And I've got a graphic that I want to point out because the S&P 500, it's a proxy for the US market. And it is what the financial media talks about 24/7, is what's happening here in the US, and they're focusing on the S&P 500 primarily. They talk about the Dow as well, and the NASDAQ. But the S&P 500 is a very common benchmark for the US stock market. But what this displays is many different asset classes. So on the left hand side, I've got different types of stocks, both US and international. So there's large companies, and there's mid sized companies, small sized companies. And they all have different dynamics. There's international stocks, so those are companies that are headquartered overseas. And they're in developed markets and also in emerging markets.

And then what I have in yellow here is the S&P 500. And so what I wanted to plot out here is the performance of the S&P 500 going back 20 years. This is year by year performance of the S&P 500. You can see that line. For the first 10 years, it was one of the worst performers compared to the other asset classes. You can see it trended towards the bottom third, towards the worse for that first decade. And then over the next decade it started to improve. But you can still see it's not the best performing asset class in any given year. It's actually only been the best one year. There's been other asset classes that have performed better. Now this black box, it says AA. Well, that stands for its asset allocation. And what this is, it's a combination. It's weighted. It's a weighted combination of all these different asset classes, and then rebalanced on an annual basis.

And you can see represented here on the white line, is that it smooths out the returns. It's never going to be the best performer, and it's never going to be the worst performer. It's because it's a combination of all the different asset classes. And so the objective is to smooth out the returns. And so we get that question a lot. People kind of ask, "Okay. Well, how's the S&P doing compared to the portfolio and other dynamics?" And so this is a way to help put that in perspective because there'll be periods where the S&P is performing better than an asset allocated portfolio. And there will be periods where the asset allocated portfolio's doing better than the S&P 500, but that's by design. It's on purpose that it's going to perform that way.

Now here is actually some data, some math behind this. Here's the CAGR, which is compounded annual growth rate, nominal is before inflation, so typically that's the number that you see when returns are posted. But I have all of those asset classes listed here from best to worst. And you'll see the asset allocated portfolio right there in the middle over the last 20 years, versus the S&P 500, which is in the bottom third of the last 20 years. There's the reason for diversification, it's because the goal is really to kind of be in the middle when it comes to all these different asset classes because they're all going to perform differently at different times.

For example, the mid cap value and small cap value, while best performers over those last 20 years, actually have struggled here in the last couple of years. That doesn't mean they're going to be bad performers going forward, but comparatively to the other asset classes, they've actually underperformed for two. So you've got to kind of look at short-term performance relative to long-term performance. Now next thing I did is, I said, "Well, what happens when we add some bonds to the portfolio?" Because with a lot of our folks, and especially our retired clients, we have bonds in the portfolio. Well, you can kind of see here the return goes down a little bit, actually, it doesn't go down that much. But if we add 40% of bonds to the portfolio, so we reduce all the equity, all the stock investments by that same percentage, and then we increase the bond portion to 40%, reduces the return a little bit, but significantly reduces the downside risk and the standard deviation.

And standard deviation is: How much does it move relative to its return? So a higher standard deviation is a higher risk investment, or a more volatile investment. Lower standard deviation is less volatile. So if you add asset allocated portfolio, even when coupled with bonds, provides as much of a free lunch as there is when it comes to investing. It really does create that optimal portfolio for a lot of folks. Now everyone's different in terms of their allocation and how much they should have in stocks and bonds as well. So this is just a broad kind of overview of the thought process, not representative of anyone's particular portfolio in any way.

So where do we go from here? Well, as I mentioned, we have a tight labor market. And when we have a tight labor market, we expect to see wages rise, which we are seeing. And when wages go up, consumers spend more. When consumers spend more, GDP goes up. When GDP goes up, earnings are also going up, which leads to higher stock prices. And this is, I shared this graphic at our last update, and I will continue to share it going forward because this is really the thought process around our expectations for higher stock prices. These are all, every one of these are still very positive. And so no reason to expect stock prices to have any major downturn, especially when coupled with a recession. Now again, it doesn't mean we won't have volatility. There will always be these periods where the markets are moving up and down. But we don't see a recession. And again, those recessions are where the large volatile and the long, sustained drawn downs are at in the stock market.

Fear and greed index, something that I look at on a regular basis, this is just put out by CNN. It's a conglomeration of a couple of different metrics, and right there in the neutral zone. This is really on a short-term basis. When it gets onto the greed side, we might expect to see a little bit more volatility on a short-term basis, and vice versa on the fear side, so right there in the neutral stance.

Now I mentioned stock price performance when we have a recession and when we don't have a recession. And so this is looking at the last five rate cuts. So this is going back to 1989, and this is when the Fed has cut rates for the first time. So that happened in '89, '95, '98, '01, and '07. Fed was raising rates, then they paused, and then they started to cut rates. What I've highlighted here, those first three, those actually happened when we didn't have a recession. So they cut rates, it stimulated the economy. Stock price performance very strong over the next three, six, and 12 months. The bottom two, '01 and '07, Fed cut rates, but we also had a weak economy. And we can see down here, minus 13, minus 20 over the next 12 months, and that's because we went into a recession.

So they were cutting rates to stimulate the economy leading into a recession. And I have data that actually goes back much farther into the 1920s, and it looks at this same thing. And it confirms the same thing. I mean, we can go back extremely far with some of this data. And we've had periods where the Fed cut rates, and we didn't have a recession. And we see very strong stock performance over the next 12 months. And that's what I was trying to lay out, is that's where I believe we're at today. We're in a period where they're cutting rates, kind of backtracking for what they did last year, because they got ahead of themselves. They really should not have increased rates in Q four. Backtracking that, and making the yield curve less inverted. And I think that's going to be a boost to the economy and a boost to higher stock prices.

Well, with that, I know I mentioned we have time for questions if anyone does want to provide some questions, or type any questions in, I will definitely take a look at those. I know we're a little bit over time. I don't have a lot of time to answer all the questions. So what I'll do is I'll reach out for any of those that ask questions, and aren't able to answer them. But essentially, the way to think about all of this stuff is we want to do that in the context of a financial plan because there's so many unknowns. And as 2019 has shown us so far, uncertainty is not by itself enough to offset the still strong fundamentals in the US economy and corporate America.

Instead, these and other market uncertainties require an intense focus on financial markets, all the economic data in the political news. Markets always face uncertainties, and over the long-term, it's core economic and corporate fundamentals that drive market returns. It's not the headlines. So as much as we want to focus on the headlines, it's not the headlines. It's those fundamentals that I've pointed out. It's typical to have volatility, even though we know it can be unnerving, it is typical. It's common to see that.

And so my kind of takeaway is it remains critical to stay invested, patient, and stick to the plan. That's why we work diligently with you to establish a personal allocation based on your financial position, risk tolerance, and investment time horizon. We thank you for all of your ongoing confidence and trust with us, and we're always honored and humbled that you've given us the opportunity to serve you. So please, if you have any questions, any concerns, feel free to reach out to us, especially when it comes to anything on the investment side. We're here to discuss anything that comes up, in addition to the financial plan as well, because there's two components to this. It's the plan and the investments.

Today I focused on the investments. But the plan is just as important. That's the tax plan, the distribution plan. All of those things coupled together provide a solid allocation for everybody. Well, with that, I see a couple questions. I will address those offline. But thank you all for attending, and we will see you next quarter.