US stock markets went through a significant correction during the last quarter of 2018. The table below illustrates the losses that the various market indexes experienced from October through December 2018[1].

Indexes	4-Oct-18	20-Dec-18	Gain/Loss	Gain/Loss (%)
Dow Jones Industrial Average	26,952	22,863	(4,089)	**-15.17%**
S&P 500	2,941	2,462	(479)	**-16.29%**
NASDAQ	8,133	6,484	(1,649)	**-20.28%**
Russell 2000	1,742	1,322	(420)	**-24.11%**

Our December 2018 Newsletter concluded with the following:

Conclusion: We have experienced a great Bullish market phase since the beginning of 2009. Investors have gotten used to seeing dips that quickly reverse and have proven to be great buying opportunities. This year has experienced two noticeable corrections that jolted investors into rethinking the real possibility of a recession. Having said that, we believe that the US GDP growth, favorable employment and earnings strength should bolster the markets for the foreseeable future. As mentioned in our previous Newsletter, we would reiterate that this is an opportunity for investors to add to quality companies in the area of Healthcare, Industrials, Financials and Information Technology.

Since the Q4, 2018 market correction, major US equity indexes have gained about 12-14%[2].

Our thought during the 2018 correction was that investors were reacting to noise despite the strength of the US economy, and therefore it was a good time to initiate new equity positions and add to existing ones. In retrospect, this proved to be a smart decision.

Sometimes one gets lucky…

We have mentioned many times the concept of "mean reversion". In plain words, "things revert back to their mean…". An amalgam of economic factors and human psychology impacts the movement of the markets. The markets are in reality made up of humans.

[1] ***Source:*** [*www.yahoo.com/finance*](www.yahoo.com/finance)

[2] ***Source:*** [*https://tradingeconomics.com*](https://tradingeconomics.com)

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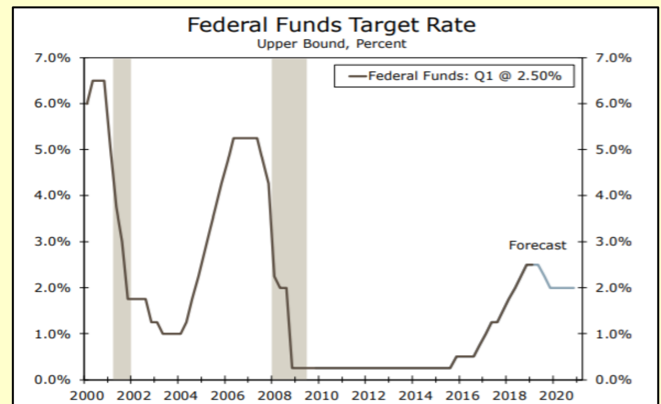
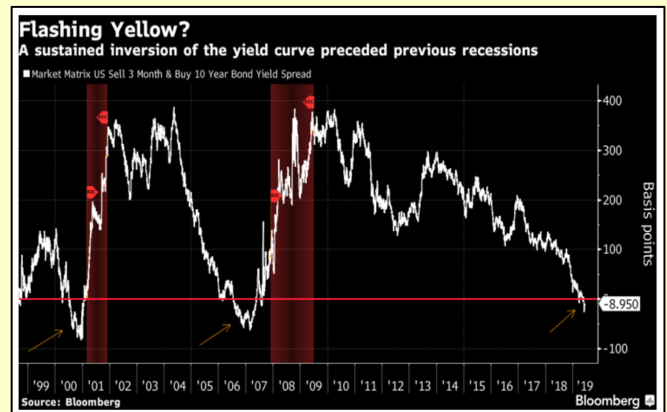
Following are crucial parameters that impacts human behavior which ultimately drives markets:

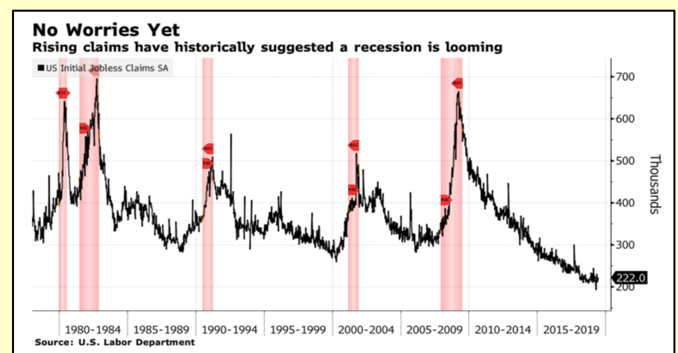
1. **Fed Fund Rates[3]:** It can be observed in the adjacent chart that interest rates trend downwards during and after a recession. This is a daliberate action by the Federal government in order to infuse liquidity into the economy during recessions and or times when they believe the economy is contracting. We believe that the current rate environment is pro business. More importantly, the addition of human and material resources into the global economy from various emerging countries has and will continue to impact inflation for a prolonged period of time. As there is abundance of cheap materials and services globally, inflation will remain tame. Therefore, we believe that the interest rates paradigm has shifted and shall remain at relatively lower levels. This would allow the Federal government to keep rates at a lower levels, which would continue to help the US economy.



2. **Inverted Yield Curve:** An inverted yield curve is one where the longer term interest rates are lower than the short term rates. This happens when investors believe that there is imminence of a recession and hence the expectations of reduction in rates by the federal government. The difference between the 10-year US Treasury rate and the 3-month Treasury has been a reasonably accurate indicator of a recession. Empirical evidence shows that there is approximately 14 month lag between an inverted yield curve and a recession. We can observe in the graph above that we are at levels that should not be ignored and are indicating a slowdown in the US economy.



3. **US Job Market:** The US economy is primarily driven by the retail consumer. Therefore, it is important to consider the employment aspect. The adjacent chart shows that jobless claims started to



[3] *Source: Wells Fargo Economic Insight*

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decline since the economic recovery after the great recession in 2008-09.

Even though jobless claims have risen for the month of May 2019, its not at an alarming rate. In addition, one month does not define a trend. We believe that the US is still in a fairly strong employment environment, with unemployment at less than 3.8%.

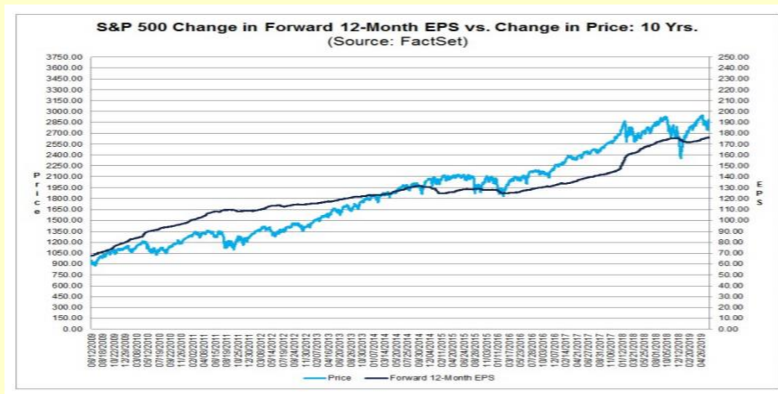
4. **US Economy:** It can be seen in the adjacent table[4] that the economy grew at 3.1% in Q1, 2019. Economists believe that the US economy will grow within a range of 2.2-2.5% for the rest of 2019. That is not too shaby for a $23 trillion economy. Obviously, the US-China trade tariff rhetoric has and will impact both economies in the short term.

Wells Fargo U.S. Economic Forecast

	Actual 2018				Forecast 2019				Actual			Forecast	
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	2016	2017	2018	2019	2020
Real Gross Domestic Product [1]	2.2	4.2	3.4	2.2	3.1	2.4	2.2	2.5	1.6	2.2	2.9	2.7	2.1
Personal Consumption	0.5	3.8	3.5	2.5	1.3	2.9	2.4	2.4	2.7	2.5	2.6	2.5	2.1
Inflation Indicators [2]													
PCE Deflator	1.9	2.2	2.2	1.9	1.4	1.6	1.7	1.8	1.1	1.8	2.0	1.6	2.1
Consumer Price Index	2.2	2.7	2.6	2.2	1.6	1.9	1.9	2.1	1.3	2.1	2.4	1.9	2.3
Industrial Production [1]	2.3	4.6	5.2	3.9	-1.9	-1.8	1.6	2.2	-2.0	2.3	3.9	1.1	0.8
Corporate Profits Before Taxes [2]	5.9	7.3	10.4	7.4	3.1	6.2	3.7	5.7	-1.1	3.2	7.8	4.7	0.6
Trade Weighted Dollar Index [3]	103.1	107.3	107.6	110.1	109.8	109.0	108.8	107.8	109.4	108.9	106.4	108.8	105.0
Unemployment Rate	4.1	3.9	3.8	3.8	3.9	3.7	3.7	3.6	4.9	4.4	3.9	3.7	3.6
Housing Starts [4]	1.32	1.26	1.23	1.19	1.20	1.25	1.27	1.28	1.17	1.20	1.25	1.27	1.29
Quarter-End Interest Rates [5]													
Federal Funds Target Rate	1.75	2.00	2.25	2.50	2.50	2.50	2.50	2.50	0.52	1.13	1.96	2.50	2.44
Conventional Mortgage Rate	4.44	4.57	4.63	4.64	4.28	4.20	4.25	4.30	3.65	3.99	4.54	4.26	4.26
10 Year Note	2.74	2.85	3.05	2.69	2.41	2.60	2.65	2.70	1.84	2.33	2.91	2.59	2.66

Forecast as of: May 31, 2019
[1] Compound Annual Growth Rate Quarter-over-Quarter
[2] Year-over-Year Percentage Change
[3] Federal Reserve Advanced Foreign Economies Index, 2006=100 - Quarter End
[4] Millions of Units
[5] Annual Numbers Represent Averages

The good news is that the US economy is resilient enough to tolerate the initial impact of the trade dispute. The problem will arise if this drags on for sometime and US and Chinese corporations decide to modify their behavior in favor of protectionism. This could derail the economic fruition both countries have enjoyed and increase the probability of a recession.



The chart on the left shows the change in price for the S&P 500 vs the change in earnings. The positive correlation between the two is apparent, both intuitively and also empirically.

US corporate earnings have declined approximately -2.5% for Q2, 2019, after a slowdown in Q1, 2019 as well. Again, a one time decline in any aspect of the economy doesn't make a predictive trend. But it is a matter of concern in the prevailing political and business tensions between US and China.

[4] ***Source:*** www.Wellsfargo.com

So far we have emphasized the importance of economic fundamentals that basically drive the markets. I would rephrase this thought and say that its "Economic Fundamentals that drive investor behavior that drive markets…".

We have observed that the markets have evolved to be increasingly reactive to news, as news has become abundantly and easily accessible. Who would have thought that the President of the United States would disseminate crucial news via Twitter, let alone using a social media application like Twitter.

Despite the changes in the economic and political arena, we have experienced a bullish market for the last decade. As the US economy continues to grow, history shows that the probability of a market correction led by an economic recession continues to grow.

Again, there is no fundamental reason to gravitate towards the camp of panic or bearishness. We believe that investors can accumulate additional gains in their portfolios by being relatively active in the current markets. Timing the markets is a fools errand, but considering active investing in certain instances could be very fruitful.

This should be done in a methodical manner using critical variables that help understand the short term volatility in the markets. For instance, variables like the Volitility Index (VIX) is seen as the investor fear gauge. As an example, the VIX's valuation can be used as a measure to be fully or partially invested in the markets. A lower level of VIX shows complacency in the markets. These levels could be viewed as a contrarian indicator to raise cash and vice versa. Again, this is just one variable in the amalgum of crucial and attributable parameters which can be considered in making these decisions. **I would however caution long term investors from using this technique as it requires a higher commitment to closely monitoring the markets.**

Conclusion: After a significant market correction at the end of 2018, we have now experienced an equally bullish Q1-Q2 2019. Market fundamentals are still reasonably strong, but a 10-year bull market is compelling us to be cautious. As mentioned above, we would not be fully invested at current market levels and would gradually raise cash. It is imperative that we understand the risks of being fully invested if our time horizon is short to medium term. We therefore would take the stance we were at during mid 2018; one of caution and be partially invested in the equity markets.

PLEASE REMEMBER: Each investor is unique and should invest to complement their respective financial conditions and objectives.

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