Observations and Perspectives:

Terri Spath, CFA, CFP®
Chief Investment Officer

Terri Spath joined Sierra Investment Management in 2015 and has more than 27 years of investment management experience. She is responsible for market and economic analysis, portfolio allocation and investment strategy for the firm.

"A recession would definitely put a dent in the bull market, but we aren't selling anything in anticipation of that. Yet."

Canaries in the Coal Mine: What to Watch as Stocks Continue to Make New Highs

Stocks continue to teeter at all-time highs and the outsized profits enjoyed since November of last year are really a continuation of the bull market that turned 8 years old this past March. Low starting valuations, improved economic growth and employment, increased corporate earnings and low interest rates have driven the moves upward.

A couple of things about bull markets: they don't generally die of old age and there will be no grand announcement when Elvis has left the building. We still don't love valuations – every metric shows that stocks are at expensive levels. Valuation is a terrible timing tool, though – it's far better at quantifying how far things can fall (or rise). Also, we are at the start of a v-shaped recovery in earnings which will help support stock levels. Based on forward price-to-earnings, the S&P 500 is just a few percentage points greater than its long-term historical average, but this doesn't allow much room for error.

We are also concerned about investor complacency: volatility is roughly half its historical average; it suggests that investors don't have a healthy enough fear of what could go wrong. Historically that doesn't have to revert quickly to the mean either, though.

What would derail this market is a recession. Our canaries in the coal mine indicators are:

- **Housing starts to decline** year over year ahead of every recession. Why? A house is typically the largest purchase a consumer makes so it's made when feeling confident about current income and future prospects. This data point can be choppy from month-to-month, but was negative in both April and May. *If March was a peak, it suggests a recession on the horizon.*
- The trend in **consumer sentiment typically trends negative** ahead of recession. The latest number is slightly below the highs reached earlier this year, but the *trend is not yet negative so no recession on the horizon.*
- The **Conference Board's index of Leading Economic Indicators turns down** ahead of a recession. This index captures 10 variables including employment, manufacturing and housing metrics. Although the index has predicted recessions that did not ultimately occur, it always falls ahead of recessions that do occur. *This metric has been trending positively so no recession on the horizon.*
- Historically, the **yield curve inverts in front of a recession**: in other words, longer term interest rates become lower than short term ones. This can be measured by the 30-year Treasury minus the 5-year or the 10-year minus the 2-year or 1-year. By any of these, the curve has not inverted. However, what is "different this time" is that central banks have had their thumb on the long-end of the curve making this indicator potentially less reliable than it has been in the past. The yield curve has indeed "flattened" since the November elections and is close to lows seen about a year ago, but is not inverted so again, *no recession on the horizon.*

We have our eyes on other canaries too – some healthy, some not.

- As mentioned earlier, earnings growth has been strong and is on track to continue improving, creating a tailwind for "risk-on" assets.
- Auto, restaurant and apparel retail sales have weakened, a sign of softer confidence and falling growth. Home improvement sales and on-line sales have quickened, though.
- Unemployment has improved significantly, but wage growth per capita is far below average.
- Gross federal debt now exceeds GDP, a ratio that hasn't occurred since World War II and a drag on future economic growth.
- The Federal Reserve is on track to continue to raise rates at the short end of the curve. Unwinding its $4.6 trillion balance sheet could put pressure on prices and yield increases at the longer end of the curve too. Rising rates are another drag on future growth.

Our conclusion, then, is that a recession would definitely put a dent in the bull market, but we aren't selling anything in anticipation of that. Yet. A way to participate in gains and also prevent big, unrecoverable losses is to develop a sell strategy. We set stop-loss limits underneath our holdings in order to establish a level to get out of the way of a downward trend in prices. This allows us to invest in strength and avoid weakness, a key to making money by not losing it.