"The one great enemy of the human race is fear. The less fear you have the more health and harmony you will have. The only real problem of mankind is to get rid of fear. When you really do not fear a situation it cannot hurt you. Of course, you must remember that fear exists in the subconscious (unconscious) mind without your necessarily being aware of it. The great thing to remember is that fear is a bluffer. Call its bluff and it collapses."

Emmet Fox
20th Century Spiritual Leader
1886-1951

THE YEAR AHEAD – 2019

By James K. Tonrey, Jr., Chief Executive Officer

The financial markets are supposed to discount the future, up to nine months out, given that all public information is known and, therefore, priced accordingly. The markets are seen as a reliable future indicator of the economy, a look into the crystal ball, since real people and institutions place their money on the direction of asset prices. However, as we have all too often experienced, things can change quickly in the world we live. Now more than ever, emotions (fear and greed) are playing a greater part in investment management in the short-run. One only has to look at the legitimacy and growth in the study of behavioral economics. The increase in momentum investing, both to the upside and downside, is here to stay as institutional algorithmic trading and the 24/7 news cycle is now woven into the fabric of our daily lives.

There is certainly enough to worry about. *It goes without saying that investors should expect more short-term volatility in their long-term portfolios.* Let's discuss three fear factors (risks) that are in the news every day and how they may come into play in the upcoming year.

First, there is *inflation and deflation*. For the past ten years, and even beyond, economists have debated the inflation versus deflation argument. Simply stated, inflation is the result of asset prices increasing and eroding the purchasing power of the consumer. The cost of both basic and luxury goods rising at a faster rate than wages. Inflation is good when it is kept in check but stalls growth in the economy if left untethered. The Federal Reserve Bank (Fed) currently targets 2% inflation as its mandate. We are hovering around the 1.8% range at the moment.

Deflation, on the other hand, has the opposite effect. Deflation reduces the level of asset prices. Technology has added to deflationary pressures by driving more efficiency and disrupting industries. Deflation is good in that it allows the consumer to buy more goods and services at better prices, but it is dangerous in an economy with $22T of debt. Finance 101 recommends that a consumer should not leverage a depreciating asset. As an example, a house purchase, over time, is usually a good asset to leverage, or borrow against, due to historically increasing prices. A car, however, would be considered a bad asset to leverage as the minute it is driven off the lot it is worth much less, never to regain the original cost of the vehicle. The loan amount, however, remains the same. A deflationary environment would be an extremely difficult scenario to handle for our economy. This is why the Fed will go to great lengths to prevent any sustained deflation. They will backstop the economy with lower rates over a longer period. The Fed worries that, like the auto purchase, our gross domestic product (asset) will head lower while the debt will remain the same or possibly increase. Not a favorable combination.

The second area of concern is *interest rates*. Recently, the yield curve has bounced back and forth and is now close to inverting. This is when the interest rate on the three-month treasury bill is higher than the rate on the ten-year treasury note. Usually, and quite often, it can signal that a recession is on the horizon. The current three-month bill is at 2.22% and the ten-year note at 2.40%. One has to ask this question….*why would anyone buy a guaranteed ten-year note that will only pay .18% more a year and lock it in for ten years?* The answer is that those investors may think that we are entering a period where deflationary forces dominate and push down interest rates, along with other asset prices. Therefore, locking in the ten-year note is favorable to having to reinvest at lower interest rates. Some European economies, as well as Japan, actually have negative rates. It works like this. An investor buys a ten-year government bond for say $100,000 (not taking into account currency) and ten years later the government pays the investor back with $99,000. This would only be a good deal if asset prices, like real estate and stocks, declined in value over that same period and/or interest rates continued to move negatively. An investor would be glad to get almost 100% of their principle back *guaranteed*, since possibly much more would have been lost investing the funds elsewhere.

The third potential headwind for markets is the ever present *geo-political risk*. The three most observed in the headlines today are: *China and the on-going trade dispute; Brexit – Britain leaving the European Union (EU); and global growth slowing in both emerging and developed economies*. One could argue that they are all interconnected. Slowing growth in China affects many other economies around the world, particularly here in the United States. At the same time, Britain's exit from the EU is uncharted territory and the uncertainty around this move is significant. Suffice it to say, investors continue to climb Wall Street's wall of worry.

There is simply too much overlap to take each of these risks/fears and analyze them on their own. They are not free-standing. Our world is so financially interrelated that one decision will inevitably affect multiple others, which are, on the surface, unrelated. Interestingly, *chaos theory* provides us with a good example of this cause and effect through *The Butterfly Effect*, a metaphor closely associated with the work of scientist Edward Lorenz.

"This effect grants the power to cause a hurricane in China to a butterfly flapping its wings in South America. It may take a very long time, but the connection is real. If the butterfly had not flapped its wings at just the right point in space/time, the hurricane would not have happened."

The underlying thesis is that the outcome of small, seemingly inconsequential and unrelated, actions in one physical state may have large consequences to another variable in a totally distant state. Like weather patterns, the financial markets can and should be viewed with the same examination. Small financial decisions and subsequent changes in the economy of Germany, for example, could have an impact on a mountain bike company in Denver. While this seems a bit nebulous, the interrelated nature of our world's finances makes it possible.

Managing an investment portfolio today with so much noise and uncertainty presents challenges, certainly, but also opportunities for those who are patient, prudent and disciplined. This year is no different. Just another set of issues to fear. But isn't that always the case? We should call their bluff and concentrate on those things we can *control*, not only will our investment portfolios be healthier and continue to grow but so will our lives.

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