CAUBLE & HARRE
WEALTH MANAGEMENT

12977 NORTH 40 DRIVE, SUITE 213
ST. LOUIS, MO 63141
314-576-1112 | CAUBLEHARRE.COM

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The strength in the markets after the difficult fourth quarter of 2018 continued through the second quarter of this year. Headlines read that the S&P500 had the best start of a year through six months in the last 20 years. That makes you feel pretty good. What the headlines leave out is the carnage that occurred in the last quarter 2018, just prior to this record run. The first six months of 2019 might have made the record books, but the S&P500 is only 1% higher than it was nine months ago. And the index is only 2.5% higher than the peak back in January of 2018, almost a year and a half ago.

Headlines don't provide context. There has been a lot of movement in the markets over the past year and a half, and there have been some major changes. But in terms of price appreciation, not a whole lot has changed from point to point. What has changed is the valuation of the market.

Even though there has been 2.5% of price appreciation since January of 2018 (and about a year and a half of dividends), the market today has a lower valuation. By valuation, I mean the Price/Earnings multiple of the market, or the price for each dollar of earnings that investors are willing to pay. The market is cheaper today that it was in January of 2018. In January of 2018, valuations were 8% higher.

Why is this important? The more expensive the market is, the less ability it has to absorb chaos/problems/uncertainty without experiencing abrupt price changes. When the market's valuation is historically normal, then its reaction to events can be smaller. Let's say that the market is going to drop due to a recession, and that the valuation will drop to a level that is 10% below the historical average. If you begin the process at a historically average level, you have less to fall than if you start with the market selling at a valuation that is 10% higher than normal (like it was in January of 2018). The market's valuation is currently 3% higher than its historical average.

There has been a significant shift in the market's expectations for the Federal Reserve to cut interest rates. At the beginning of this year, the market was just beginning to believe that the Fed would at least stop raising rates. Now, the market believes that the Fed will cut interest rates multiple times this year.

Indicators continue to show that the economy and corporate earnings are slowing. The belief that the Fed will reduce rates is tied to the belief that they are doing so to delay and hopefully avoid a recession. A recent poll showed that most economists responding thought the recession would occur in 2020. This might suggest that while there will be a next recession, it is not likely to happen then (apologies to economists).

LIZ H. CAUBLE, CFP®
liz@caubleharre.com

PETER B. HARRE, CFA
peter@caubleharre.com

KENDALL M. YOUMG, CFP®
kendall@caubleharre.com

This has been a long economic recovery, and that makes calls for recession more believable. While it has been quite long, it has also been quite weak. This suggests that the excesses in different parts of the economy and markets that usually precede a recession have not built up like they have in the past. Sure, we can find some in this or that corner, but not across the board.

It does make sense to review portfolios to make sure that we are comfortable with holding the current positions through the next recession, whenever it occurs, and we have been doing so.

Please contact us with any questions or concerns.

Regards,

Peter B. Harre, CFA

LIZ H. CAUBLE, CFP ®
liz@caubleharre.com

PETER B. HARRE, CFA
peter@caubleharre.com

KENDALL M. YOUNG, CFP ®
kendall@caubleharre.com