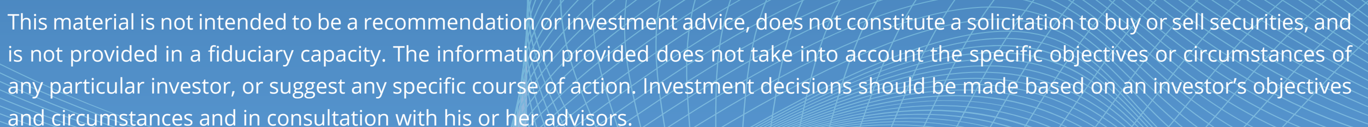
Market Commentary

Airbags for Your Investments

November 2019



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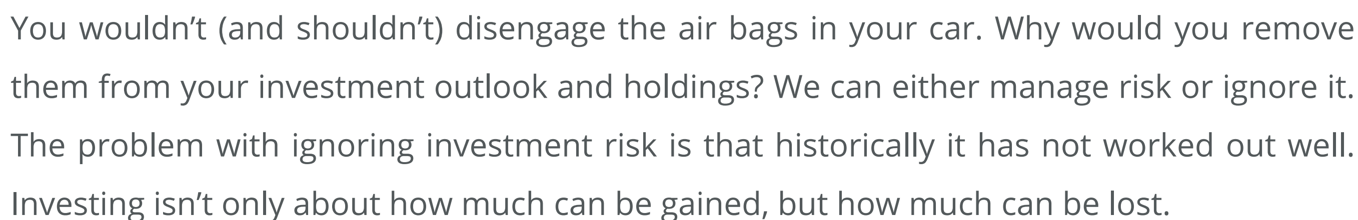


You wouldn't (and shouldn't) disengage the air bags in your car. Why would you remove them from your investment outlook and holdings? We can either manage risk or ignore it. The problem with ignoring investment risk is that historically it has not worked out well. Investing isn't only about how much can be gained, but how much can be lost.

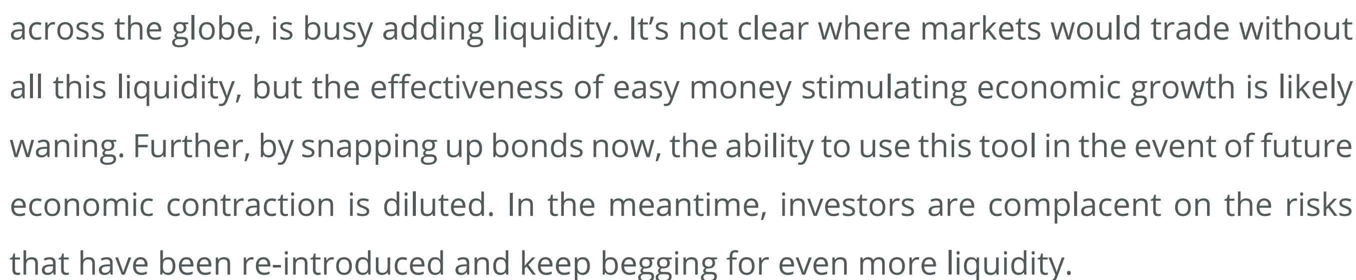
A Casual Approach to Risk = Taking Big Risks

Right now, we are in a perilous environment to make a big bet, either to the upside or the downside. If anything, investment markets have become too complacent about the certainty of a trade deal, the certainty of the activities on the Hill or the certainty of the U.S. economy. None are certain at all, yet investors have all but dismissed these risks. In a situation of uncertainty, where the outcome can still very much go either way, a nonchalant approach to risk means taking a big risk.

Easy Money Is Whetting Appetites for "Risk On"

In our view, many investors have inadvertently developed a Pavlovian response to the U.S. Federal Reserve (the "Fed"). When the governors at the U.S. Federal Reserve are getting ready to ring the bell for yet another rate cut, markets begin to salivate in anticipation and the scramble for "risk-on" asset classes again materializes. At the October press conference announcing yet another 2019 rate cut, a not so widely discussed (in our view) Fed tool re-entered the picture. Specifically, the Fed quietly stated it would begin "expanding" its balance sheet. Historically, this activity has been labeled "quantitative easing," but Mr. Powell insisted this time is different. To us it looks exactly the same: the Fed is again the single largest buyer of Treasuries and its balance sheet has again surpassed $4 trillion.

Liquidity is liquidity in the eyes of thirsty investors and the Fed, like other central banks



across the globe, is busy adding liquidity. It's not clear where markets would trade without all this liquidity, but the effectiveness of easy money stimulating economic growth is likely waning. Further, by snapping up bonds now, the ability to use this tool in the event of future economic contraction is diluted. In the meantime, investors are complacent on the risks that have been re-introduced and keep begging for even more liquidity.

Record Corporate and Government Debt Levels Should Be Subtle Danger Signs

While the Fed's balance sheet is again ballooning, government debt is also exploding higher, recently reaching 105% of GDP. The only other time the U.S. debt/GDP was this high was at the end of World War II. After World War II, the fast-growing U.S. economy's debt levels went down sharply, a situation we do not have now, so nosebleed government debt/GDP levels are here to stay.

Corporations are also borrowing at high levels. In fact, corporate debt/GDP is higher than at peak levels reached in any of the past 3 recessions. Compared to the government and to corporations, the American consumer has looked quite prudent. However, the situation is still worth noting: total debt per consumer is above 2008 levels as auto debt, student loan debt, and credit card debt keeping going up.

In an economic slowdown, or worse in an economic contraction, the record high balance sheet for the Fed means that the central bank has a lot less room to move the needle. Debt/GDP at levels not seen since World War II means that the U.S. government has less room to spend more in order promote economic growth. Corporate debt that has never been higher can wreak havoc on a slowing or contracting economy if downgrades and defaults begin impacting the bond market. At a minimum, these debt statistics are subtle danger signs for investors and consumers.

Solution: Continue to Manage Risk

In our view, tactically participating in the uptrends that are occurring across many asset classes makes sense. However, we continue to monitor for the creaks that happen before the cracks, and will hold every investment until a downtrend begins significantly enough to trigger a stop loss Sell signal. Shrugging off risk is a gamble, not an investment strategy. Keeping the air bags in working order in your car is recommended, as is managing investment risk at all times, even when the environment appears benign.

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Terri Spath is Chief Investment Officer at Sierra Investment Management. She jointly oversees the investment activities of the organization and appears frequently in the financial press.

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