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Four Major Headwinds to This Market – And Why You Should Ignore Them!

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Investors celebrated 2019; the S&P 500 including dividends rose over 31%. A rising tide of liquidity and monetary stimulus lifted not only US large cap stocks, but domestic small fries (+26%), overseas outfits (+22%), REITs (+25%), even bonds (+9%), oil (+35%), and gold (+19%). A strong US consumer, constituting two thirds of the American economy, helped immunize our economy against challenges facing our manufacturing sector.

That was then. We are now in a new year, indeed a new decade. What can we expect? While anything is possible, no one is projecting a repeat of last year's stellar performance.

Valuations are stretched. Although on balance we are not as expensive as the late 1990s, on some metrics we are more expensive: for example, when looking at stock prices versus revenues. A big plus for investors is the low interest rate environment. Rates are much lower than they were in the late 1990s, and this makes relative valuation of stocks versus bonds much better for stocks.

Nevertheless, many risks exist. No one believes that 2020 will be a 2019. While investors can accept that, few want to risk giving back last year's profits. There's a movement afoot to protect, indeed nail down last year's profits. What's the right strategy?

Bottom Line

Despite the stretched valuations and concerns that stocks give back gains following great runs, investors with longer term horizons should stay the course.

Many issues could make 2020 a losing year. Those include geopolitical disturbances, trade disputes, election year uncertainty, even rising interest rates. Here's why, with the proper time frame, investors are best advised to ignore these risks.

1. Geopolitics

The markets have already seen one bit of drama this year, the US taking out of an Iranian general, with a bit of counterfire from Iran. Although the market seems to have shrugged that off, few believe that's the last we'll hear out of the Middle East this year.

It's not just the Middle East we'll be watching. North Korea is likely to continue to rattle its cage or worse, as no treaty has been reached there. Venezuela, Argentina, Chinese encroachment in the South China Sea, and Hong Kong all bear careful scrutiny.

So, why not move to the sidelines? Two reasons. First, prices reflect all this information. Unless you've got a secret hotline to say Kim Jong Un, selling on disturbing geopolitical news won't give you an edge. Second, is the world more hostile than it's been the past decade? If you'd sold at the start of the decade, you have missed out on the near tripling of your nest egg.

The only thing harder than divining the market is divining what's in store in say the Middle East or North Korea. Expect, when all is quiet, that geopolitics can rear its ugly head, and rebalance to target allocations. When the world is in turmoil, look to buy to restore your risk asset allocation. Remember famous financier Rothschild's maxim: "Buy on the sound of cannons, sell on the sound of trumpets." While buying amid signs of war would not be easy, at least don't fall prey to selling on the sound of cannons.

2. China Trade Dispute

Investors cheered the news that the US and the Chinese had reached a Phase I trade accord. However, investors must brace for the inevitable hangover after the signing. What, there's no schedule to lift the remaining tariffs? How will the agreement be enforced? It didn't include what?

The litany of complaints and the ensuing volatility should not shake you out of your portfolio. Again, you're better off forecasting interest rates than scrutinizing the twists and turns in the trade war.

Substitute heightened trade tensions for the sounds of the cannon and Rothschild's investment maxim may work for you. Economies work better for all if there's more trade, so the economic pressure to reach mutually beneficial trade deals is great.

Don't let the trade dispute throw you off your long-term course. Take advantage of sell offs due to trade disputes to bargain hunt. If the market rallies on the perceptions all the trade issues are forever resolved, take some chips off the table.

3. November Elections

As we get approach November the rhetoric from the politicians will get deafening. If this person gets elected, taxes will smother us, and the market will crash. If that person gets elected our health care stocks will be in shambles, fossil fuels operations will cease, debt will explode. Others say the current economy is a house of cards, to collapse once the bill comes due for unneeded tax cuts, and the full effects of closing our doors to global trade become apparent.

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I am reminded of a client who told us right before the 2016 elections that it was good that Trump would not get elected, because if he did, the market would collapse.

Two points are apparent. First, you are not going to predict political developments ahead of all other investors. Even if you could, the effect of them on the markets will be difficult to forecast. Why is that? Ask the pollsters why predicting the outcome is so difficult.

As to the effect on the markets? Thank the genius of the founding Fathers. To make real changes you need the approving votes of three bodies, the Senate, the House, and the White House. Even if approved by those three, there may be scrutiny by the Supreme Court. Bottom line, change comes slowly, if at all, and markets appreciate lack of uncertainty.

So, what type of Administration is best for stocks? I like Warren Buffett's quote: "If you mix politics and investing, you're making a big mistake." History shows that investors can be successful without regard to who's in the White House. It also seems all politicians are strongly incented to do what is best for the economy. A strong economy is the best prescription for holding onto power.

4. Rising Interest Rates

Given that interest rates have come down more or less continuously for a near 40-year period, from a double-digit level to just 1.3% in 2016, investors are nervous about interest rates reversing course and moving higher.

Higher interest rates could be a negative to the stock market; many investors have bought up stocks simply because yields on bonds have been too low. Higher rates could reverse that trend. If an investor could get 5% on a CD, why would that investor settle for an average 1.8% yield on the stock market?

Although a risk, we don't think investors should move to the sidelines because of it. First, when interest rates might rise is not easy to divine. For the last 7 years investors have feared rising rates, only to find that rates have continued to decline.

Even if rates do rise, look at the cause. If yields are going up due to a strengthening economy, spurring demand for mortgages, big ticket purchases, and capital expenditures, that could trigger higher earnings. Those greater earnings will help make stocks look cheap, offsetting the less favorable comparisons versus the higher bond yields.

Even if the higher rates are simply due to inflation, without any real economic boost, in other words a type of stagflation, many stocks could still do well. That would echo the 1970s, when inflation pushed up the prices of many commodities. As a result, oil and gold-oriented stocks outperformed.

In short, the fear of rising interest rates should not cause long term investors to exit the stock market.

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