Fourth Quarter 2019 Commentary

A trade war with China, actual military conflict in the Middle East, the Federal Reserve lowering benchmark interest rates, a presidential impeachment trial underway … and yet with all these troublesome indicators, the U.S. stock market continues to "climb the wall of worry." The S&P 500 returned 9.1% in the fourth quarter, which in most years would be considered good enough for the full twelve-month period. Compounded together with the 13.6% gain in Q1, 4.3% in Q2, and 1.7% in Q3, though, the S&P returned a total of 31.5% for 2019, a truly stellar one-year result that ranks it second so far this century.

The Dow Jones Industrial Average, with its higher representation of Old School companies like Caterpillar and 3M, posted total returns a bit more muted but still high in an absolute sense: up 6.7% in Q4 and 25.3% for the full year.

On the tail of such high recent returns, many are asking whether this lengthy bull market has finally reached the end of its run. Or should we expect to see a continuation of gains in the stock market?

Howard Marks, cofounder of Oaktree Capital Management and one of the most successful investors of all time, took a crack at answering this age-old question in his most recent book *Mastering the Market Cycle: Getting the Odds on Your Side*. The book describes the various business cycles—such as the economic cycle, the cycle in profits, the credit cycle, and the cycle in investor psychology—and how to cope with them.

Cyclical Behavior

The dictionary defines a cycle as "any series of occurrences that repeats or is repeated." Thus, when we consider a cycle such as the economic cycle, we might think about a period of recovery, followed by a period of expansion, followed by a period of decline, and then back to the beginning. The main lessons of the book boil down to the following:

- to have a complete understanding of cycles, we must comprehend that one event in the life of a cycle *causes* the next event

- the economic environment, the profitability of companies, and investor sentiment all swing like a pendulum, and they can and sometimes do go to extremes

- understanding the psychology of investors and deciphering how they are thinking and dealing about risk—are they more risk averse or more risk-seeking?—is highly important, as excessive risk tolerance leads to a dangerous investing environment

- the key benefit to understanding where we are in a cycle is that it can show how to position a portfolio by helping us decide when to zig compared to the average investor's zag. That is, it might behoove us to be more aggressive (i.e., buy stocks) when things look dismal and assets are therefore cheap; or conversely to be defensive (i.e., refusing to buy, or possibly even sell) when other investors are euphoric and assets are richly valued.

The best illustration in the book about cycles is what Marks calls "the three stages of the bull market:

- the first stage, when only a few unusually perceptive people believe things will get better,
- the second stage, when most investors realize that improvement is actually taking place, and
- the third stage, when everyone concludes things will get better forever."

A good example of these stages is the period we are in now, going back to early 2009. In 2008 the U.S. was in the midst of the Great Recession with home prices plummeting, banks faltering, unemployment rising, and mortgage foreclosures, all of which led to investors panicking. In early 2009, when things still looked dismal, a few investors saw that things could not get much worse and that stocks were cheap. It was a time of extreme negative sentiment and exaggerated risk aversion, and it turned out to be the start of a great bull market for stocks.

In the ensuing decade, the pendulum has swung from that initial panic to a much more optimistic environment. The economic cycle has entered into an era of higher employment, higher wages, and higher growth in GDP. In turn, investor psychology has turned from risk aversion to risk taking and we have definitely entered that second stage of the bull market, as most investors have participated in the big rally. Which naturally leads to the question of whether we are currently in the third stage and, if so, when will the cycle turn, taking the stock market down with it.

Where Are We Now?

To help us get a better sense of where we currently stand, *Mastering the Market Cycle* provides a nice cheat sheet of things to watch out for, and we reproduce most of the important elements below. For each pair of items, Marks prompts us to "check off the one you think is most descriptive of the current market." The more checkmarks you end up with on the left-hand column, the more optimistic you think the market is and the closer it must be to a top. It is at those times that Marks suggests that we be defensive and not overly aggressive in buying stocks.

Economy:	Vibrant	OR	Sluggish
Outlook:	Positive	OR	Negative
Lenders:	Eager	OR	Reticent
Capital markets:	Loose	OR	Tight
Lending terms:	Easy	OR	Restrictive
Interest rates:	Low	OR	High
Yield spreads:	Narrow	OR	Wide
Investors:	Eager to buy	OR	Uninterested in buying
Asset prices:	High	OR	Low
Asset owners:	Happy to hold	OR	Rushing for the exits
Recent performance:	Strong	OR	Weak
Popular qualities:	Aggressiveness	OR	Caution and discipline
Available mistakes:	Taking too much risk	OR	Taking too little risk

Going through this list, item by item, provides what Marks calls the “temperature of the market.” While not every checkmark is necessarily on the left-hand side today, we believe that a majority definitely are. While we are certainly not selling everything you own right now, neither do we feel like kids in a candy store when we look at the available stocks to buy. We are, in the phrase made famous by Mr. Marks, proceeding with caution.

Conclusion

Sir John Templeton famously said that “bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria.” In *Mastering the Market Cycle*, Howard Marks expounds on Templeton’s wise dictum and shows us how and why to differentiate between euphoria and pessimism in different cycles. Doing so will make us better investors and hopefully lead to better returns for our portfolios.

With this in mind, we will do our best to navigate your portfolio through the cyclical waters ahead of us, and we thank you for granting us the privilege of doing so. We look forward to reporting to you again in April.

Sincerely,

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