ANALYTICS INVESTMENT ADVISORS, LLC

The U.S. Economy and Stock Market

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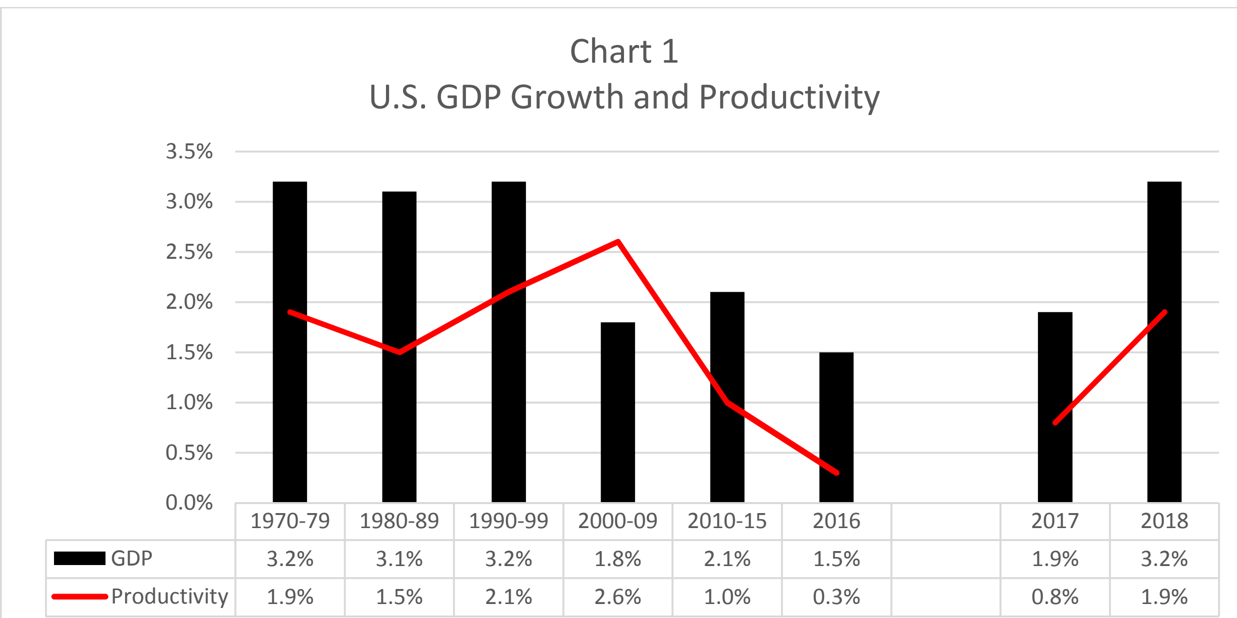
"Rarely has a flip of the calendar marked such a pronounced change in market and investor psychology" [1]

What? *"Pro-business policies, cutting taxes, slashing regulations and encouraging energy production has released pent-up dynamism of American capitalism; and, powered by the initiative of American workers, the U.S. economy is creating prosperity for every class and color of people".* [2]

- **GDP** steadily increased from 1.5% in 2016, to 1.9% in 2017, and an estimated 3.2% for 2018[3], the latter statistic being comparable to each of the 3 ten year GDP averages between 1970 and 1999. (Chart 1)
- Non-inflationary **Productivity** more than doubled from .8% in 2017, to 1.8% in the first three quarters of 2018.[4] (Chart 1)



	1970-79	1980-89	1990-99	2000-09	2010-15	2016		2017	2018
GDP	3.2%	3.1%	3.2%	1.8%	2.1%	1.5%		1.9%	3.2%
Productivity	1.9%	1.5%	2.1%	2.6%	1.0%	0.3%		0.8%	1.9%

U.S. Bureau of Economic Analysis

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[1] *Barron's*, "Up and Down Wall Street", December 17, 2018, p.2.
[2] Puzder, Andy, *The Capitalistic Comeback,* Hachette Book Group, 2018.
[3] GDP 1Q2018 = 2.2%; GDP 2Q2018 = 4.2%; GDP 3Q2018 = 3.5%; and, GDP 4Q2018 = 2.9% (estimate).
[4] The historic relationship between GDP growth and productivity is well established. See Commentary, "Labor Productivity and GDP Growth", April 5, 2017, www.AnalyticsLLC.net.

- **Earnings Insight**[5]
    1. For Q3 2018 77% of S&P 500 reporting companies (48%) have reported a positive EPS surprise, and 59% have stated positive sales surprise.
    2. For Q3 2018 the blended earnings growth rate for the S&P 500 is 22.5%, the third highest earnings growth since Q3 2010.
    3. The forward 12-month P/E ratio for the S&P 500 is 15.5, below the 5-year average (16.4) but above the 10-year average (14.5).
    4. In aggregate, earnings have exceeded expectations by 6.5%, which is above the 5-year average of 4.6%. These positive EPS surprises have generated improved earnings growth rates for the S&P500 to 22.5% in October from 19.3% on September 30th.
    5. S&P 500 companies have seen the worst price reaction (-1.5%) to positive EPS surprises since Q2 2011.
    6. The CY 2019 earnings growth estimate is 10%, and revenue growth is projected to be 5.4%.
- The **Conference Board's Leading Economic Index** indicates robust growth in early 2019, but longer-term growth moderating to 2.5%.[6]
- Total and core **Consumer Price Index (CPI)** was 2.2% year-over-year in November, consistent with the Federal Reserve's longer-run target. Moreover, holiday sales grew 5.1% to more than $850 billion, making it the best season in the last six years according to data Mastercard released on December 26th.
- The November **Producer Price Index (PPI)** for final demand increased .1% month-over-month in November, which left the index for final demand up 2.5% year-over-year, versus 2.9% in October, thus reducing inflation fears and lessening the likelihood that the Federal Reserve will be aggressive with future rate hikes.
- **Unemployment** was steady at 3.7% for November, October, and September, while the labor participation rate increased .2% from November to 63.1% of the 258,888,000 civilian population in December; the highest historic recording being 67.3 % in 2000. "This has been the best year for the real economy in the last 20 years regarding jobs, industrial production, manufacturing, construction and low employment, with seven million more jobs than people to fill them."[7] The labor market added an impressive 312,000 jobs in December, while the nation's unemployment increased .2% to 3.9%, an 18 year low. This compares to the average gain of 215,000 per month over the previous five years.
- The **Unemployment rate for Hispanics and Latinos** was 4.4% in December, the lowest level of Bureau of Labor Statistics data since 1973. Moreover, The Hispanics labor participation rate rose in December to 67.0%, the fourth straight monthly increase.
- In December, the average hourly earnings for all employees on private nonfarm payrolls rose 11 cents to $27.48; while the yearly **Average Hourly Earnings** improved 84 cents, or 3.2%.
- **Retail Sales** increase .2% in November, while core retail sales, which exclude auto, gasoline stations, building materials, food services and drinking place sales, increased .9%.
- **Industrial Production** was up 3.9% year-over-year in November, while **Capacity Utilization** remains 1.3% below the long-run average at 78.5%.
- The **Chicago PMI Index** for the November increased from 57.9 in October to 72.5 in November, which is the highest level since May 2014, an encouraging sign of robust manufacturing demand.

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[5] FactSet (NYSE:FDS | NASDAQ:FDS).
[6] The source of the data for the following paragraphs is 2018 Briefing.com unless noted otherwise.
[7] Mack, Eric, 'Stephen Moore: Throw Out the Fed for Economic Malpractice', *Newsmax,* December 23, 2018.

- Similarly, the **ISM Manufacturing Index** reflects an acceleration in national manufacturing activity amid concerns of a general slowdown in growth. According to ISM, the past relationship between the PMI and the overall economy indicates that the November reading corresponds to a 4.9% increase in real GDP on an annualized basis.
- The **ISM Non-Manufacturing Index** rose to 60.7% in November from 60.3% in October, the second highest reading in 2018, and indicates that the past relationship between the Non-Manufacturing PMI and the overall economy corresponds to a 4.3% increase in real GDP on an annualized basis.
- The **Conference Board's Consumer Confidence Index** decreased to 128.1 in December from a revised 136.4 in November, giving credence to the belief that the pace of economic growth will decelerate somewhat in the first half of 2019.
- **Durable Goods** orders increased .8% in November after an upwardly revised 4.3% decline in October. A concomitant .6% decline in nondefense capital goods orders excluding aircraft, and a .1% decline in shipments of the same goods, will have a negative impact on Q4 GDP, currently estimated to be 2.9%.
- Single unit **Housing Starts** were down 9.5% in the Northeast; down 3.2% in the Midwest; up 3.0% in the South; and, down 24.4% in the West, all of which substantiates the general weakening levels of homebuilder confidence, and a reflection of the impact of rising interest rates are having on single-family construction activity.

Why? "*Under capitalism, one improves life by satisfying the needs of others (consumers) by making sure they get what they need. In reality, it is capitalism that encourages altruistic behavior, produces vast economic benefits, and lifts standards of living across broad demographics (everyone benefits to differing degrees).*" [8] *"Tax cuts and fewer regulations are sending black and Latino jobless rates to record lows, while working-age minorities are benefitting in ways they rarely, if ever, have enjoyed in the modern era."* [9]

So why, if the U.S. economy is presently doing so well under capitalism, is the stock market, which is forward looking, not more in sync with equity markets which produced the worst December since 1931? [10] The following paragraphs offer several plausible explanations.

- The conflict between Keynesian demand stimulation and Say's Law where the emphasis is on increasing production, is reminiscent of the Walter W. Heller v. Milton Friedman 1960's policy debates regarding fiscal v. monetary policy, which were in reality not an either/or proposition, but rather a "dialogue" regarding the most judicious combination of monetary and fiscal models to maximize societal economic benefits.[11] Accordingly, there is a plausible case to be made that in the present economic environment, not enough attention has been given to Say's supply side theory relative to the Keynesian demand approach; the argument for which goes as follows.
- Keynesian economists argue that since aggregate demand is volatile, a market economy will often experience inefficient macroeconomic performance in the form of recessions and inflation, and that these aberrations in aggregate demand can be best managed by monetary policy and fiscal policy. In contrast to 1803, John Baptiste Say stated: "It is worthwhile to remark that a

[8] Under socialism, you improve your life by addressing the needs of those in power – the government elites – and striving to get what you can before somewhat else does" (Puzder, p. 12). See Commentary, "Capitalism as a Social Concept", September 10, 2012, www.AnalyticsLLC.net, for an in depth discussion of this subject.

[9] Meyers, Jim, "America Minorities Big Winners in Trump Economy", *Newsmax*, April 2018, pp.14-15.

[10] The Dow Jones Industrial Average declined 507 points on December 17th 2018; *MarketWatch.*

[11] Friedman, Milton and Walter W. Heller, *Monetary v. Fiscal Policy – A Dialogue,* The Graduate School of Business, New York University, 1969.

product is no sooner created, than it, from that instant, affords a market for other products to the full extent of its own value"[12]

- This comparison is relevant because on December 20th the Federal Reserve raised the Federal Funds Rate 25 basis points to 2.50%, and telegraphed two additional increases of a similar magnitude in 2019 to 3.0%, apparently aware of that aggregate demand is projected to decline, inflation is steady at 2%, the economy is at full employment[13], and there have been significant increases in productivity 2018 to 1.9%. (Chart 1)
- One can therefore reasonably conclude that a significant portion of the historic stock market decline in December 2018 was due to the perception that raising rates in a declining demand environment, with no inflation, full employment, significant productivity gains, and solid corporate earnings is antithetical to a rationale balance between fiscal and monetary policy.[14] Briefing.com put it this way: "...the wage acceleration the Federal Reserve has been bracing for was missing, but that won't likely keep the Federal Reserve from raising the target range for the fed funds rate at its December meeting, yet it's the type of data point that could lead the Federal Reserve to be more cautious-minded about raising rates after that."[15] Let's certainly hope so...![16]
- Trade discussions with China are currently causing additional uncertainty, but are likely to be successful, generating significant long term benefits to the United States because: 1) China is dependent on the $10 trillion American consumer market to maintain historical growth rates; 2) China's growth economy is diminishing due to unsold inventories resulting from the 10% tariffs currently being levied by the United States; 3) the demands made by the United States regarding theft of technology, confiscation of intellectual property, expropriation of property, selling technology to enemies of the United States are non-negotiable and irrefutably defensible; and, 4) lower tariffs are in China's best economic interests by allowing full access to thousands of additional products that will result in a higher standard of living for 1.5 billion Chinese citizens.[17]
- High frequency trading has been acknowledged by the Federal Reserve to be more prevalent in 2018, a potential source of increased volatility, and a phenomenon they intend to investigate.

How?

- Keep the faith... The U.S. economy is in great shape, the Federal Reserve will more than likely moderate its interest rate policy in 2019, and the tariff dispute with China has a reasonable probability of becoming mutually beneficial, all of which should generate a robust economy and stock market.
- Use Exchange Traded Funds for diversification and growth potential, utilizing relative strength as a proven technical indicator for potentially higher returns[18] and favorable risk/returns indices to insure judicious and efficient portfolio allocation. [19]

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[12] J.B. Say, 1803, pp.138-9. Say's Law was expanded by other classical economist; James Mill and David Ricardo.

[13] A necessary condition for Say's Law, that supply creates its own demand, to be valid.

[14] See Wesbury, Brian S., Robert Stein and Strider Elass, "Fading Fiscal Stimulus", *Monday Outlook*, First Trust, November 19, 2018, for a similar but more detailed presentation.

[15] "November Nonfarm Payrolls", December 7, 2018.

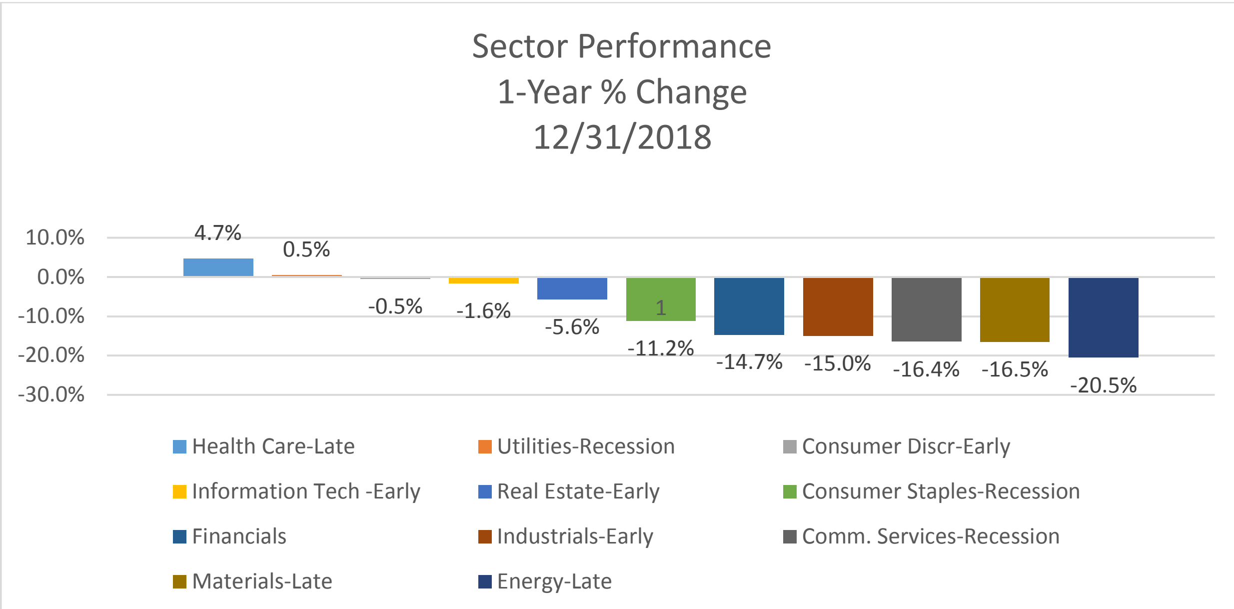
[16] On Friday, January 4th Chairman Powell was forced to admit: "With muted inflation readings that we have seen coming in, we will be patient as we watch to see how the economy evolves." *Wall Street Journal*, January 5, A1. Cleveland Fed President, Loretta Mester concurred: "I'm in a position now where I don't feel there is urgency. The focus on whether the Fed will raise rates one or more times this year is a little misplaced at this point. We have time to look at the data as it comes in." *Wall Street Journal*, January 5, 2018, A11. Predictably, the DJIA increased a record 745 points (3.3%).

[17] The ultimate and predictable outcome of a more judicious application of the Law of Comparative Advantage.

[18] See Commentary, "Momentum Investing Using Exchange Traded Funds – Recap and Update, October 8, 2018 www.AnalyticsLLC.net, showing statistically significant relationships between Return and Relative Strength; e.g., that for every 10% increase in relative strength over a 1 year time period, there was between 3.14% and 3.58% increase in Returns. The percent of Return variability explained by Relative Strength for those equation ranged from 77.3 to 83.2%.

[19] The Sharpe Ratio is a common, frequently used, and easily interpreted option.

- Remember that momentum (relative strength) investing (which focuses only on price) is not the same as growth investing, and is a proven long term sustainable anomaly[20] that exploits a systematic investor expectation error of being overly pessimistic and hesitant to be bullish when prices are rising.[21]
- When researching which sectors to favor and how to interpret the business cycle, consider the possibility that the current business cycle has averted the recession phase due primarily to the bold fiscal policies of the current administration cited above, causing technology, consumer discretionary to outperform in 2018, the presence of which suggests an early to mid-cycle phenomenon rather than mid to late-cycle suggested by some forecasters.[22]



Sectors and Business Cycle Phases (Early, Mid, Late, Recession) that predicable outperform.[23]

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[20] The evidence is so overwhelming that Eugene Fama, an original architect of the Efficient Market Hypothesis (EMH) called it the "premier anomaly", "Dissecting Anomalies", *Journal of Financial Economics,* 63, (2008):1653-1658.

[21] Gray, Wesley R. and Jack R. Vogel, *Quantitative Momentum, A Practitioner's Guide to Building a Momentum-Bases Stock Selection System*. John Wiley & Sons, 2016, p. 39; Table 3.1, p. 54, showing momentum out performed value, growth and the S&P500 between 1927 and 2014, and, pp. 53-56.

[22] It is notable that given that three out of the five best performing sectors in 2018 to have predictable outperformance in the Early phase of the business cycle were: Consumer Discretionary, Information Technology, and Real Estate, perhaps provided some of the rationale for Jerome Powell's statement that: "The U.S. Economy is experiencing a remarkable positive set of economic circumstances, and that there is no reason to think this cycle can't continue for some time, effectively indefinitely"; Central Banks, *Wall Street Journal*, October 3, 2018.

[23] "Sectors & Industries – Business Cycle*", Fidelity Investments,* 12/31/2018.

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Performance Summary

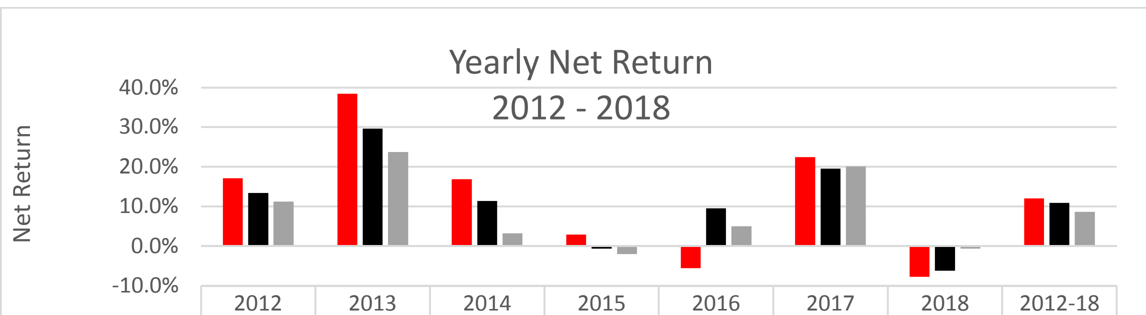
- **Cautious Strategy**: Cautious investors seeking better than nominal returns, but with low risk and emphasis on preservation of wealth (Risk Score: 111-200).
- **Moderate Strategy:** Prudent investors desiring a portfolio designed to accomplish medium to long term financial goals and an investment strategy which accounts for taxes and inflation. Calculated risk is acceptable to achieve good returns (Risk Score: 201-290).
- **Assertive Strategies 1 & 2:** Assertive investors with sufficient income to invest mostly for capital growth. Higher volatility, moderate risk, and more aggressive investments are acceptable to accumulate wealth over time (Risk Score: 291-390).
- **Aggressive Strategy:** Aggressive investors intending to compromise portfolio balance in pursuit of higher long term returns. Security of capital is secondary to potential wealth accumulation (Risk Score: 391-450).

	2012-2018 Avg.*	**YTD* 12/31/2018**					
S&P500 (SPX)	**10.91%**	**-6.24%**					
Barclay US TR	**1.78%**	**.01%**					
			AUM	**Beta**	**R^2**	**SD**	**Sharpe****
Cautious	9.88%	n/a	0%	.90	94	10.14	.81
Moderate	10.58%	-5.74%	13%	1.12	90	12.88	.80
Assertive 1	12.04%	-7.78%	56%	1.26	93	14.33	.82
Assertive 2	15.88%	-7.90%	10%	1.50	91	15.54	.95
Aggressive	17.27%	-14.07%	20%	2.23	90	25.87	.86

*Net Average Return, Portfolio Center, Schwab Portfolio Technologies. Returns are negotiable and range between 50 and 125 basis points.

** Risk Statistics, Morningstar Advisor Workstation; most recent 5 years, computed quarterly.

Beta	Expected change in portfolio return per 1% change in market index return.
R^2	Percent of variation in regression equation explained by the independent variable (S&P500).
SD	Standard deviation of the dependent variable (Net Return).
Sharpe Ratio	Reward-to-Variability Ratio; i.e., portfolio return above risk free rate of return divided by standard deviation (RVAR).



	2012	2013	2014	2015	2016	2017	2018	2012-18
Assertive1	17.1%	38.4%	16.9%	2.9%	-5.6%	22.4%	-7.8%	12.0%
S&P500	13.4%	29.6%	11.4%	-0.7%	9.5%	19.5%	-6.2%	10.9%
MSCI World	11.2%	23.7%	3.2%	-2.0%	5.0%	20.1%	-0.7%	8.6%