CAMMACK RETIREMENT

Top Four Risks for Investors in 2019

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Ten years ago, our economy experienced one of the most significant market downturns in recent history. For many us, the collapse of Lehman Brothers and the events that followed are memories that still linger in the back of our minds. And, nearly one decade later, investors are raising some important questions: After multiple years of stock market gains, what could go wrong? How will the markets react to the potential instability of global markets? Is the market peaking? Could the economy overheat? Will the market have another 20% or worse drawdown soon? The short answer to these questions is that it is difficult to time markets and predict crashes. Despite the market rallying strongly since the bottom formed in March 2009, history has shown us that market corrections can happen frequently.

Investors saw the first hint of a market correction when volatility returned in the latter part of the third quarter and during the current quarter. October saw the S&P 500 come within a hair of correcting 10% from its previous peak. Since 1950, the S&P 500 has had 36 occasions where it corrected by 10% or more, which equates to a correction about every two years.

Thus, corrections are a relatively common scenario in the market. Since retirement savers will almost always regret decisions made based on short-term emotional impulses, they should be aware of, and prepare for, these risk-based market events. Understanding how different scenarios play out can enable investors to make rational decisions that benefit them significantly in the long run. And by having a fundamental understanding of the risks in the market, the shock of potential drawdowns can be allayed.

As we move into 2019, our investment team has identified multiple risk factors that could have significant market impact in the coming year.

1. RUNAWAY INFLATION AND INTEREST RATES

The Federal Funds Rate remained near zero from December 2008 until the first 25 basis points (bps) hike in December 2015. These rate hikes are driven by the Federal Reserve's desire to prevent the economy from overheating and to help keep inflation in check. Certain pockets of the stock and bond market have reacted, but the market overall has not been derailed by these hikes. However, a deviation from the Federal Reserve's path of gradually increasing the overnight rate (expected to be 25 basis points at a time) would likely cause the market to react poorly. For example, if the Federal Reserve announced a 50- or 75-basis point hike, it would come as a shock to the financial system and a surprise to market observers. This sort of unexpected action would likely be triggered by a sharp devaluation of the U.S. dollar or outsized inflation. Our current economic recovery has seen mostly low inflation, and according to the Federal Reserve of Cleveland, inflation expectations for the next decade should remain around 2.0% annually.

It is important to keep in mind that the Federal Reserve's goal is to achieve maximum employment and low, but steady, inflation (typically a 2.0% core PCE target); and their focus is not to maximize stock prices. Nonetheless, actions of the Federal Reserve do have an impact on financial markets. Concerns over missteps have come to the forefront as a primary market fear for investors. Should inflation heat up and run higher than expected, this could trigger the Federal Reserve to hike rates more aggressively. All of which would likely be a recipe for sharper stock market corrections. Simply put, sharp rate hikes make money more expensive. Variable rate loans become more expensive, mortgage borrowing can slow and hamper the housing market, and businesses would have to borrow at higher costs, which can lead to a decline in capital investment. The combination of these factors can weigh on economic growth. Lately, rate hikes have been slow and steady and it is expected that the final Fed Funds Rate will reach 3.1% in 2019.

2. LACK OF GLOBAL ECONOMIC COOPERATION

Since the conclusion of the Second World War, international cooperation from an economic and political standpoint has been a key tailwind for the U.S. economy and other global economies. Termed "globalization," the concept of international economic cooperation is important to free trade and the flow of capital and labor to exploit efficiencies, allowing all nations to maximize their economic output.

The outcomes of globalization, however, are not always well-received. For example, manufacturing and other manual jobs, which were the economic backbone of many communities in the United States and other developed nations over the last generation, have largely moved overseas. This has led to increased nationalism and the deterioration of international trade agreements—a recessionary threat. In the U.S. and elsewhere, there is an increased willingness to circumvent or do away with current trade arrangements and treaties; the United Kingdom leaving the European Union is a prime example. Other examples include the U.S. doing away with NAFTA and attempts by President Trump to make bilateral agreements with other trading partners that avoid the process and regulations already in place.

There is a lot at stake when it comes to international trade. While American consumers may want to see more jobs created in the U.S., it is likely that their desire for inexpensive goods from China and elsewhere is stronger. Open markets and free trade have been good for the U.S. consumer, but not always for the American worker. While economic brinksmanship in the form of tariffs and tearing up trade deals may seem appealing to some, President Trump and other world leaders must balance continued cooperation while being sensitive to their impacted citizens. A serious breakdown in trade could lead to runaway inflation, decreased profits, and severe protectionism that could stagnate or shrink the domestic gross domestic product (GDP).

3. DEBT BUBBLE

Post 2008, interest rate compression and infusion of liquidity by global central banks have resulted in a massive accumulation of debt by both sovereign and corporate issuers. Rising interest rates put pressure on profit margins and earnings, and make debt refinancing more expensive. Slowing economic growth can also lead to challenges, as heavily indebted companies have a harder time repaying their debt as their earnings decline.

On a national level, high federal debt could eventually restrain economic growth and cause interest rates to increase. With continued increases in federal spending and a decrease in tax revenue, the federal deficit will continue to rise.

Moreover, with federal deficits on track to rise in the years ahead, the federal government's borrowing needs could crowd private borrowing, which would result in higher interest rates and even more challenges for indebted companies. A combination of both rising U.S. interest rates and fiscal deficits, along with a potentially huge wave of riskier corporate credit, provides an uncertain backdrop and potential for greater market downturns.

4. EMERGING MARKETS CONTAGION

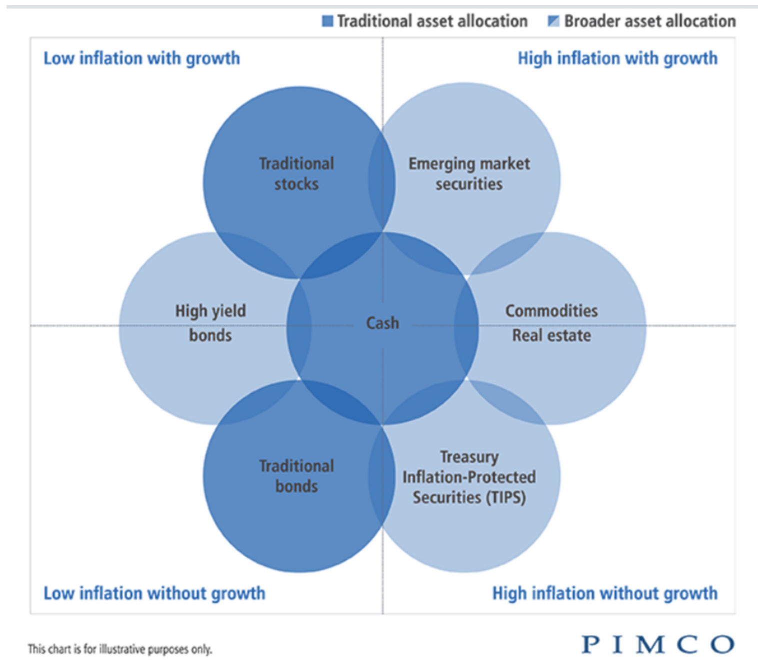
Fear of tariffs and the possible implementation of trade protectionism policies have created an uncertain environment for emerging markets investors. Emerging market equity and fixed income are currently underperforming in developed markets. The combination of currency devaluation and political instability in many countries has created a strong headwind for the emerging markets' economies. Also, elevated risk in relation to how the Chinese government will navigate monetary and fiscal policy to avoid a "hard landing" of its economy affected other emerging economies. Deceleration of Chinese economic growth means weaker global demand for commodities and overall declining export demand from China, further pressuring its trading partners.

U.S. economic growth continued to improve as global growth decelerated. Stronger economic growth and higher interest rates led to dollar appreciation versus many international currencies. A strong U.S. dollar may cause capital to flow away from emerging markets, which are heavily reliant on foreign inflows to fund fiscal or current account deficits.

Populism and geopolitical risks, both at home and abroad, are downside risks for emerging markets. Corporate leverage has increased in emerging markets since the global financial crisis, with high levels of corporate debt issuance in non-local currency. A strengthening dollar could severely damage corporate balance sheets within emerging markets.

UNDERSTANDING THE RISKS

While risks are certainly elevated, a well-diversified portfolio will help to mitigate them. Retirement plan menus should include funds that have a well-documented research process that looks for attractive valuation at a reasonable price. Participants in the early years of their career have a long time period until retirement and are therefore better able to invest in all economic scenarios and cycles. Late career participants need to review their holdings and manage risk appropriately. Target date funds and managed accounts invest portfolios with this in mind; and an investor's portfolio becomes less susceptible to market and economic risk as the participant nears retirement. Diversified asset allocation is important as asset classes perform differently in a variety of scenarios. The inclusion of non-traditional and real assets can help participants position for a broad range of economic scenarios. The following illustration shows different economic cycles and the asset classes that perform well in those scenarios. Given the inability to precisely predict what is next in the economic cycle, a diversified portfolio will have asset classes that perform well when others do not.



Source: [PIMCO]

CONCLUSION

While investors are right to question where the market will go from here, a fundamental understanding of the risks may help allay the shock of potential drawdowns. And, given the inability to precisely predict what is next in the economic cycle, a diversified portfolio will have asset classes that perform well when others do not.

Note: This information is intended to be educational and is not tailored to the investment needs of any specific investor. Views expressed are as of the date published, based on the information available at that time, and may change based on market and other conditions. Diversification does not guarantee a profit or protect against loss.

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Cammack Retirement Group has been helping retirement plan sponsors meet their goals for half a century. Solely focused on serving retirement plan sponsors, we provide a tailored approach to investment advisory and consulting services. We work with some of the nation's leading academic and research institutions, healthcare providers, corporations, non-profit organizations and public sector employers to help them manage fiduciary risk.

For more information on our services, please contact **Mike Volo,** Senior Partner, at **781.997.1426** or **mvolo@cammackretirement.com**.

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