WILLINK
ASSET MANAGEMENT LLC

January 2018: *Are we headed for another Stock Market Crash?*

Brooksley E. Born

July of 2007 a growing number of regulators, economists, and others – among them Commodity Futures Trading Commissioner Brooksley Born, NYC professor Nouriel Roubini, Peter Schiff of Euro Pacific Capital and Indian central banker Raghurham Rajan – have by now made their case for increased regulation and reform of mortgage lending practices and the new and unregulated derivative securities. They cite the prospect of a looming crisis.

But luminaries such as former SEC Chair Arthur Levitt, former Treasury Secretaries Robert Rubin and Alan Greenspan and Asst. Secretary Larry Summers convince Congress to ignore the warnings; and to "let the markets work".

Only marginally cognizant at this point of the mostly behind the scenes controversy, Willink Asset Management LLC (WAM) is however aware of how far "out of balance" its portfolios have become.

So, even as the stock market continues its surge WAM rebalances its client portfolios, reducing stock market exposure back to target allocations. And for clients depending upon their portfolio for most of their income, the unusual step of pulling back below target is taken.

Allocation among stocks, bonds and cash is a primary means we use to manage portfolio risk, rather than forecasts of events or stock prices.

By early 2008 faltering stock markets capture headlines. But "talking heads" in the financial news continue to disparage policy critics, explaining events as a housecleaning necessary for the bull market to continue.

IT IS INSTEAD THE ONSET OF THE GREAT RECESSION. In succession Bear Stearns, Countrywide Mortgage, AIG, Lehman Brothers, Merrill Lynch, Fannie May, Freddie Mac, GM and Chrysler will stumble or fall. WAM will soon realize that more could have been done. At least no client throughout the crisis will have to sell positions at a loss in order to meet demand on their portfolio for income or expenses as a result of WAM's actions.

It will take more than five years for stock prices on Wall Street to climb back to previous levels. An account tumble of 40% (roughly what the S&P 500 endures.) requires a gain of 66% to break even. No WAM client will suffer anything remotely near that collapse. But on Main St. unemployment, mortgage foreclosures and low productivity will continue for years until recovery. The damage to many employees, businesses and homeowners remains to this day.

Memories linger. Countless hours during the crisis would be spent guiding our clients to better times. Many of you today still recall exactly how you felt; younger clients might regard it as ancient history.

So, we might guess what many of you are thinking, even if you aren't asking. How is this relevant to today? Will it be the same this time? How long will the current bull market continue? How will Willink Asset Management know? Is it time to take gains off the table? What do we know about strategies and

products advertised to ride the bull while protecting gains? Are there important differences between now and then? Can you endure a similar number of years to recovery if the market does tumble? Can your portfolio be better positioned to harvest reasonable gains while maintaining the needed liquidity for income–and to seize opportunities if there is a market downdraft?

The Good News: It's different this time.

The Bad News: Every market tumble is different.

The Better News:

1. There are few behind the scenes warnings that we can discern**,** unlike 2007.

2. The remarkable and sustained growth of US stocks represented by the S&P 500 in 2017 (total return of roughly 22%, and almost 7% in the fourth quarter alone) appears to have been a reasonable response to a worldwide economic recovery. While it is true that the artificial depression of interest rates by central banks here and abroad has encouraged global business to grow, it is notable that respectable company earnings reports in most sectors appear to support current stock prices. That means this is not simply boost from the US tax bill, or in the US at this point, no longer dependent on aggressive interest rate manipulation.

3. The tried and true methods for managing investment risk have not changed. These have little to do with trying to forecast when the market will turn.

   These have much to do with assessing your own time horizons—the time frames when, and the dollar demands on your portfolio that must be met.

   Then we match those demands with appropriate investment vehicles and strategies.

   Then we monitor portfolio performance as it relates to expected demands and make adjustment, rebalance, make trades etc. as appropriate.

Recall that much of the trade action is not readily apparent to you. It occurs within our fund structure as the tide moves from growth to value stocks or large to small companies etc.

Forecasting stock price and interest rate movements, or trying to connect the dots between political and economic events is entertaining. But reliable studies of these activities show that such attempts are less successful than calling NFL rankings. Think we are wrong about that?

The markets can only do three things; stay about where they are, move up appreciably, or move down appreciably. If you take the time (as serious researchers have done) to allocate the analysts' and forecasters' picks among these three outcomes you will discover that most of the time, the field is spread more or less evenly among the three. And when the field begins to load up on one or another outcome….?

The field is about to be wrong. Witness the herd mentality and euphoria leading up to 2008.

We haven't seen anything much like that as we head into 2018. Not yet, anyway.

What then might be reasonable to expect, and prepare for in 2018?

- Lower stock returns in the coming year. The S&P 500 doesn't bestow 20% returns year after year.
- Increased volatility for stock prices. It was hardly noticeable last year—and that is not normal.
- The trading community (the various institutional traders, hedge funds and others that account for some 70% of the daily trading volume) actually enjoy some volatility. It's how they make shorter term profits when it seems to them it's unlikely the market will continue up at an historic pace.
- A mixed bag in terms of interest earnings from fixed income (bonds, cash equivalents). Bond buying to stimulate the economy is being pared in the US, but not in Europe and Asia.
- Sector rotation away from technology to seize opportunities or bargains in other sectors and countries that haven't fared as well as Facebook, Apple, Amazon, Netflix and Google. But don't count tech out.
- The "dumb money" might soon show up, as it often does near market peaks. That is when folks take on credit card or home equity debt to buy stocks (or bitcoin cryptocurrency).
- Some of our clients will become depressed if their portfolio value recedes from a recent high point, no matter what we say or do. That stock prices tumble ("correction" is the polite phrase) to the tune of 10 to 20% every couple of years is normal. Expect it. And if you can't tolerate it, you may have too much in the market.
- Inflation. Remember inflation? The loss of purchasing power? We are not economists. But we wonder what happened to it. That might be the boogie man that tests all our ability to stay in balance.

Here is to a great year. We will be calling you if it's been a while since we last spoke. In the meantime, please don't hesitate to contact us if you have questions or concerns.

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