3EDGE
ASSET MANAGEMENT

# Because: Market Melt-Up

## The Good, The Bad and The Ugly

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DeFred G Folts III
Chief Investment Strategist
3EDGE Asset Management

During the recent recording of our View from the Edge podcast, which I record every month with Eric Biegeleisen, Director of Research, I exclaimed half-jokingly that at this point it feels as though the U.S. equity market simply can't be stopped. Not even a rapidly spreading, deadly virus from China can slow this market. Of course, we know that bull markets don't last forever and perhaps it is best to be cautious particularly when markets start to feel as though they may never go down again. I was also reminded of a quote by famous investor George Soros who said, "When most people think the worst imaginable outcome is failing to participate fully in gains, the result is risky behavior." So, with the U.S. equity market seemingly in market melt-up mode, let's take a look at some of the data points which could either augur well or ill from here.

**The Good**

- Fears of an imminent recession seem to have faded for now.
- The truce on trade between the U.S. and China has been a relief to many companies.
- Wage inflation remains reasonable for an economy at historically low levels of unemployment.
- Interest rates are low, and the Fed seems intent on keeping them there.
- Plans for Capex spending by companies ticked up in early 2020, after declining for much of 2019.

**The Bad**

- Containing the spread of the coronavirus is not a given, should the situation worsen. It could still turn into an even larger human tragedy, disrupt global supply chains and negatively impact both business and consumer confidence.
- As was the case in 1999/2000, but with different company names, a handful of large tech companies (FAANG stocks) are supplying much of the impetus to the markets – the parallel isn't perfect but does demand investors' attention.
- Lastly, the U.S. economy is consumer-driven and household consumption has recently begun to show some early signs of slowing.

**The Ugly - Debt**

- The projected U.S. fiscal deficit for the year is approximately $1 trillion, around 4.6% of GDP which is extraordinarily high and projected to continue like this in the future.
- Corporate debt has now reached near-record levels (over $15 trillion) in relation to GDP.
- Total consumer debt has now reached over $13 trillion.
- This large and growing level of indebtedness cannot go on forever, but it is difficult to predict when and how it will end.

**What do we know?**

- U.S. stocks have been rising faster than the fundamentals, for example, the price-to-sales ratio of the S&P 500 index is currently at historically high levels.
- Investor psychology seems to be a major force pushing equity indices ever higher and we seem to be living in a market melt-up.
- Periods of exuberance can be self-reinforcing, and consequently overvalued markets can become even more overvalued for an extended period before correcting.
- Some of the sharpest gains in stock prices have occurred during the final stages of a bull market, prior to the onset of the next bear market.

**What to do?**
At 3EDGE, we believe that the current market environment requires a balanced approach. It may make sense to allocate a portion of a portfolio into equities but at a reduced level and complemented by other positions such as Treasuries, TIPS (Treasury Inflation Protected Securities), gold and short-term fixed income/cash equivalents that potentially serve to hedge against a stock market decline. The objective is to participate somewhat in any remaining upside while recognizing that the market's eventual turn could be abrupt and not easy to predict, suggesting a need to have defensive hedges in place beforehand. We realize that in the short term, being more defensive can lead to sacrificing some investment returns, but our aim is to avoid the full brunt of a bear market decline.

We will continue to follow our discipline and employ our model and research methods, analyzing a number of valuation, economic and behavioral factors on behalf of clients, giving special attention to the warning signs highlighted above.

**3EDGE Asset Management,** One International Place, Suite 4430, Boston, MA 02110
**T** 844.903.3343 **W** 3edgeam.com