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In our January 23, 2019 stock market report, after one of the worst Decembers in history for stocks, I concluded the worst was over due to a more dovish interest rate stance from the Federal Reserve Board.

However, I also recommended playing it safer, not getting all out, but rather lightening up on stocks based on the following concerns:

- The market has already risen over 300%.
- The market is at historically sky-high valuation levels seen at the tops of previous major bear markets.
- Over aged by over double the historical norm of 3.6 years.
- Geopolitical uncertainties abounding.
- Interest rates just starting to rise.
- Corporate profits peaking.
- Decelerating worldwide economy.
- Possibility of trade war escalating.
- Inverted Yield Curve which has historically preceded recessions.

Every single concern mentioned above still confronts the market except rising interest rates. In fact, Federal Reserve Board, Chairman Powell indicated the Fed's willingness to lower rates in a July 10th testimony before Congress.

Question

Why is the Federal Reserve Board considering lowering rates? I believe they fear a recession indicated by an Inverted Yield Curve (See "Inverted Yield Curve" in the attached January 23, 2019 report).

Federal Reserve Bank of New York Recession Indicator

According to David Rosenberg, Gluskin Sheff & Associates Inc.'s chief economist and strategist, anyone who "can't see the recession" coming to the U.S. isn't looking at a key indicator. Rosenberg cites a gauge compiled by the Federal Reserve Bank of New York. The monthly indicator is based on the gap between yields on three-month Treasury bills and 10-year notes and shows recession probabilities over 12 months. **The reading in July was 32.9%, a 12-year high.**

Yield Curve Inversion Expert's Findings

According to a June 5 Market Watch article, *this yield curve expert with a perfect track record sees recession risk growing,* Campbell Harvey, a professor at the Fuqua School of Business at Duke University is an expert predicting recessions based on yield curve inversions. He has tracked yield curve inversions for more than 30 years. He showed the reliability of the indicator in his doctoral dissertation at the University of Chicago in 1986.

That dissertation showed that an inverted yield curve would have anticipated the previous four recessions. After its publication, the model predicted the next three recessions — 1990-91, 2001, and 2007-09 — **so it has a perfect track record going back about 40 years. He says the current inversion is flashing yellow, if not red, for markets and the economy.**

Yield Curve Inversion & Recessions

Don't forget, stock market prices reflect future earnings. Bear markets have historically started near the top when things look their best!

I believe what an investor should do is look for those warning signs that signify it is late in the bull market cycle where one should be pursuing a more defensive investing course.

An inverted yield curve is one of those characteristic warning signs, and another is the Federal Reserve's own yield spread model mentioned above that has moved to its highest level in predicting the probability of recession in 12 years.

Recessions are the stock markets worst nightmare. They cause bear markets due to business contracting, loss of jobs and declining corporate profits. Corporate earnings direct the stock market. The biggest stock market declines occur due to reduced corporate earnings primarily caused by recessions. **But here is the tricky part. The declines typically start before any recession actually hits catching most investors by surprise!** Herein lies my reasoning for lightening up on stocks mentioned in my January report:

> *I am not interested in taking the big risk of getting the last drop of profits out of the market. I am more interested in not losing what I made in the stock market over the past 10 years! I strongly believe the risks are and will continue to be far greater than the rewards in stocks with the potential downside far greater than the upside. With all the dangers and uncertainties facing the market, I believe investors should be focusing on prudent risk management and playing it safer by being "preemptively defensive".*

Market Joke

There is a joke that bond market investors have a PHD while stock investors have a high school diploma. I believe the joke is applicable to how stocks are behaving now! Why have Interest rates dropped sharply? The bond market is telling us a recession is on the horizon. **The stock market is ignoring the reason rates are dropping, at least for now! But at any point in time, I believe the market will realize rates are dropping due to an impending recession. At that time, I believe stocks will drop a lot more than they have advanced, causing a bear market and erasing years of gains! Is it worth taking the risk of being fully invested in stocks when conditions exist to lose years of gains when one least expects it?**

Not a Low Risk Environment!

Think about this! Almost every bear market of the past 86 years has taken back or repossessed close to one-half or more of the previous bull market's gain (the only exception was in 1956). Based on today's bull market that started in March 2009 at DJIA 6547, that could easily mean losses of -40% or more in the next recession. Correspondingly, we are not in *a low-risk market environment today*

which I believe is a compelling reason for investors to be "preemptively defensive" as described in my January report!

Read the January Report

With an expanding Inverted Yield Curve, decelerating world economy, and uncertainties of a trade war with China, doesn't acting to lock in some profits rather than reacting to potentially large losses make sense? One can be walking on melting ice and be fine until he or she unexpectedly falls through!

The fact that the major indices have made new highs does not mitigate substantial risk due to concerns expressed within and the January 23rd report. **To better understand why, I urge reading the report in conjunction with this follow up!**

I believe my reasoning for being P*reemptively Defensive* by lightening up on stocks made prudent business sense in January with the potential downside more than the upside…and even more so now! That is why I have written this report in hopes of helping investors see the prudence of locking in some profits to avert potential substantial losses… as I did in my reports near the top of the market in 2000 and 2007!

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