VAGUE DESTINATION

coddiwomple

verb | cod•di•womple | \kä-də-wäm-pəl
: to travel in a purposeful manner towards a vague destination

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Despite the fact that economies and financial markets constantly march towards Vague Destinations, a successful investor must remain purposeful, which means being data-dependent, process driven and risk conscious.

This week in "The Big Fundamental," we are going to coddiwomple through US growth and discuss its ramifications on US markets...

Tim Duncan retired last year after 19 seasons as a forward for the San Antonio Spurs. His nickname was "The Big Fundamental." As nicknames go, it leaves a lot to be desired, but frankly it describes his game to a T. The guy played sound, fundamental basketball, which is considered boring in this world of SportsCenter highlights. Yet his career performance was the stuff of legends.

When it comes to trading markets, it's the Fundamental Gravity of a market that matters most. It's not as much fun as perusing price charts, watching for abandoned baby candlestick patterns or those Fibonacci levels that the Illuminati love so much. And it's certainly not as entertaining as watching gas bags talk about stocks while pushing buttons on a sound machine. Booyah!

Nothing in this world, outside of central bank policy, has more impact on the direction of U.S. asset prices than the trajectory of U.S. growth and inflation. Nothing.

~~Risk~~ Media Averse

The media coverage of last week's release of the March retail sales numbers is an excellent example of why you must remain data dependent and media averse if you want to be a successful investor.

Reuters' headline read "U.S. retail sales, inflation data highlight weak first quarter growth."

CNBC - "US retail sales fell 0.2% in March vs. 0.1% drop expected."

Wall Street Journal - "U.S. Retail Sales Fall for Second Straight Month."

These headlines highlight the two aspects of economic data reports that most people erroneously pay attention to: Wall Street expectations and month-over-month changes in data.

The only aspect of an economic data report that you need to concern yourself with is ***the annual rate of change of a given data point***; nothing more and nothing less.

A monthly data point's comparison to economists' expectations provides absolutely no value other than revealing that economists are as useful as meteorologists.

And month-over-month changes in economic data points are so noisy you'd think you were at a five-year-old's birthday party at Chuck E. Cheese. Do you know what I saw?

The annual growth rate of retail sales accelerated to 5.2% in March from February's 5.1% pace. Not only that, but since breaking out above the 5% threshold in January, retail sales continue to hold that level, which is the highest growth experienced since 2012.

Contrary to what the media would have you believe; the retail sales report paints a picture of a strengthening U.S. consumer and an improving U.S. economy.

And we care if the U.S. economy is accelerating or slowing down because it allows us to allocate our portfolios for maximum gain and minimum risk.

Bonds are Riskier than Silicon Valley

U.S. growth has been accelerating over the last three quarters, and the winning playbooks have been long high-growth sectors like financials and technology.

Since June 30, 2016, the S&P 500 is up 16%, which is an astronomical nine-month return.

But to put it in perspective, U.S. financials, via the Financial Select Sector SPDR (XLF), are up 30%, and the U.S. technology sector, via the Technology Select Sector SPDR (XLK), is up 26%.

The sectors you wanted to avoid over that time frame were bonds and their equity cousins, like utilities. Since last June, utilities, via the Utilities Select Sector SPDR (XLU), have returned just 2.5%, while long-dated U.S. Treasuries, via iShares Barclays 20+ Year Treasury Bond (TLT), have declined 12%.

Understanding the Fundamental Gravity and shifting your portfolio accordingly is not just about earning the best returns. It's most importantly about managing risk.

In the current period of accelerating growth, the S&P 500 has experienced a maximum (peak-to-trough) drawdown of just -4.3%. XLF and XLK have experienced similar drawdowns, of -6.7% and -4.1% respectively. Technology stocks have delivered nearly double the return of the S&P with slightly ***less*** downside risk.

Contrast this with the downside risk experienced by people invested in bonds and their equity cousins for the past nine months. Utilities (XLU) has fallen by as much as 12%, and TLT has experienced a maximum drawdown of 18%. That's almost an outright crash! Think about the implications of what we've just discussed.

Your grandpa's T-Bond has had over FOUR times as much downside as a collection of Silicon Valley's finest publicly traded companies.

Not only have technology stocks had a quarter of the downside of U.S. Treasuries over the last nine months, they have also delivered 38% more return!

It's not just about knowing where to be positioned and what to avoid when growth is accelerating. It's equally important to position your portfolio appropriately once U.S. growth begins to slow again.

Slow Growth Playbook

If the media and fearmongers are right and U.S. growth is starting to slow, then the playbook for trading U.S. markets is going to shift markedly.

You're going to avoid the growth sectors like financials and technology, and shift your portfolio towards bonds and their equity cousins.

The risk and return stats from the last economic slowdown, from Q1 2015 to Q2 2016, prove why this is the "slow growth" playbook.

Over those 15 months, the S&P gained 2.5% and experienced a 13% drawdown. U.S. Financials (XLF) declined 2.6%, but at one point during that stretch was down as much as 23%. Ouch! Technology stocks (XLK) gained 6% with a 14% drawdown.

Bonds and their equity cousins easily outperformed both the S&P 500 and the growth sectors, with less downside. Utilities (XLU) gained 22% with an 11% downside, and long-dated Treasuries gained 8% while experiencing a 10% pullback.

While technology stocks outperformed the S&P, they lagged significantly behind both utilities and U.S. Treasuries, and delivered more risk. The risk contrast is not as dramatic as during high growth periods, but it is still significant — that is, assuming you consider the potential to at least triple the S&P's return with less risk to be significant.

The Bottom Line

The importance of a market's Fundamental Gravity is the same as the tide in sailing. You can sail for a while paying attention only to the wind, which in trading parlance is the price action of a given market. But if you don't understand the tide, which represents the market's Fundamental Gravity, you eventually crash into the rocks. Understanding the tide is not only the key to avoiding the rocks, it's also the key to earning outsized returns while dramatically reducing your risk.

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