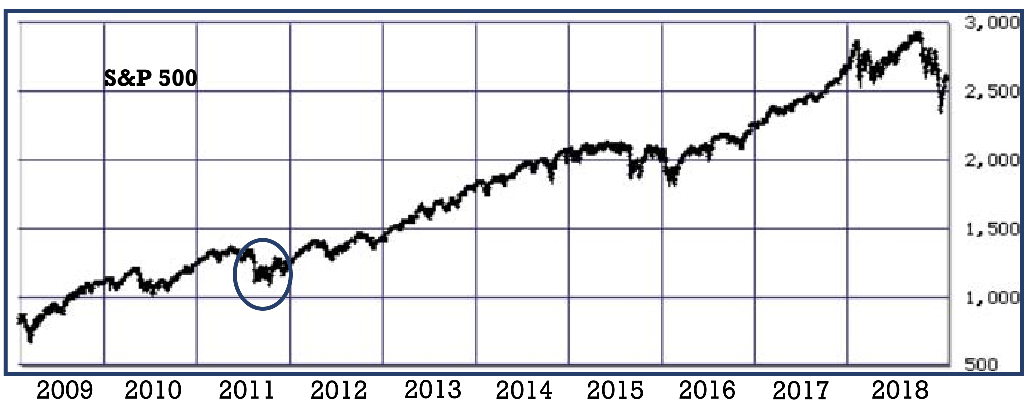
RECESSION IMMINENT?

BUT FIRST, SOME PERSPECTIVE

In the summer of 2011, the S&P 500 dropped by some 17%. Before reading further, please take a moment to try to recall what might have been troubling investors back then. If you came up empty, don't feel too badly because I know a guy who did, too.

In 2011, investors grappled with the potential ramifications of Standard & Poor's' decision to trim the United States' long-term credit rating from AAA to AA. Investors were also fearful of the potential consequences of a debt-ridden Europe. For what it's worth, here's how this particular smidgen of torment looks in the context of a decade's worth of domestic stock performance.



Since 2008, the media, which thrives by stirring emotions with dramatic headlines, has at various times floated the following notions: that the trouble we endured during 2008/9 could morph into a full-blown depression, that the U.S. could fall victim to a double-dip recession, that too much monetary stimulus could result in runaway inflation, that too little of it could result in persistent and devastating deflation, that Greece's debt issues could infect the financial system in other parts of the developed world, that the record-long economic expansion within the U.S. must necessarily be near its end simply because it had already existed for a record long time, that rising interest rates in the U.S. could trigger a recession, etc., etc., ad infinitum, wash, rinse, repeat. Sadly, this financial noise not only persists, the ubiquity of the media and the Internet intensifies it.

OPPORTUNITY DANCES WITH THOSE WHO ARE ON THE DANCE FLOOR

Looking back, that 17% hiccup hardly seems noteworthy. Although it was undoubtedly uncomfortable as it unfolded in real time, it possessed no power to damage any investor who didn't acquiesce to the temptation to sell into it. For investors who used that price dip to reestablish their pre-downdraft level of equity exposure, it turned out to be an opportunity, albeit one that went unappreciated by many until after the opportunity vanished. In my view, the lesson of the summer of 2011 could have been drawn from any number of squiggly lines appearing to the left or right of that particular summer.

REALISTIC EXPECTATIONS AMID FRAGILE PSYCHES

Investors who equate anything less than stable and/or advancing portfolio values with investment failure are out of synch with reality. To the extent an investor can't tolerate downdrafts such as the one that occurred this past December, the one that occurred during 2011, or the many that occurred between them that I didn't happen to circle, the vagaries of the capital markets are bound to be chronic stressors.

In my mind, the cure is to either be satisfied with the paltry returns available from deposit products (returns that have tended to be largely nullified by inflation and income taxes), or to accept the fact that the fragile psyches that permeate the capital markets frequently result in some messy sloshing.

Remaining planted during downdrafts requires some perspective, but not a huge dose of it. After all, every market downturn this country has ever endured has eventually been erased by a subsequent recovery of greater magnitude. Of course, it's possible that a downturn will eventually be severe enough to snap the spine of the economic system that has allowed the Western world to achieve a standard of living that would have been unimaginable a couple centuries ago, but if something that severe were to occur, how likely do you think it would be that banks, credit unions and other institutions that trade on the comfort of their guarantees could make good on them? And remember, when those institutions invest their own funds, they invest in capital market instruments, too. Although the fears of 2019 differ from those of 2011, I suspect the 20% correction from which we now seem to be emerging will, in time, be relegated to being a blemish on the historical record that's no more significant than the one I happened to circle.

COAL AND DIAMONDS

James Rothenberg, the vice chairman of an investment firm that advises mutual funds, wrote the following letter in 2011. Of course, advisory firms have an incentive to retain shareholders' assets, but I think this note is as germane now as it was then. Reading this letter reminds me of the notion that the only real difference between a lump of coal and diamonds is that diamonds perform better under pressure. I think the same holds true for successful investing.

August 8, 2011

Dear fellow investors,

The past few days have been very difficult for investors. The steep one-day losses on top of the volatility of the past few months and the decision by Standard & Poor's to downgrade the credit rating of long-term U.S. government debt have been unnerving. I've been in the investment business for more than 40 years, and I wish I could tell you that living through periods like this gets easier with practice, but it doesn't. We all know that we should stay focused on the long term, but I know how difficult that can be in tumultuous times such as these.

Still, over the years, I have learned that one of the best things any investor can do is step back and put the markets' often chaotic behavior into a broader context. I know how hard that is, but I also know it's crucial to long-term investing success.

For many investors, the context for today's market is 2008. This is not 2008. Recent losses in global equity markets notwithstanding, there are major differences between then and now. The major U.S. banks are in much better shape than they were when the housing market collapsed. Today economic growth is weak, but it is positive. In 2008 stock prices often seemed disconnected from economic reality. Today corporations are *producing solid earnings even in* a *weak economy*. *As* an *investor*, *I find that reassuring*.

What has and hasn't changed

When deciding how to invest, I ask myself what's changed and what hasn't. Interestingly, the two things that seem to be behind much of the recent unease in the markets are things that haven't changed much in the past year: the European debt crisis and the situation in Washington, D.C.

Concerns over Europe's sovereign debt troubles are certainly justified, but they're not new. Whether Greece, Portugal and Ireland, or Spain and Italy, the basic problem — how to handle the debt that hangs over Europe — hasn't changed. In fact, European monetary authorities seem more determined than ever to avoid a default. At American Funds, we've watched the European debt situation closely from the beginning and continue to factor it into our investment decisions.

Standard & Poor's actions were also disquieting. But again, context helps me as an investor. I was investing in the late 1970s when we first heard the term "stagflation" to describe inflation with no growth. I remember 1981, when interest rates on the 10-year U.S. Treasury bond moved above 15.5% and it seemed rates would continue to climb.

Of course, knowing that things have worked out in the past doesn't necessarily soothe nerves today. However, contractions are a natural part of any market cycle. In fact, during my years as an investor, the Dow Jones has suffered a one-day loss of more than 4% of its value 36 times. That doesn't make the current losses easier to take, but it helps me put them in perspective.

The lure of the sidelines

If I could share one thought with you while you're watching the news on TV or reading the paper, it would be this: Remember that an index, whether the S&P 500 or the Dow Jones, isn't a measure of your portfolio. It's what your portfolio is doing, not what "the market" is doing that matters. A globally diversified portfolio of stocks and bonds doesn't move in lockstep with any single market or index. A downturn in one market — whether U.S. or international, stock or bond — can be cushioned by an opposite or lesser move in a different market.

Still, I know that during a period of volatility the lure of the sidelines can be very strong. In fact, probably the number one question on every investor's mind today is "What should I do now?" Every individual's situation is different, but I believe the answer to the question is the same for everyone: Talk to your financial adviser. Your adviser can help you stay the course or make the necessary adjustments to maintain a well-diversified portfolio designed to help you reach your financial goals.

I noted at the beginning of my letter the importance of putting events into context, and I believe the most important context of all is simply time. During the four decades I've been at American Funds, I have seen strong bull markets and tough bear markets, huge gains in a single day and big one-day drops. Through all the ups and downs, the nation's economy has expanded, our standard of living has improved, and individuals who stayed invested in a well-diversified portfolio of stocks and bonds were positioned to reach their financial goals. To me, that is the most important context of all.

WHAT ABOUT A RECESSION?

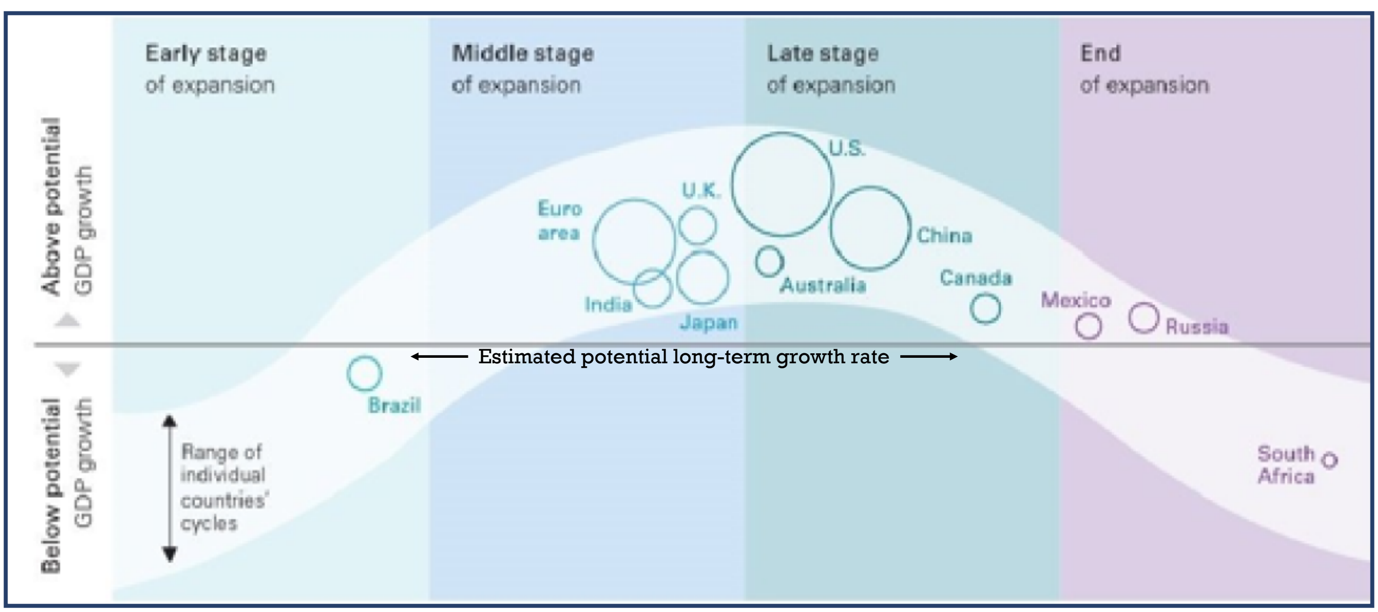
With the NASDAQ declining 4.0%, the DOW Jones Industrial Average declining 5.6% and the S&P 500 declining 6.2%, 2018 finished as a stinker. Aside from the fact that recessions afford committed investors an opportunity to acquire assets at discounted prices through portfolio rebalancing, the specter of a recession seems to be on the forefront of many people's minds so I've looked into it a bit.

WHERE ARE COUNTRIES IN THE ECONOMIC CYCLE?

In the blurry image below, The Vanguard Group and the International Monetary Fund collaborated to plot the world's major economies against a backdrop divided into the four stages that comprise the typical business cycle. The size of each circle represents the relative size of each country's relative economic output as of 2017. The higher (lower) a circle is plotted relative to the horizontal line, the higher (lower) the associated country's current growth rate is versus its hypothesized, long-term potential. As you can see, this research team believes that most of the world's major economies are currently expanding at a rate that's higher than what can be sustained. So, some economic slowing appears to be in the cards for most of the world.

But, expecting economies to eventually slow from above-average rates of growth does not at all imply economic deterioration is imminent any more than the slowing of a speeding car implies it is on the cusp of rolling backward. Although I'm not providing data here, please know that capital market instruments have provided meaningful returns to investors during many periods of slowing growth.

MOST MAJOR ECONOMIES GROWING NICELY



Most of the world's major economies appear to be growing at rates that exceed their long-term capabilities. As you can see, the U.S. is leading in this regard (note that the center of the circle that represents the U.S. is further "north" than any other circle in that graph). Investors certainly appreciate economic growth, but they especially appreciate a growing rate of economic growth. That's not where the U.S. is at the moment, so investors have begun to factor this into their collective view of things and valuations have relaxed some. When investors factor in uncertainty about the impact tariffs and rising interest rates might have on future economic performance, it makes sense for them to err on the side of caution by taking some of their gains off the table (by selling) and by deferring future investments until their sense of clarity improves. All of this seems normal to me.

PENDULUMS & MARKETS

Like a pendulum hunting for its equilibrium point, markets are dynamic inasmuch as they're always in a state of flux. Whereas the equilibrium of a pendulum may be upset by forces that are typically obvious, the forces that can upset markets are not only numerous and varied in their nature, they can be difficult to detect and even more difficult to quantify. The end result is that no matter how intent investors are on decoding the "true" value of capital market instruments, they tend to operate in a perpetual swirl of self-doubt.

GEORGE CARLIN'S COCKROACH SOLUTION

The image of investors being forever uncertain that they're reading the tea leaves correctly causes me to recall how George Carlin wished we could control cockroaches: He wished for a spray — not one that would necessarily kill roaches, but one that would fill them with self-doubt as to whether they were in the correct home. In similar fashion, capital markets create an environment where its participants persist in a perpetual state of self-doubt that fosters hypersensitivity to stimuli much the same way roaches react to kitchen lights.

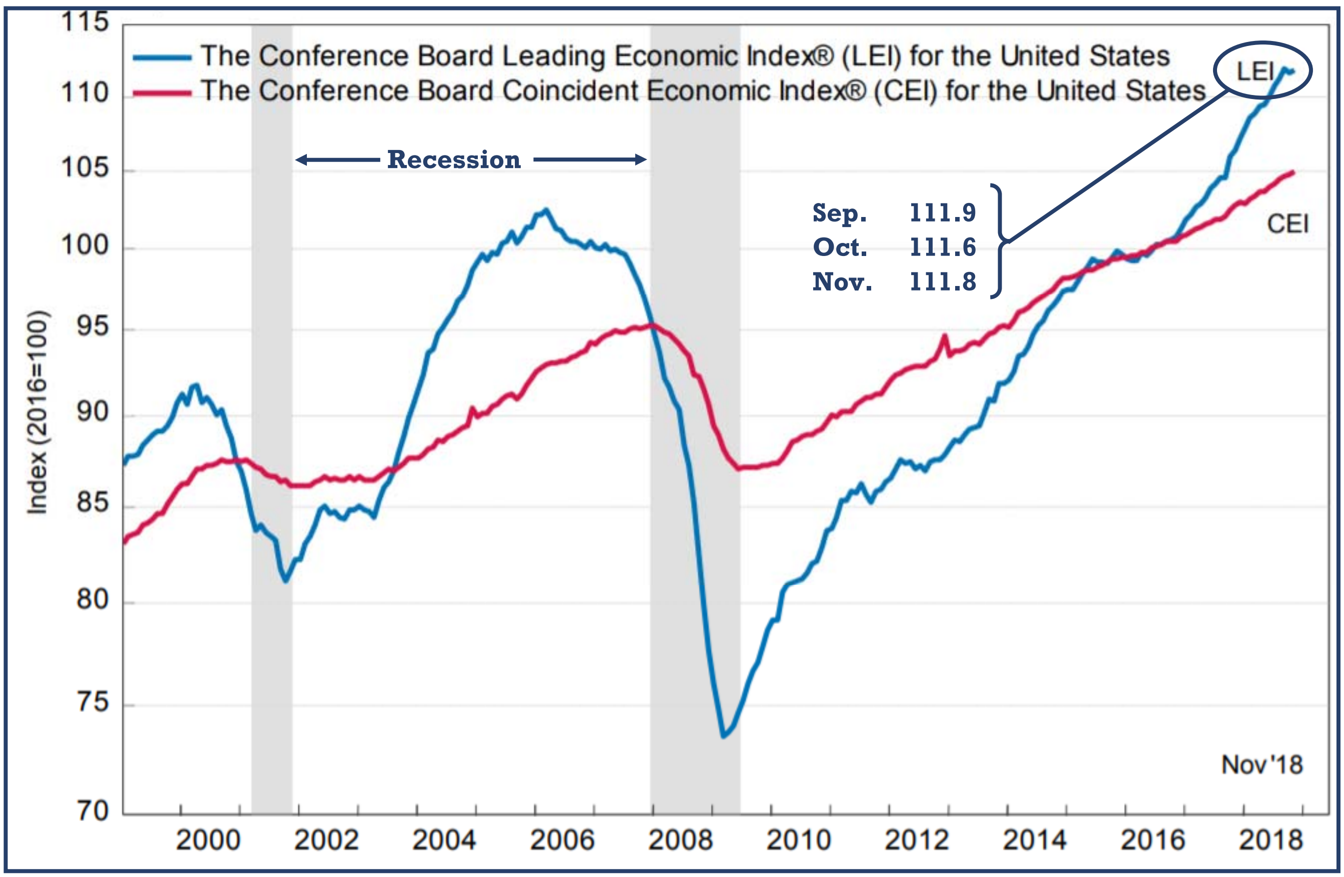
FED UTTERS THE MAGIC WORDS

Our central bank has been raising interest rates in an attempt to restore some firepower to its recession-fighting arsenal. The Fed has apparently sensed that the rate of growth in this country has reached an inflection point, because it recently communicated to investors that any future rate hikes it might implement will be "data dependent." So, if the economy slows more than expected, the Fed will halt its rate hikes for a while, or maybe even altogether.

This recent assurance from our Fed has buoyed investors' moods since the Christmas Eve market nadir. In contrast to the U.S., the economies of Australia, China and Canada, Europe, India, Japan and the U.K. are thought to be in the earlier stages of expansion where their rates of growth may still be rising. Historically, investors have tended to prefer the earlier stages of expansion to the later ones, but again, being in a later stage of an expansion is not at all the same thing as being stuck in reverse.

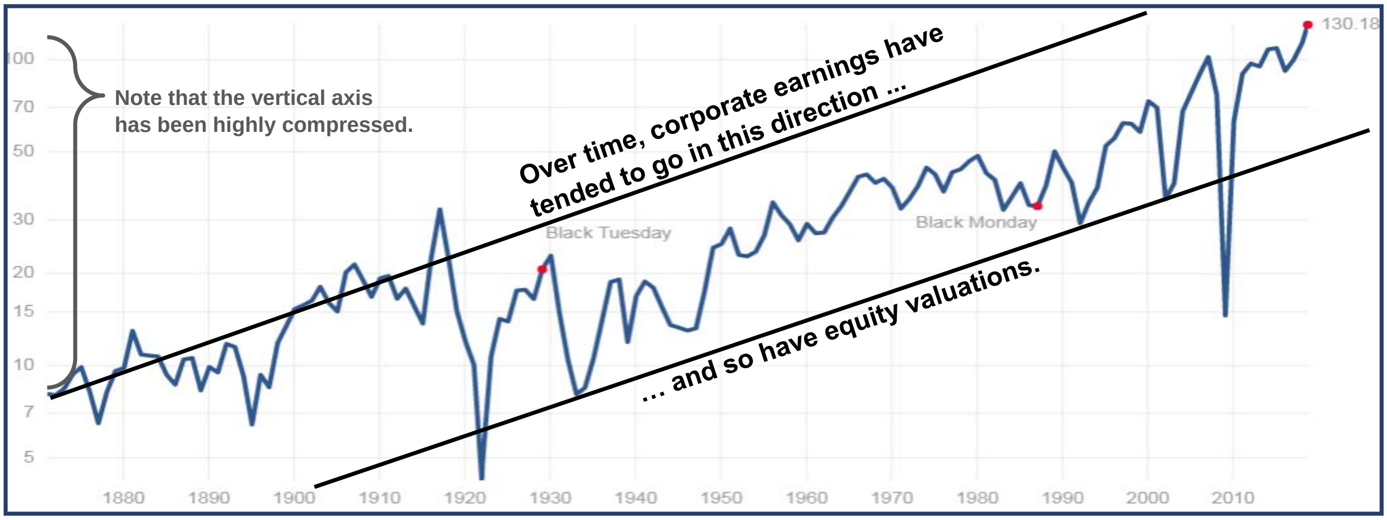
LEADING ECONOMIC INDEX® INFLECTS

As you can see here, the U.S. economy appears to have reached an inflection point, but then again, it would be unrealistic to expect it to surge, indefinitely. In fact, many economists predicted that as the sugar rush of the most recent tax cut wore off, the rate of growth within the U.S. economy would have to slow.



WHY STOCKS RISE

Equities don't become overvalued simply because their prices have risen a lot or because they've risen more than people figured they would. They become overvalued when their prices are disproportionately high versus the perceived earnings and cash flow streams to which those shares of stock are entitled. Since every valuation model is premised upon estimates, probabilities, conjecture and outright guesswork, the notion of "value" is very much a matter of art that is subject to substantial estimation error. The image below depicts the earnings to which one share of each company within the S&P 500 index have been entitled at various points in time. As you can see, corporate earnings have risen dramatically over the years.



As shown above, owning one share of each company in the S&P 500 now would currently entitle you to about $130 worth of corporate earnings, a figure that is roughly 50% higher than when that vice chairman penned his 2011 letter. For reasons that are beyond the scope of this note, the nature of our economic system is, in my opinion, structured to allow corporate earnings to increase over time. That's what has happened and that's what I believe will continue to happen, but don't expect that porridge to be without some lumps.

SELECT THOUGHTS FROM SOME INSTITUTIONAL FIRMS REGARDING 2019

- Vanguard: Fixed income returns ~ 2.5% – 4.0%; Equity returns ~ 5.0 – 7.0%.
- UBS: "European and U.S. equities gain up to 5%."
- HSBC: "Neither significant retracement nor rebound for global risk assets."
- JP Morgan: "The end is not near, but markets will behave like the end of the cycle is at hand."
- Oppenheimer: "Returns will be more modest across most asset classes."
- International Monetary Fund: The global economy will grow 3.5% during 2019 and 3.6% during 2020. It recently reduced its 2019 estimate by .2% and its 2020 estimate by .1%.

If ugly things unfurl, please allow me to take advantage of it by rebalancing your portfolio. Unless the world actually does break, rebalancing into dips and downturns has shown itself to be a time-tested way of turning lemons into lemonade. — Glenn Wessel