# Mitch on the Markets

## The 3 Biggest Risks in 2018

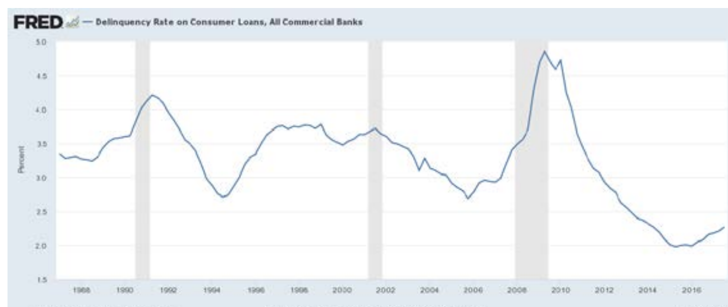
By Mitch Zacks
Portfolio Manager

As 2017 draws to a close, it's high time for investors to think earnestly about how the next year could shape up, and what portfolio adjustments may be warranted to get prepared. Last week, I gave readers four reasons to be bullish in 2018, but this week I want to balance that view by considering a few risks to the bull market.

Below, I'll detail the three biggest risks that concern me, but it should be noted that this list is by no means comprehensive. There are other, which we consider more marginal risks but which we are nevertheless monitoring closely like the impact of geopolitical conflicts, escalating 'cold war' confrontations with Russia and China over trade and other issues, civil and political discord, and others. For now, I'll focus on these three.

**Risk #1: Reversal of the Credit Cycle**.

Delinquency rates on consumer loans, C&I loans (mainly energy related), and others have been quietly rising since 2015 as credit growth slows. Rising delinquencies in these areas have historically preceded recessions (grey bars in chart below), and to make matters more troubling, U.S. bank credit growth appears to have peaked right around the same time delinquencies bottomed in 2015.




Should delinquencies continue to increase as the Federal Reserve tightens monetary policy, it could discourage banks even further.

We are also watching corporate debt structure, as leverage sits at a 13-year high. In 2007, it was consumers that were wildly overstretched. Today, it may be the corporate sector that is over indebted, having long relied on debt to fuel sizable stock repurchases. If the credit cycle continues to show signs of potential unwinding, it could be something to pay close attention to.

**Risk #2: The Yield Curve and Money Supply**

Stocks and bonds are seemingly painting differing interpretations of the economy. Stocks' strong, consistent performance would indicate favorable economic conditions, while the yield curve—which is currently positive but flattening—would indicate a slowdown ahead. In the last two cycles, stocks advanced while the yield-curve flattened, but stocks eventually declined once the yield curve inverted. On average, the yield curve inverts 16 months prior to an economic recession and 13 months before meaningful stock-market corrections.

As of this writing, the 1-year U.S. Treasury is 1.71%, the 10-year Treasury is 2.46% and the 30-year Treasury is 2.82%. That makes for an upward sloping yield curve, but it's far from steep and has been flattening. What's more, consistent growth, falling labor market slack, higher earnings, and a small pickup in core inflation should allow the Fed's tightening cycle to continue, which would put upward pressure on the shorter end of the yield curve. If interest rates on the long end do not rise in lockstep or faster, the yield curve could flatten further and could eventually invert. While we aren't predicting an inversion will occur in the next six months, it certainly would be a significant warning sign for the economy and the equities markets if it happened sometime next year or in 2019.

Another factor to consider is that every recession in the last 50 years has been preceded by a decline in money supply growth (to zero or below), so investors should be more cautious at this point in the cycle (now that the Fed is tightening). We expect at least one rate hike in 2018 and a continuance of balance sheet reductions, albeit over several years.

**Risk #3: Investor Sentiment**

The last risk has nothing to do with any fundamental data or analytical research. The best way to explain this risk is through a quote by John Templeton: *"Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria,"* adding that *"the time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell."*

Gauging investor sentiment is difficult to do. There is no set metric that will flash red when investors are getting too complacent or taking-on too much risk. But the recent run-up in stocks – coupled with what appears to be an imminent tax cuts and forecasts for more global economic growth – has many investors feeling optimistic about the year ahead, and is also seemingly having the effect of shifting investors' risk appetites. If stocks continue to run and investors start to, for instance, ask for higher equity allocations, this might raise a red flag.

## Bottom Line for Investors

While these and other risks exist in the current environment, we continue to believe that the positives outweigh the negatives. Overall, 2018 should be another positive year for stocks, and we would encourage long-term growth investors to maintain equity allocations in-line with their individual goals.

**About Mitch Zacks**

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

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