Quarterly Playbook
4th Quarter 2019

Current Financial Planning and Investment Themes
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"O ye, of little faith"

As the most hated bull market in history rolls on, there are plenty of "doubting Thomases" making their voices heard. As we enter the 4th quarter, the S&P 500 has had the best first three quarters of a year since 1997! Nonetheless, the chorus of nay-sayers continue to sing their tune, which creates skepticism for market participants. However, our view is that the actual data overcomes the skeptical attitudes and provides another leg higher for portfolios here in the 4th quarter…

US Economics

The biggest question we hear about on a daily basis is "are we headed for a recession". In our view, the fact that we are even discussing this is laughable! However, because we are inundated with the continuous news cycle of "possible signs of a coming recession", it is only proper that we investigate. As a reminder, recession is defined as "two consecutive quarters of negative GDP growth". Not a *slowdown* in growth, but *negative* growth (shrinkage). To put into context, the 1st quarter GDP this year came in at 3.1%, the 2nd quarter this year came in at 2.0%. So, the first half of the year averaged 2.55%, which would be second highest GDP growth year since 2010, with the highest being 2018 and 2015 tied at 2.9%. So, then we look to see if the trajectory for future GDP is projected to further decline. The Federal Reserve of Atlanta *estimates* 3rd quarter GDP at 2.1% as of September 27, far from negative. Furthermore, the Federal Reserve board's own estimates of 2019 GDP growth was *increased* again to 2.1%-2.3% from 2.0%-2.2% in June. Meanwhile, the September official U-3 unemployment rate dropped to 3.5%, its lowest level in 50 years! In addition, the U-6 unemployment rate (broader definition including part-time) dropped below 7% for the first time since the year 2000, coming in at 6.9%. Also, the highly important labor participation rate rose to 63.2%, up from 62.9% in June, indicating more individuals are coming back in to the workforce, a very good sign. Lastly, the LEI (Leading Economic Index®) which measures 10 additional leading economic metrics is still showing an expanding economy, albeit a little slower than last year. To summarize, we can all agree that the economy is slowing a bit off its high point last year, but we should not try to translate slightly slowing growth into fear of a recession….

US Equity Markets

As expected, the 3rd quarter was a bit choppy in the US Stock market, but ended the quarter slightly higher than where it started. 3rd quarters are generally known for being choppy, and 4th quarters are generally known for having a stock rally, 2018 being an exception. Our view is that stocks extend their Year-to-date rally into the 4th quarter with another leg up. That said, we expect that the Federal Reserve won't pull a rogue move like they did last year (indicating they will raise rates to unsustainable levels), but rather "play nicely" with markets by taking steps to steepen the yield curve by lowering short-term interest rates. We also expect the US-China trade news to be incrementally positive at the very least, meaning they are "working towards a deal" or ideally signing a trade agreement of any sort. Given those two items are on track, we expect the gains to come from both P/E (Price to Earnings) multiple expansion and solid earnings announcements. Additionally, as we mentioned last quarter, TINA (There Is No Alternative) is back in play for the US stock market. As bond yields have fallen to very low levels and international prospects are dim, TINA somewhat justifies higher valuations and prices…

US Fixed Income

Our thinking on the US bond market has shifted somewhat as global yields remain unbelievably low, with Germany still having negative yielding bonds through 30 years, Japan and France negative through 10 years, and most of the rest of the developed world issuing bonds below 1%. In this crazy environment, US treasury bonds look incredibly attractive with yields ranging from 1.35% to 2.01% as of this writing. Add in the backdrop of a stronger US Dollar and a more level-headed Federal Reserve lowering rates, this supports an environment in which US yields again have slight downward pressure. Remember, lower yields mean higher prices. Our update in thinking is that these incredibly low global yields will remain far longer than previously expected. This carries through to the rest of US credit with corporate and high yields 1-2% lower than expected as well.

International Markets

International stock and bond markets have continued to recover from last year's sell-off, and we expect this uptrend to continue, but at a lackluster pace. Economic troubles continue to restrict any meaningful rallies, leaving the MSCI All Country World ex-U.S index as mostly sideways since 2011. The lack of returns compared to volatility is causing a good deal of inefficiency. In a nutshell, there isn't a lot to be excited about outside the US.

Real Estate
REITs continue to be on fire! Strong cash flows, pricing power, low interest rates, and overall favorable economic conditions are putting REITs in a sweet spot. As mentioned previously, REITs are also insulated from trade worries which remove a major volatility factor. The attractive attributes have us thinking that the rally will continue in this asset class, helped by some support from income seeking investors. We remain with the expectation that real estate will move higher in step with US equities through the remainder of the year.

Legislative Affiars
The biggest legislative news currently is the renamed "impeachment inquiry" being pursued by the House. This has markets watching but not yet reacting to the "show" thus far. There is also a feeling that the news around the impeachment inquiry may signal what will happen in the 2020 election. As it stands currently, Elizabeth Warren has a slight lead in the polls and would be the challenger to President Trump. Wall street is a little anxious as there have been numerous articles printed on both sides of the political aisle about how Ms. Warren's proposals would scare the economy including the wealth tax (a 2% tax based on your net worth), 70% upper limit on personal income taxes, and 90% upper limit on corporate income taxes. We agree that these would have major economic implications, but at this point, the Democrats would have to control all 3 branches to even have a chance to accomplish these ideas, which seems very unlikely at this point. Moreover, we would expect if Elizabeth Warren is the ultimate nominee, her proposals would moderate for the general election. As a side-note, an interesting piece of recent research illustrates that an incumbent President has won re-election 11 out of the last 11 times if there was not a recession the two years prior. If there was a recession within the two years leading up to the election, the incumbent lost 5 out of those 7 times. That said, we are entering the period where politics, and who is likely to control the government, will have an emphasized affect on the markets. It is safe to say, passing legislation like the SECURE Act or a NAFTA replacement bill is solidly in the background at this stage.

Interest Rates & the Fed
It's the Yield Curve Stupid! This is what I want to scream at Jerome Powell during his press conferences that use every excuse imaginable to justify lowering rates. Their main theme is "global economic uncertainty", but in reality, the real driver of the need to lower rates is that the Fed rate hikes pushed up short term rates to the point of inverting the yield curve, so they need to fix it. Yes, it technically is correct that global uncertainty pushed longer bond yields down to add to the yield curve inversion, but the messaging here needs to be clearer. If it were me, the message would be "the economy is in good shape and we are simply lowing our Fed Funds rate to alleviate the yield curve inversion." Period. Stop. There is no need to further blur the message with more justifications. Mr. Powell can simply say, the market is clearly telling us that our previous idea of a neutral Fed funds rate was too high. This would give confidence to markets and take the focus off of the Fed. We see the Fed as coming back in line with expectations and continuing to support the expansion and markets.

Financial Planning Corner

A TAXING STORY: CAPITAL GAINS AND LOSSES

Chris Rock once remarked, "You don't pay taxes – they take taxes."[1] That applies not only to income, but also to capital gains.

Capital gains result when an individual sells an investment for an amount greater than their purchase price. Capital gains are categorized as short-term gains (a gain realized on an asset held one year or less) or as long-term gains (a gain realized on an asset held longer than one year).

Long-Term vs. Short-Term Gains

Short-term capital gains are taxed at ordinary income tax rates. Long-term capital gains are taxed according to different ranges (shown below).[2]

Long Term Capital Gains Tax Brackets (for 2019)

Tax Bracket/Rate	Single	Married Filing Jointly	Head of Household
0%	$0 - $39,375	$0 - $78,750	$0 - $52,750
15%	$39,376 - $434,550	$78,751 - $488,850	$52,751 - $461,700
20%	$434,551+	$488,851+	$461,701+

It should also be noted that taxpayers whose adjusted gross income is in excess of $200,000 (single filers) or $250,000 (joint filers) may be subject to an additional 3.8% tax as a net investment income tax.[3]

Also, keep in mind that the long-term capital gains rate for collectibles and precious metals remains at a maximum 28%.[3]

Rules for Capital Losses

Capital losses may be used to offset capital gains.[4] If the losses exceed the gains, up to $3,000 of those losses may be used to offset the taxes on other kinds of income. Should you have more than $3,000 in such capital losses, you may be able to carry the losses forward. You can continue to carry forward these losses until such time that future realized gains exhaust them. Under current law, the ability to carry these losses forward is lost only on death.[4,5]

Finally, for some assets, the calculation of a capital gain or loss may not be as simple and straightforward as it sounds. As with any matter dealing with taxes, individuals are encouraged to seek the counsel of a professional tax advisor before making any tax-related decisions.

1. Brainy Quote, 2019
2. Tax Foundation, 2019
3. IRS.gov, 2019
4. Intuit TurboTax, 2019
   The information in this material is not intended as tax or legal advice. It may not be used for the purpose of avoiding any federal tax penalties. Please consult legal or tax professionals for specific information regarding your individual situation.

We're here to help. If you have questions about this or any other topic, call us at (855) AFS-4545.