ACM Newsletter

(603) 437-5056 www.appliedcapitalmgmt.com planning@appliedcapitalmgmt.com

2019 – 2nd Quarter

The stock market provided us another quarter of continued recovery from the -20% correction that occurred late last year. Stock indices are at or near their all-time highs. With a degree of optimism, the underlying economic fundamentals support these stock prices but there is little certainty as to whether that will be fulfilled.

Much of this recovery was due to a reversal in the Federal Reserve interest rate policy. In 2018 the Fed was phasing in normal (higher) interest rates. Market sentiment feared that it would be too restrictive causing stocks to fall. The most recent comments from the Fed Chair seem to indicate a rate cut which has a stimulative effect on the economy; A complete reversal from their policy in 2018.

The Fed cites concerns in global trade, growth slowdown, and a lack of inflation. Under normal circumstances, an investor would interpret this list to be one detailing risks yet market sentiment is positive because of the stimulative effect lower interest rates can have on the economy. This perverse dynamic was true from 2010 to 2015 as bad economic news was good news for stockholders - as they expected further stimulus from the Fed and vice versa. A school of thought has developed saying that we should get comfortable with the Federal Reserve rescuing the economy no matter the circumstances; a concept few investors have theorized citing direct correlation between the 2018 correction and the Fed "pivot". These folks may not be too far from the truth since the Fed Chair said he would like to sustain the economic expansion. *The significance of this is that growth isn't the responsibility of the Federal Reserve. Their mandate is isolated to achieving maximum employment and stable prices (i.e. inflation).*

In the same testimony the Fed Chair said that the relationship between employment and inflation is weaker or non-existent which means they don't need to raise rates just because we have full employment. Further, the Fed Chair does not think there are significant consequences to keeping interest rates low. Under previous regimes, a Federal Reserve that kept rates low for too long lead to excessive inflation (70's) or imbalances in stock prices (90's) or imbalances in debt (00's). The Fed doesn't see significant problems in any of these departments today. We are inclined to agree… The risks for keeping rates low, are low. So even though the Federal Reserve has full employment and moderate inflation giving them permission to increase interest rates, the more appropriate question may be: Why not lower rates?

With this new understanding of the Fed supporting the expansion, we find ourselves with the following:

- Stocks priced with a certain amount of optimism (they are moderately higher than the historical average of the Price to Earnings Ratio).
- Bonds have appreciated in value as interest rates have gone down (consistent with the Fed testimony), which leaves little room for continued appreciation.
- Growth stocks exceed the normal premium that they fetch.
- Defensive stocks carry a premium that normally doesn't exist.

Based on this overview and when forced to make a decision between stocks, bonds, or cash, we expect the market to follow the path of least resistance. If you want growth, you'll pay a premium. If you want conservativeness, you'll pay a premium. If you want cash, you are guaranteed to lose purchasing power. The path of least resistance could be to the upside, more on that later.

We should take this opportunity to rebalance - moving gains in stocks over to bonds. And of the bonds which we invest, make sure they will respond positively to a negative swing in market sentiment (i.e. negative correlation). Doing this will make sure that we aren't chasing returns or holding onto "winners" for too long. <u>The goal is to improve the resiliency of your invested portfolio.</u>

Note: Although we have noted resulting changes to our models and made general summaries on our opinions, this newsletter is not inclusive of all our research. For additional market commentary, analysis and/or outlook feel free to call or email. We are willing to field questions with respect to the hiring and firing of our active managers and changes to client specific models. Please reference your individual statements for specific asset allocation and performance metrics.

Please contact us with any material changes to your situation regarding investment objectives and/or risk tolerance.

APPLIED CAPITAL MANAGEMENT INC
REGISTERED INVESTMENT ADVISOR

P.O. Box 1437, 50 Nashua Rd., Suite 200, Londonderry, NH 03053

The Federal Reserve is not the basis for all investment and allocation decisions, we want to share some charts that may be closer to home. These charts will tell you a story of persistency in the US consumer who drives 67.6% of economic growth (measured by GDP).

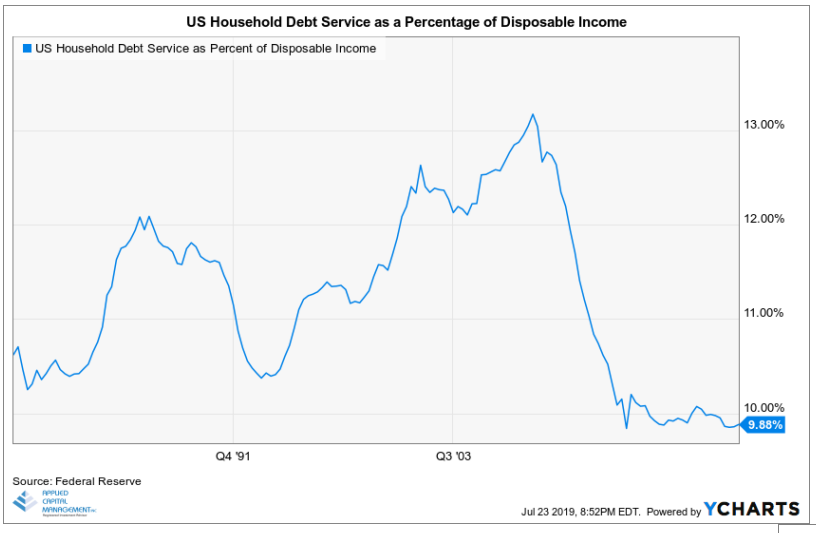
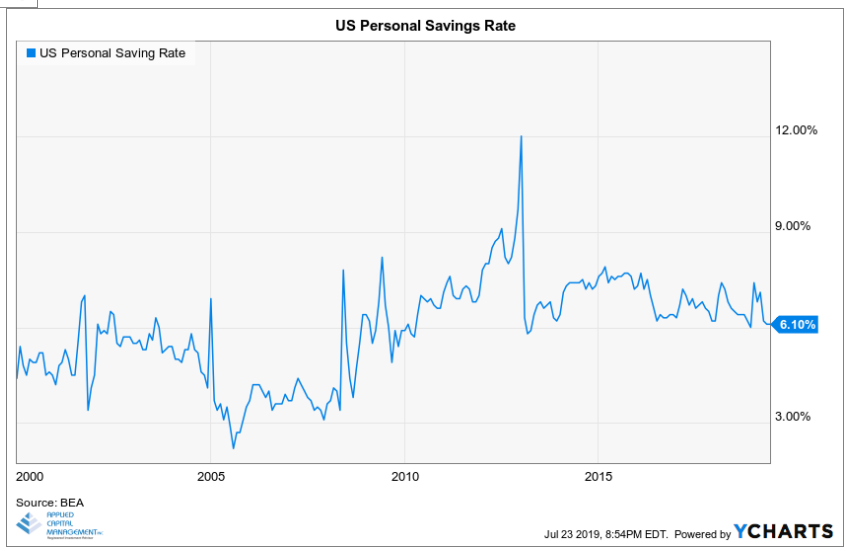


Chart 1: This chart shows how much of the US consumer's paycheck goes towards servicing debt. The trend has been lower and history tells us it has the capacity to go higher (increased spending propels GDP). This chart, in conjunction with delinquency indicators, tells us that we don't need to be concerned about the consumer defaulting on their obligations to any major extent.

Chart 2: This chart shows a moderate increase in the amount of the average paycheck that is saved. The US has a low savings rate, comparatively speaking, but the recent trend shows that we've done a better job of saving. While this doesn't help increase GDP, it gives credence to the possibility that a recession may not result in foreclosures as was the case in 2008.



Note: Although we have noted resulting changes to our models and made general summaries on our opinions, this newsletter is not inclusive of all our research. For additional market commentary, analysis and/or outlook feel free to call or email. We are willing to field questions with respect to the hiring and firing of our active managers and changes to client specific models. Please reference your individual statements for specific asset allocation and performance metrics.

Please contact us with any material changes to your situation regarding investment objectives and/or risk tolerance.

APPLIED CAPITAL MANAGEMENT INC
REGISTERED INVESTMENT ADVISOR

P.O. Box 1437, 50 Nashua Rd., Suite 200, Londonderry, NH 03053

Figure 1: This is an excerpt from Disney's 2018 Financial Statement:

> *Parks and Resorts revenues increased 10%, or $1,881 million, to $20.3 billion due to increases of $1,349 million at our domestic operations and $532 million at our international operations.*
>
> *Revenue growth at our domestic operations reflected increases of 6% from higher average guest spending and 2% from volume growth.* ***Guest spending growth was due to higher average ticket prices for theme park admissions and for cruise line sailings, increased food, beverage, and merchandise spending and higher average daily hotel room rates.***

Disney tends to be 'recession resistant' but the spending inside of their parks is not. When there is evidence of discretionary spending inside the park, it tells us the average household is experiencing good financial conditions.

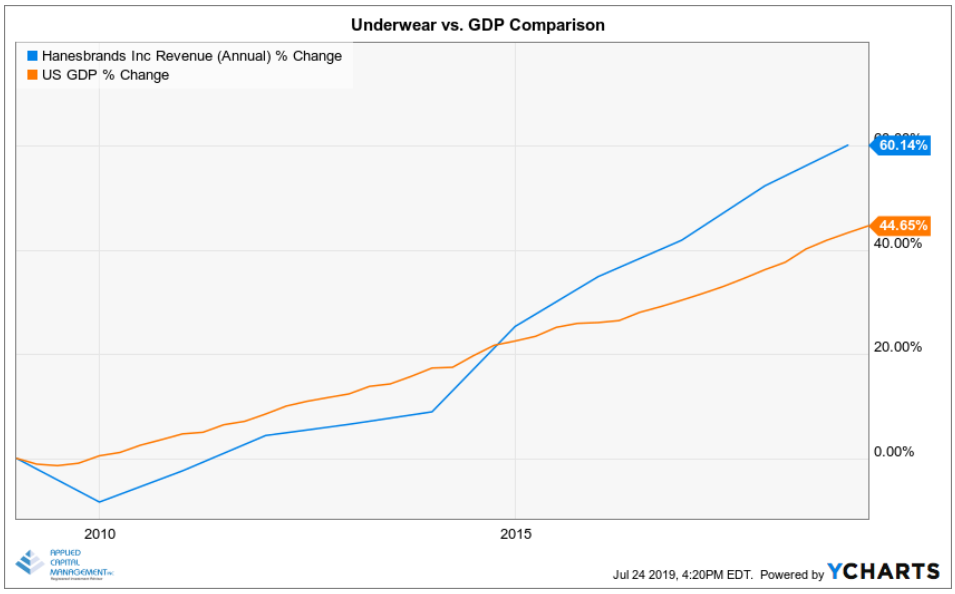


Chart 3: There are some unusual indicators of late economic cycles. One of them is men's underwear. The theory is that men don't like to spend money on underwear... so if there is evidence of spending, it must mean the that there is superfluous cash flow. Here you see the revenue growth of HanesBrand outperforming economic growth. *We are using HanesBrand as a proxy for underwear sales; the company, however, is more diversified.*

Note: Although we have noted resulting changes to our models and made general summaries on our opinions, this newsletter is not inclusive of all our research. For additional market commentary, analysis and/or outlook feel free to call or email. We are willing to field questions with respect to the hiring and firing of our active managers and changes to client specific models. Please reference your individual statements for specific asset allocation and performance metrics.

Please contact us with any material changes to your situation regarding investment objectives and/or risk tolerance.

APPLIED CAPITAL MANAGEMENT INC
REGISTERED INVESTMENT ADVISOR

P.O. Box 1437, 50 Nashua Rd., Suite 200, Londonderry, NH 03053

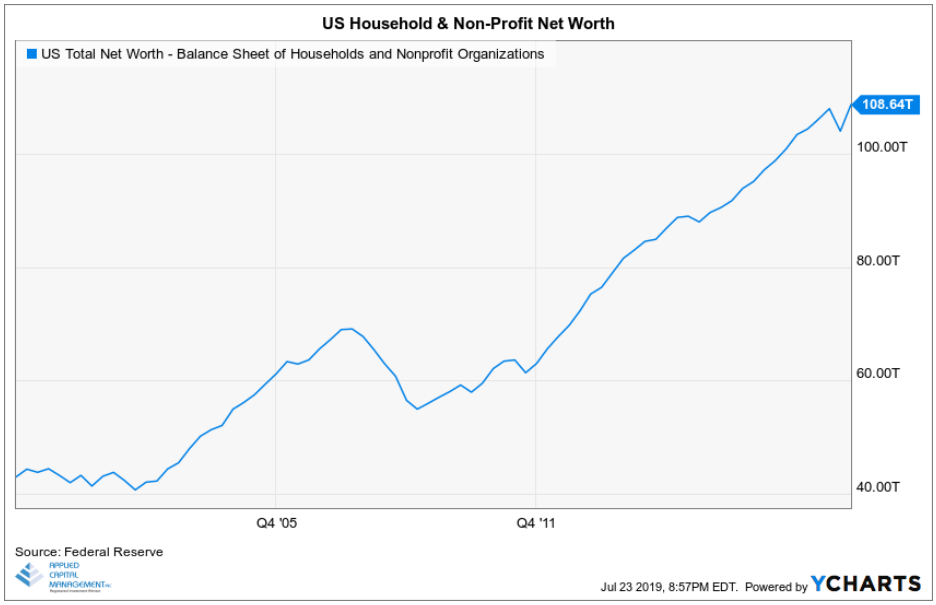
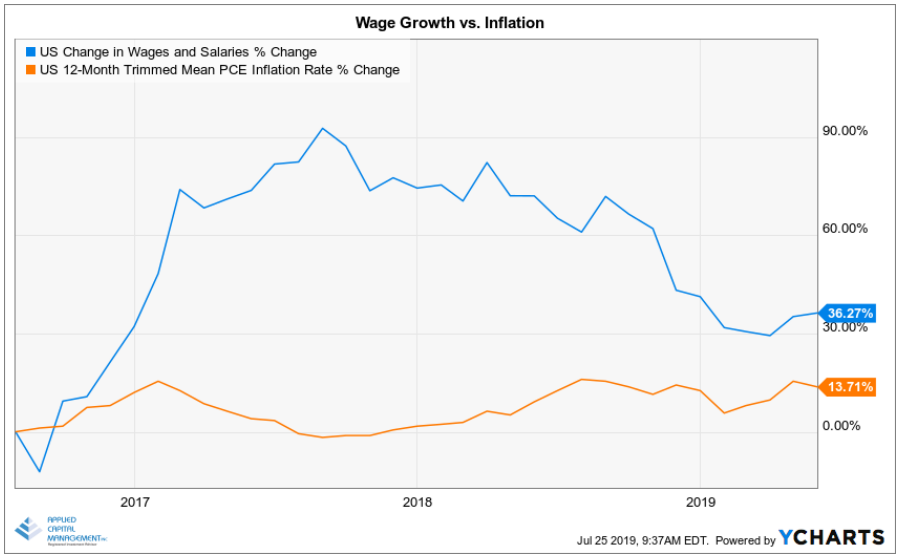


Chart 4: There is an economic principle called the 'Wealth Effect'. It has been shown that when someone sees their net worth increase, they tend to spend more money. This was cited in comments made by Ben Bernake (former Federal Reserve Chairmen) when questioned about the effect monetary stimulus has on asset prices. As shown, net worth has growth significantly.

Chart 5: This chart shows that the average worker is getting paid more money but their expenses aren't increasing at the same rate. That leaves excess capital for them to spend or save – either contributing to growth or softening a potential recession, respectively.



Investing is subject to risks including loss of principal invested. No investment strategy, including asset allocation, can guarantee a profit or protect against a loss in periods of declining values.

It is our goal to help investors by identifying changing market conditions. However, investors should be aware that no investment advisor can accurately predict all of the changes that may occur in the market. Due to volatility within the markets mentioned, opinions are subject to change without notice. Information is based on sources believed to be reliable; however, their accuracy or completeness cannot be guaranteed.

The views expressed are not necessarily the opinion of SagePoint Financial Inc., and should not be construed directly or indirectly, as an offer to buy or sell any securities mentioned herein.