Quarterly Playbook
2nd Quarter 2019

Current Financial Planning and Investment Themes
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Don't stop believin' …

This market's just a small town girl, livin' in a lonely world. It'll take the midnight train goin' anywhere! We would call this market environment "Nervously Optimistic" due to the fact that it is having a hard time finding any love, despite being fundamentally attractive and solid recent performance. However the commentary seems as if investors, media, analysts, etc. are scouring to find any signs of economic or market weakness, but they're not finding much. Maybe they were just born to sing the blues… In the meantime, the economy and equity markets keep going on and on and on and on….

US Economics

Believe it. 2018 full year GDP growth rate was basically 3%. Officially it was 2.9%, but the actual geometric average was 2.997% and arithmetic average was 3.0%. (Q118: 2.2%, Q218: 4.2%, Q318: 3.4%, Q418: 2.2%). Our estimate was 3.15% and we would have been close if the 2nd estimate of 4th quarter GDP of 2.6% was used which would have made the full year 2018 GDP 3.10%. Why are we making such a big deal about this? Simply because it bugs us. Additionally, it illustrates the type of environment we are in. Because the official number was only 2.9% and not the magical 3.0%, the strength of the economy is being discounted. We hear things like economic growth is likely to slow, which coming off a strong year would not come as a surprise. However, we do not believe it will slow dramatically. In fact, we are not convinced it will slow much at all. When we look at the two major factors in determining GDP growth, growth in labor force and growth in productivity, we see very good things. Just look at the most recent job reports that continue to perform above expectations. The unemployment (official, U-3) inched back down to 3.8% in March from 3.9% in December and U-6 unemployment rate (broader definition including part-time) followed by moving down to 7.3% in March vs. 7.6% in December. Finally, the labor force participation rate came in at just 63.0% in March vs 63.1% in December, despite spending January and February at 63.2%. However, wage growth in February accelerated to 3.4% and inflation slowed to just 1.4% in the most recent read, which was January. In our view, this is certainly a recipe for above trend growth!

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US Equity Markets
As we expected, the 4th quarter 2018 "dislocation" was corrected early on in the 1st quarter of this year. The threat of the Fed trying to "murder" the stock market has almost completely been taken out of the picture. The S&P 500 forward P/E ratio quickly reverted back to its 25 year average of around 16.2 creating a solid first quarter come-back of approximately 13%. In our view, that was only "correcting" last quarters unjustified sell-off, and now that the 3 big items we needed to get resolved (Fed, China Trade, & Gov't shutdown) are mostly complete, the rest of the year should be based on fundamentals. This should turn out well as corporate profits are largely expected to resume their pace of increase, earnings revisions are likely overly pessimistic creating opportunities to have upside surprises amidst a strong economic backdrop. Our view is that we probably have seen 2/3rds of the S&P500 return already, but the bias is to the upside going into the rest of the year…

US Fixed Income
The bond market is never really that interesting, until it is. You may have heard recent news headlines about the yield curve being "inverted". This term refers to the unusual circumstance when short term bonds (typically represented by 2-year treasuries) have a higher yield than longer term bonds (typically represented by 10 -year treasuries). This unusual phenomenon was present recently for several days and caused market watchers some concern. The reason being that out of the last 9 times this occurred since 1962, 7 of those times were a precursor to a recession with an average delay of about 14 months. The general consensus is that this happens because bank lending (which depends on receiving interest from longer term rates and paying interest based on short term rates) dries up and creates a liquidity crunch. However, we think the dynamics have changed a whole lot in the recent decade. Consider this: most of the time this inversion is caused by an overzealous Fed that cranks up short term rates quickly to fend off inflation. Well, inflation is not an issue and the Fed seems to have backed off. Additionally, long term rates are being held down by global yields that are tremendously lower and not looking to move any time soon. Additionally, the system doesn't operate the same either. Instead of paying savers rates close to a 2-year treasury yield of approximately 2.4%, most banks pay less than 0.25% for deposits, making their cost of capital much cheaper. Furthermore, we think that this distorted yield curve could remain for quite some time as the global economy is still recovering. So what does that mean for bond returns? In our view, we should have little price movement and should be able to collect interest for this year. This would put us at 2-3% for government bonds, 3.5-4.5% for corporate bonds, 5-6% for high yield & floating rate bonds. Overall, not too shabby!

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International Markets

International equity markets have recovered mostly from their 4th quarter 2018 sell-off, but not as strong as the US. We continue to see a myriad of headwinds plaguing the global marketplace. Meager growth rates, currency pressures, Brexit, the impossible position of having the European Central Bank manage monetary policy across 19 different countries, Japanese continuing "lost decade" of economic growth, etc. Valuations are justified to remain cheap, but remain an opportunity for when a period of growth comes back. International bonds are at unbelievable levels due to central bank manipulation. For example, as of the writing, if we compare the US 10-year treasury yield of 2.55% to global yields, we see the UK at 1.21%, Germany at 0.05%, France at 0.42%, and Japan at -0.04%. Our view is that when the European Central Bank and Japanese Central Bank step away and let these yields "normalize", there is significant downside. It will be a delicate task for central banks to navigate.

Real Estate

It appears we may be coming into the ideal environment for REITS resulting from the shift in market leadership as the U.S. economic cycle matures a little further. With strong cash flows, REITs continue to offer potential for attractive relative returns amid a generally favorable backdrop for U.S. commercial real estate. Supply and demand should remain largely in balance, giving landlords some level of pricing power, which should translate into healthy earnings and dividend growth in the mid-single digits. Balance sheets appear to be incredibly strong, cash flow should remain stable, and demand remains robust.

Legislative

As expected, we are seeing a pause in legislation. The new Congress is trying to get settled in, and the distractions of investigations are still in the limelight. However, there are some proposals that have bi-partisan support that are "sitting on the shelf" ready to go when the time is right. One of which is the SECURE Act, which bolsters the potential for retirement savings by doing a few things such as: 1) allowing for small businesses to operate a joint 401k called a MEP(Multiple Employer Plan); 2) increases the automatic increases for savings in 401k plans to 15% from 10%; 3) repeals the age limit for contributions to traditional IRAs which is currently 70 ½; and 4) eliminates the "Stretch IRA" strategy. All in all, a very welcome revision that can work to strengthen retiree finances and maybe relieve some pressure on social insurances in the long run. Lastly, we expect the White House to announce a trade deal with China this quarter. Our long-standing thought is that it would be last quarter, but things are seeming to drag on a bit. Markets are already operating as if it is a forgone conclusion, but solidifying it with a formal announcement will be a breath of fresh air. Again, our belief is that a combination of stronger intellectual property rights, more open Chinese markets, along with key industry tariff relief (i.e. US automobiles and agriculture) will be enough to "bury the hatchet".

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Interest Rates & the Fed

The "Powell Pivot". This is the term used for the extreme change in policy direction the Federal Reserve underwent in the first quarter. They went from predicting multiple rate hikes in 2019 to zero. In fact, they pivoted so hard that they even plan to stop the balance sheet reduction later this year. This 'full stop" is likely the result of the extreme volatility they caused during the 4th quarter of this year, the fact that inflation is still subdued below their minimum target, and the fact that by pushing up rates on the short end, they helped cause the yield curve to be inverted. They caused the market spotlight to shine bright on them, as it should have, but they want to be boring again. So they are not making any changes for the time being. This extreme pivot is not ideal though. In our view, while there clearly is not a need for higher short term rates, longer term rates would benefit from having some upward pressure put on them by the Fed continuing to let their balance sheet roll-off. Let's review what the Fed balance sheet is for a second. During the aftermath of the 2008 financial crisis, the Federal Reserve, in an effort to further decrease interest rates after their Fed funds rates was already at zero, created a never-been-done-before policy of buying treasury bonds in the open market at high prices causing yields to go lower. This quantitative easing policy was done in three different stages called QE1, QE2, and QE3. It worked, and interest rates were driven down to historic lows not only on short term but also on long term rates. In fact, other world central banks adopted a similar policy but took it to an even greater extent causing "negative interest rates". That's right - investors that bought bonds would lose money if held to maturity! That policy from other central banks is still in play and acts as an anchor for our longer-term rates. So, the Fed is currently allowing the bonds that are held on its balance sheet to mature and not fully replacing them and just sending the maturity payments back to U.S. Treasury. This has an effect of gradually letting the balance sheet decrease and not putting any downward pressure on long term rates. At the last press conference the Fed decided to stop this practice later this year. We think this is a mistake since we are in need of a steeper yield curve and that letting the balance sheet run off can assist in that. Our view is that the Fed will keep to its word about not having any Fed funds rate increases this year, but may backtrack on stopping the balance sheet reduction. We could envision a statement that goes a little something like this: "In light of our analysis of the effects our balance sheet reduction operations have had on long term interest rates and the economy, we are not seeing our balance sheet reduction practices having meaningful effects on interest rates due to the extremely low yields across the globe and therefore have decided to extend the operation into the first half of 2020 when we will reassess". But then again, what the heck do we know…. ;)

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Financial Planning Corner

"DIRTY DOZEN" TAX SCAMS TO WATCH FOR

Identity Theft

Using your personal information, an identity thief can file a fraudulent tax return and claim a refund. If you've been a victim of stolen personal information, you can contact the IRS so the agency can protect your tax account.

Phishing

Be wary of fake emails or websites looking to steal your personal information. If you receive a request for information that appears to be from the IRS, contact the IRS directly to verify the request.

Telephone Scams

Scammers will contact you pretending to be from the IRS. They may say that you are due a large refund or owe money (even threatening arrest or revocation of your driver's license). If you receive such a call, call the IRS and contact the Federal Trade Commission using their "FTC Complaint Assistant" at FTC.gov.

Inflated Refund Claims

Tax preparers promising inflated returns may ask clients to sign a blank return or charge fees based on a percentage of the refund. Beware of phony storefronts or preparers advertising through word-of-mouth to community groups where trust is high.

Return Preparer Fraud

Dishonest preparers may use tax preparation as an excuse to steal your personal information, so only use a preparer who signs the return and has an IRS Preparer Tax Identification Number.

Hiding Income Offshore

The IRS has strengthened its ability to identify offshore holdings, and the failure to report them will be costly.

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Impersonation of Charitable Organizations

Fraudulent charities raise money or obtain private information from individuals looking to help. Donate only to recognized charities, and beware of charities whose names sound similar to the well-known ones.

False Income, Expenses or Exemptions

Falsifying your tax return is a high risk, low reward exercise, especially in this age of Big Data.

Frivolous Arguments

Ignore promoters of frivolous arguments that promise you tax relief. Not only are they expected to fail, but you may be subjected to penalties and possible jail time.

Falsely Padding Deductions or Returns

Dishonestly reporting deductions to reduce tax bills or inflate refunds may open you up to penalties and prosecution.

Abusive Tax Structures

If someone is proposing to eliminate or substantially reduce your taxes through complex tax structures, walk away—they may be offering nothing more than illegal tax evasion.

Excessive Claims for Business Tax Credits

This happens when taxpayers or their tax preparers improperly claim the research credit or the fuel tax credit, which is generally limited to off-highway uses, such as farming.

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