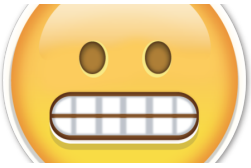


FORESTVIEW
—FINANCIAL PARTNERS—
HELPING YOU SEE THE FOREST *AND* THE TREES

2018 3rd Quarter Newsletter

2018 First Half Review

Before getting started, I'd like to welcome you to the first issue of my client quarterly newsletter. I've been wanting to create something like this since I started my company a year & 1/2 ago, but there was always more pressing matters demanding my attention, such as creating the infrastructure and getting clients to serve! Now that a lot of the "heavy lifting" is behind me, I can devote some time to this endeavor.

My goal for this publication is to share my personal take on the market, the economy, and other financial planning topics that I hope will be relevant to you. For those of you that read/watch my Monthly Market Insights (sent monthly via email), you've likely realized that those are created by a third-party content provider. While they provide a very good (and sometimes entertaining) summary of key points of data, they are largely generic and don't provide you

with any insight into how I'm currently thinking about the current environment. This is what I hope to do in this newsletter. So, let's get on with it!

I'll start by looking at the economy, which by most measures show that it's still on a tear. 1st quarter real GDP[1] grew at a weaker-than-expected 2.0% annual rate. However, based on data from April and May, the US Dept. of Commerce will soon release the first estimate of 2nd quarter GDP which will likely show that the US economy grew by 4% year-over-year. Together, this would put 1st half GDP at 3% annualized and that will be the first time in 3 years that we've seen it that high. What's causing the surge? Mostly fiscal stimulus[2]. The tax cut package that passed at the end of last year has added to both consumer and business spending. Additionally, the May 2018 report on Trade in Goods and Services showed that the nation's trade deficit decreased to $43.1 billion from $46.1 billion in April.

There are a few well known, and well respected, investment strategists that I follow. One of them is David Kelly, Chief Strategist for J.P. Morgan Asset Management (the division that manages a group of mutual funds and exchange traded funds that I sometimes use in my client portfolios). Dr. Kelly believes we can keep at this pace for the next 12 months. He points out that we are in the tenth year of this economic expansion (on track to be the longest one on record), and it's important to be realistic about the pace of growth after the fiscal stimulus fades and the full effect of the Federal Reserve interest rate hikes kick in.

Speaking of the Fed…the new Fed Chair, Jerome Powell, was sworn in earlier this year on February 5th. He has certainly shown that he is trying to be a "Chairman for the people" (see article here: https://bloom.bg/2OewIMl) by communicating in a plain-spoken manner, using concise, simple terms when describing the current economic conditions - his contribution to the Fed's longer-term trend toward greater transparency.

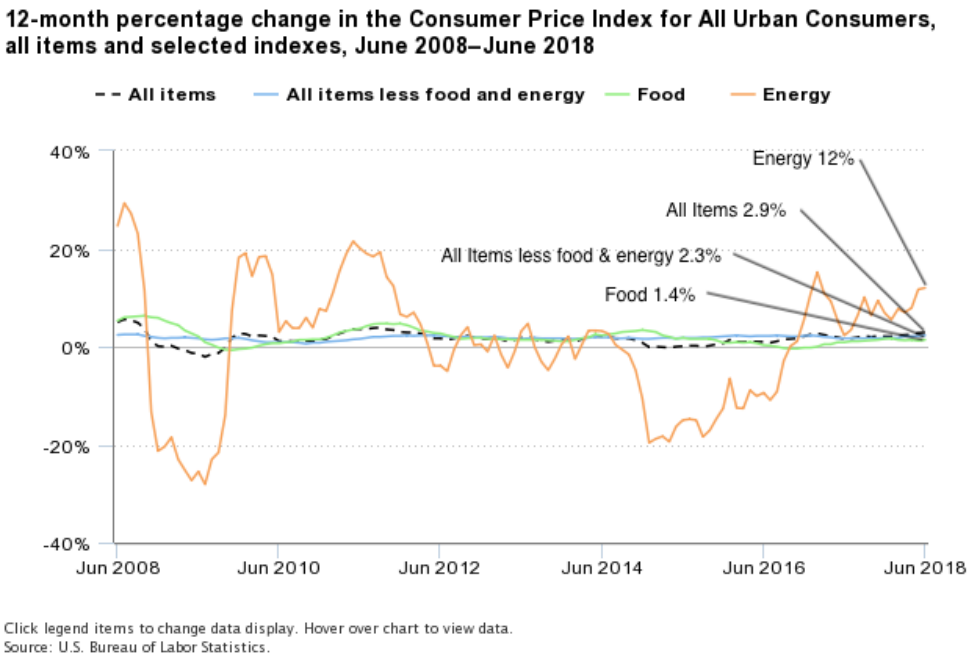
So far this year, the FOMC[3] has increased rates twice, and it's widely believed, at this point, that they will raise it two more times this year, and possibly three times next year. If this holds true, then the Fed Funds rate will likely end up somewhere between 2.75% and 3% by the middle of next year. (it is at 2% currently).

The fact that rates are rising has added some nervous tension to the stock and bond markets. On the one hand, rising rates could slow our booming economy. On the other hand, the fact that the Fed feels comfortable rising rates means that the economy is strong enough to handle it. In fact, all of the data supports these rate hikes.

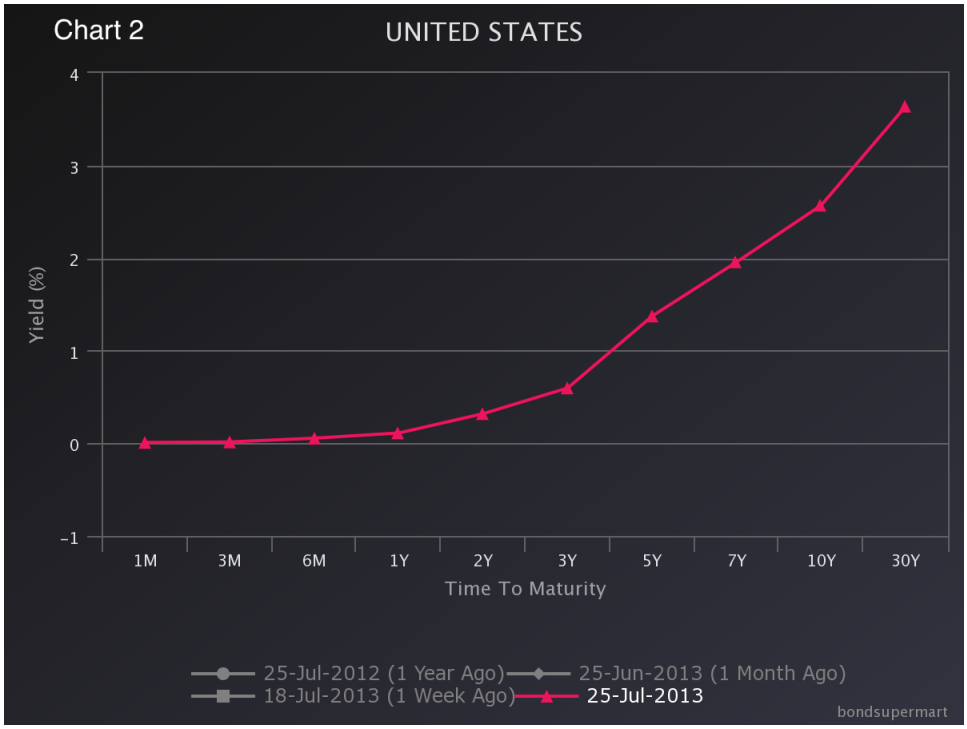
A GDP of 3% is higher than the Fed's long-term target of 1.8%. Consumer inflation (as measured by CPI-U[4]) clocked in at 2.9% (year over year June 2017 to June 2018. See chart on next page), the largest 12-month increase since February 2012. This is higher than the Fed's long-term target of 2.00%. Furthermore, the nation's unemployment rate is now at or below 4%, when the Fed's target is 4.50%. Remember that the Federal Reserve's mandate is to conduct monetary policy to support three goals: 1) maximum sustainable employment; 2) stable prices of goods & services; and 3) moderate long-term interest rates. These last two go hand-in-hand, as when prices are stable, long-term interest rates remain at moderate levels.

This leads me to discuss an important topic that has been mentioned more and more in the financial news: the flattening yield curve. First off, for those that have no idea what I'm talking about, I'll explain what the "yield curve" is.

The yield curve describes the difference between the interest rates being paid to bond investors on short-term US Treasury Bills & Notes versus longer-term Treasury Notes & Bonds. The "curve" is typically displayed in a graph with a line that plots the interest rates over the different bond maturities. The yield curve can be described as having one of three main types of shapes: normal, inverted, and flat.

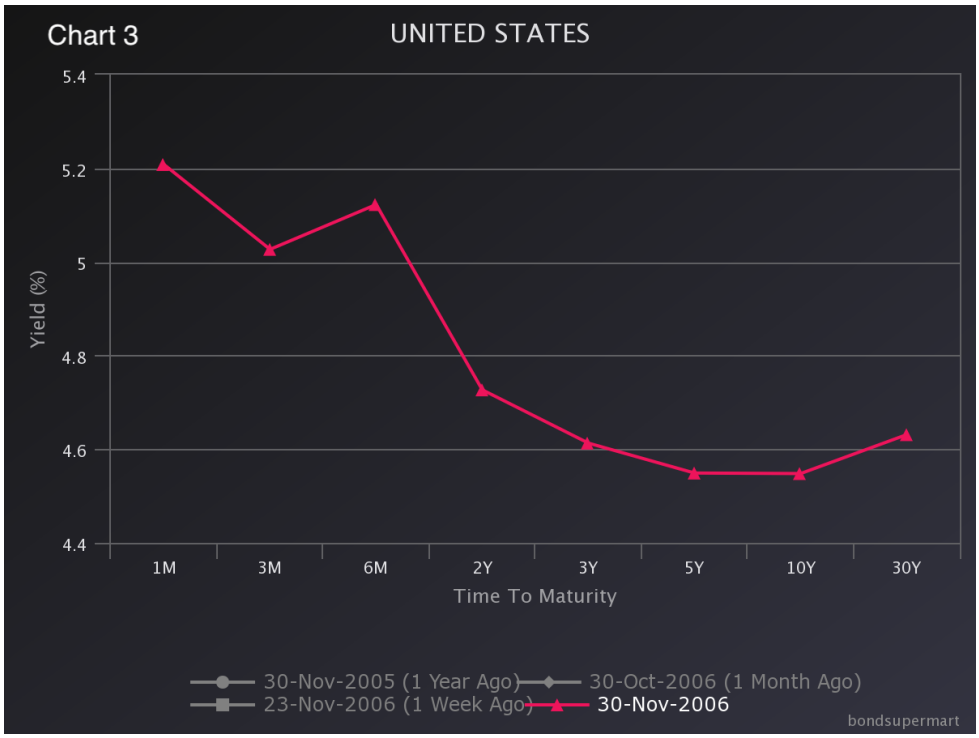


A **normal** curve is where the interest being paid on shorter-term bonds is less (usually much less) than the interest being paid on longer-term bonds. This type of curve is typical in periods of **economic expansion**. Here's a chart of what the yield curve looked like mid-2013 (chart 2).

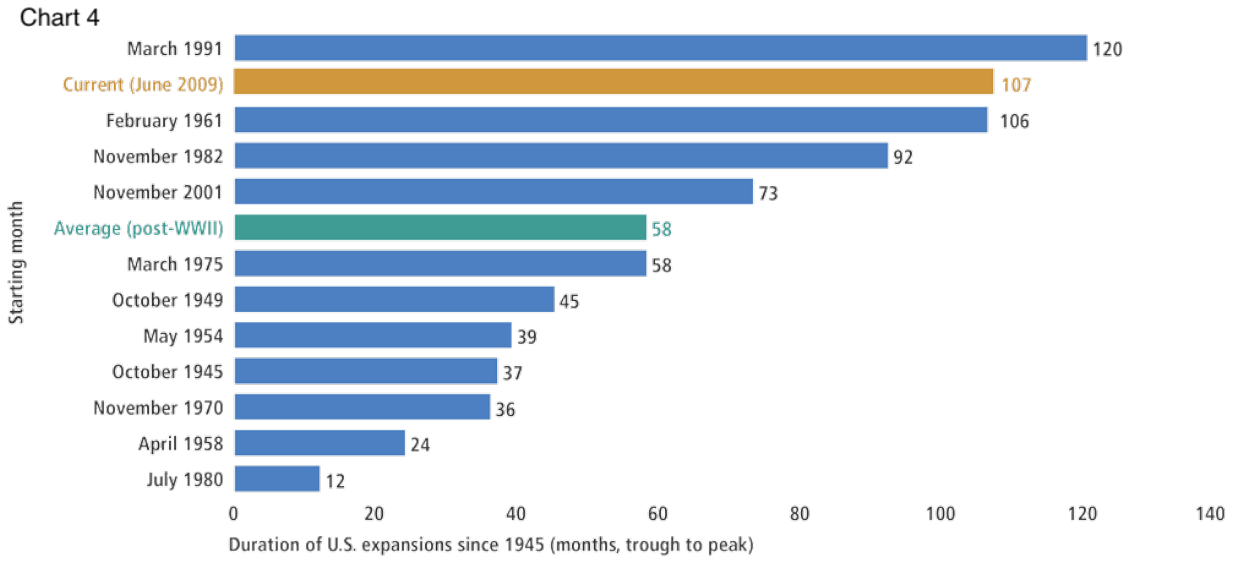


An **inverted** yield curve is where the interest being paid on shorter-term bonds is more than being paid on longer-term bonds. This curve corresponds to periods of **economic recession**. Typically, an "inversion" occurs several months to a couple of years prior to the U.S. economy going into a recession. In fact, an inversion has predicted all nine of the U.S. recessions since 1955, with a lag of 6 to 24 months.

Here's a look at the curve at the end of November 2006, a full year before the Great Recession began. (chart 3)



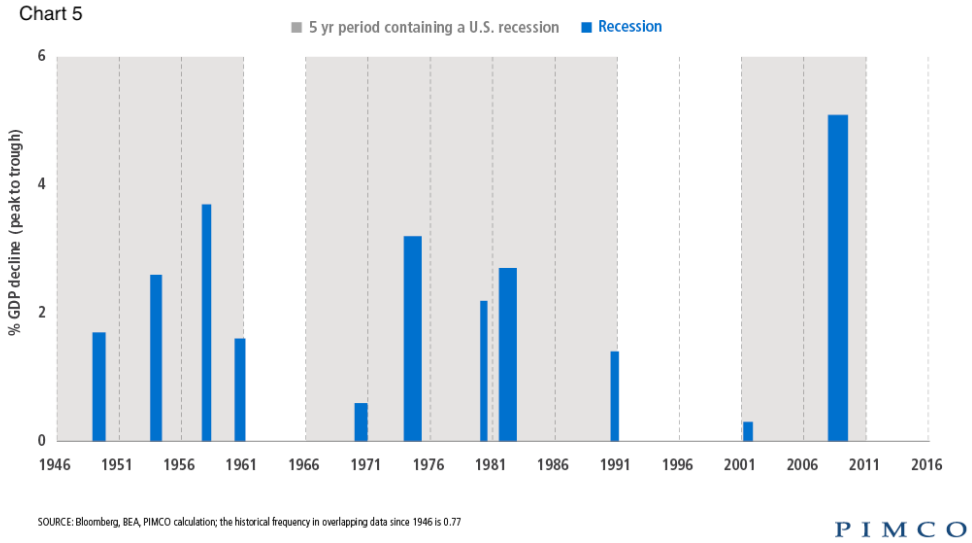
A **flat**, or **flattening** curve typically indicates that the economy is in transition from either: 1) expansion to slower development and even recession; or 2) from recession to recovery and potential expansion. As I indicated already, we are 10 years into this economic expansion, which is now the second longest expansion since 1945. This chart (chart 4) was created by PIMCO at the end of March, so we can tack 3 more months onto the 107 months shown.



Source: PIMCO, National Bureau of Economic Research. Data as of 31 March 2018.

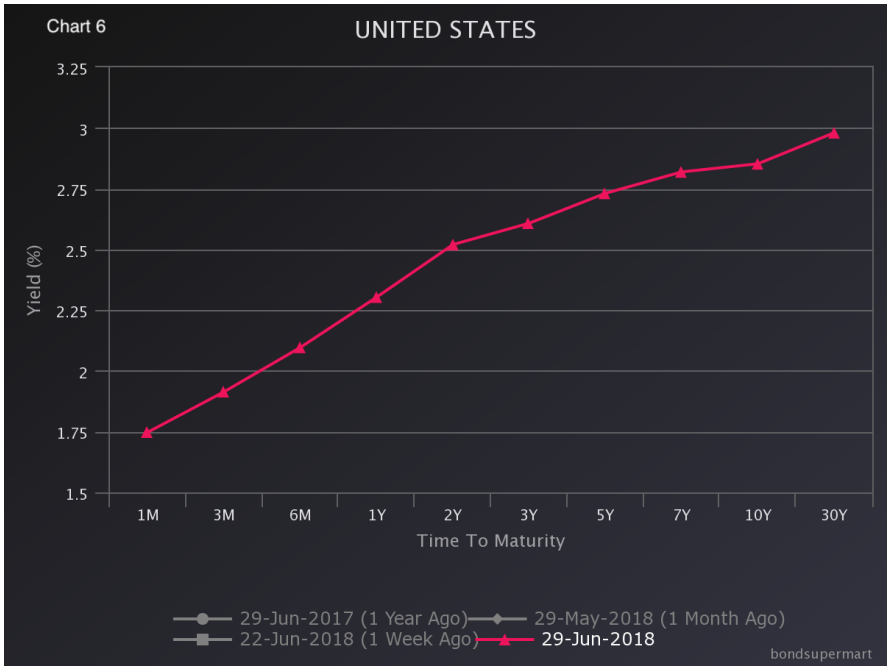
PIMCO

I hope that you can sense the cautionary tone I'm trying to set here. Looking at this another way, it is quite abnormal for us to have gone this long without experiencing another recession. Historically speaking (since 1946), the frequency of a U.S. recession over a given five year period of time has been 70%. (see chart 5. Another one from PIMCO)



This brings me to the current yield curve. What's been happening is, as the Fed has been raising rates, the short-term bond yields have been going up (the Fed mainly controls the short end of the curve). At the same time, the bond market (which controls the longer end of the curve) is not anticipating a significant rise in inflation, therefore keeping interest rates on the longer end relatively low. Consequently, the difference (called the "spread") between the 2 year note and the 10 year note has narrowed considerably. Here's a look at it as of the end of June (chart 6).

To be clear, just because the yield curve is *flattening* does not mean that we are in imminent danger of a recession. There's a huge difference between a flattening yield curve and one that's inverted. This article, written by another person I follow closely, Barry Ritholtz, is a great read on why that's the case. https://bloom.bg/2mIhoer. However, it's definitely something to be concerned about, especially given the fact that we are so far into this current expansion. I check where these rates are on an almost daily basis.



With that economic backdrop, I'll transition to the stock market. Looking at corporate profits, 2018 should be a great year. According to Factset[5], 78% of the S&P 500 companies reported 1st quarter earnings that beat analysts' average estimates, which was the highest percentage since they started tracking the data in 2008. The year-over-year earnings growth rate turned out to be almost 25%.

2nd quarter earnings season is just underway, and as of this writing (with only 17% of S&P 500 companies reporting) 87% have reported earnings surprises (beating estimates)[6]. The annualized earnings growth rate is estimated to be almost 21% for this quarter. This all said, it hasn't translated into broad-based stock price appreciation for the first half of the year.

Looking at the S&P 500 Index, after coming off an already stellar 2017, the index skyrocketed up over 7% in January alone, reaching a peak on January 26 and then hitting a proverbial speed-bump on Friday February 2nd where the S&P 500 declined 2.12% and then an additional decline of 4% on Monday February 5th. I won't belabor here about what caused this as I have already written about it. You can find that article here: http://www.forestviewfp.com/blog/stock-market-declines-over-2-on-friday

Within a matter of days the S&P 500 declined almost 10% from it's high and bottomed on February 8th. The index then struggled along for the next 2 months before finding enough stable ground to begin a new upward trend in early April. In total, for the 1st quarter, the S&P 500 fell 2.1%. To put this in perspective, this was the first quarterly loss since the third quarter of 2015!

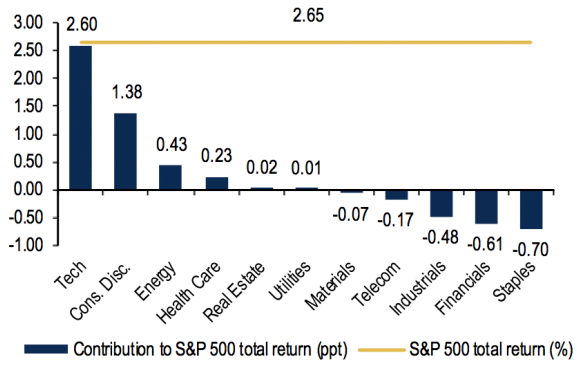
At the time of this writing, the index has not quite yet reached back to that peak level, but it's almost there. Closing out the 2nd quarter, the S&P 500 gained 3.43% for the quarter, which gave the index a total gain of 2.65% for the first half of the year.

But let's dig in just a bit and break down the styles, sectors, and even the specific companies that contributed to this gain. I do this for a reason. While there is no crystal ball that we can peer into to determine the best places to invest for the future, we can take some queues from historical sector and style rotations as well as looking at how "expensive" a particular stock is compared to the overall market. I am mindful of these things because the majority of my clients are either retired, or very near retirement. Preservation of capital is more important to them than growth of that capital.

Similar to 2017, the majority of the index gains so far for this year have come from a small handful of individual stocks in the technology sector. In fact, if you removed 5 of the major tech companies (Facebook, Apple, Amazon, Netflix, and Alphabet (aka Google)) from the returns of the S&P 500, the index would have actually posted a loss of -0.73%. Here are two interesting charts (see next page) that Josh Brown (another "guru" who I follow who works with Barry Ritholtz) posted on his blog a few days ago: http://bit.ly/2LSvwga

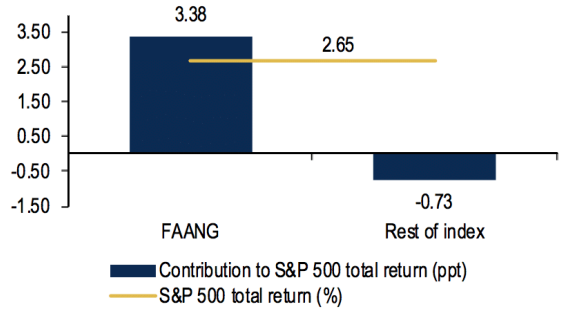
The reason I'm sharing this is that at various points in longer market-cycles, the "leaders" become the "laggards" and vice versa. This is represented by "sector" and "style" rotations. Growth stocks (a style of stocks which the technology sector falls under) have outperformed their value style counterparts for most of this expansion. However, the macroeconomic environment seems to be shifting. This boost to economic growth we're getting from fiscal stimulus, rising inflation, and rising interest rates could lead to a shift in market leadership.

Chart 4: Tech contributed 98% of the S&P 500 total return in the 1H
Contribution of sectors to the S&P 500's 1H18 total return



Source: S&P, BofA Merrill Lynch US Equity & US Quant Strategy

Chart 5: Excluding FAANG stocks, index returns would have been negative
FAANG stocks' contribution to the S&P 500 1H18 total return



Note: FAANG = FB, AAPL, AMZN, NFLX, GOOG/GOOGL
Source: S&P, BofA Merrill Lynch US Equity & US Quant Strategy

Historically, value outperforms growth when there is a pickup in economic growth, accelerating inflation and rising interest rates. Value style stocks include such sectors as financials and energy.

For those of you that are retired and withdrawing money from your portfolios for income, I have been investing the equity portion of your funds with a larger weighting toward value versus growth for some time now - value with higher than average dividend payers. Another reason for this larger than average weighting is that value is more defensive than growth during recessions - for those of you with a priority on preserving your assets.

Growth stocks fall farther and faster during bad economic times. This is because they are usually already overpriced compared to their intrinsic value as investors have been bidding up the prices believing that the company's future revenue growth will support the higher prices. There's a saying in this business: "This works, until it doesn't!". When the economy turns sour, all of a sudden those future expectations crumble to dust and those lofty prices can no longer be justified and they come crashing down.

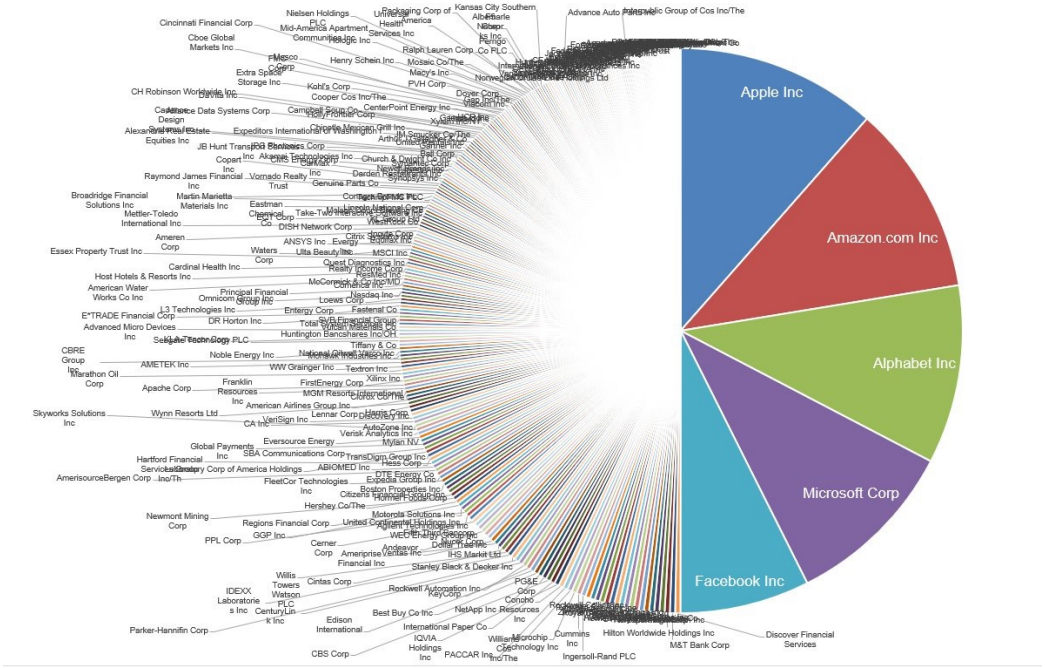
Because we are so far into this expansion, it's hard to imagine that the next recession isn't too far away. Funny thing about recessions is that they are almost impossible to predict, and we usually don't know we're in one until we're well into one already and looking back. The stock market is probably one of the best leading indicators for a recession. But even then, when you're in the throes of a market decline it can be difficult to tell if we're in a normal market correction (up to -10% loss) that will rebound fairly quickly, or if we're on our way toward a bear market (-20% or more decline with a much slower recovery).

For my younger clients, and clients for whom I'm managing money that they won't need to touch for another decade or more, I've been managing the equity portion of your funds with a more equal weighting to both growth & value, and some (more aggressive clients) with a larger weighting toward growth. Nevertheless, I will be talking to you over the coming weeks and months to get your opinion on your allocations.

Here's a listing of some relevant stock market indices[7] as of 6/29/2018:

Name	Q2 2018	YTD	1 Year	3 Year	5 Year	10 Year	15 Year
Broad U.S. Market							
Morningstar US Market TR USD	3.71	3.08	14.70	11.65	13.31	10.29	9.76
DJ Industrial Average TR USD	1.26	-0.73	16.31	14.07	12.96	10.78	9.57
S&P 500 TR USD	3.43	2.65	14.37	11.93	13.42	10.17	9.30
NASDAQ Composite TR USD	6.61	9.37	23.60	15.96	18.54	13.87	
U.S. Style							
Morningstar US Large Cap TR USD	3.57	2.88	14.87	12.15	13.52	10.05	9.16
Morningstar US Large Core TR USD	1.08	-1.97	7.56	11.09	12.48	10.63	9.81
Morningstar US Large Growth TR USD	7.01	12.34	27.24	15.21	17.72	11.64	9.55
Morningstar US Large Value TR USD	0.47	-2.68	8.76	9.68	10.04	7.64	7.75
Morningstar US Mid Cap TR USD	3.12	3.01	13.83	10.33	12.92	10.67	11.29
Morningstar US Mid Core TR USD	1.62	-0.45	10.47	8.68	12.41	10.80	11.29
Morningstar US Mid Growth TR USD	4.98	8.50	20.54	10.70	13.41	9.42	11.07
Morningstar US Mid Value TR USD	2.56	0.90	10.23	11.50	12.85	11.80	11.27
Morningstar US Small Cap TR USD	7.02	5.33	15.52	10.19	12.11	11.26	11.10
Morningstar US Small Core TR USD	6.28	3.26	12.62	9.39	11.78	10.47	11.01
Morningstar US Small Growth TR USD	7.89	11.57	23.70	11.84	13.66	11.35	10.98
Morningstar US Small Value TR USD	6.85	1.31	10.40	9.16	10.76	11.94	11.10
Foreign Markets							
MSCI ACWI Ex USA NR USD	-2.61	-3.77	7.28	5.07	5.99	2.54	7.74
MSCI EAFE NR USD	-1.24	-2.75	6.84	4.90	6.44	2.84	7.26

Okay, one more interesting chart before I move onto another topic. This one blew me away. It was originally posted by another student of the market that I follow, Michael Batnick (who also works with Barry Ritholtz and Josh Brown). Michael is the Director of Research at Ritholtz Wealth Management, a very large investment shop in New York City and one that I admire and have a lot of respect for due to the very smart people they employ. I also respect the fact that they are so willing to share their knowledge and thoughts with the world through their blog posts and podcasts. Along with this chart, Michael noted[8] that the top five S&P 500 companies, when combined, are worth $4.095 trillion versus $4.092 trillion for the *bottom 282 companies!*



Now a review of the fixed-income, (aka bond) market. As I shared already, interest rates are moving up, and inflation is picking up. My long-term view is that as long as they don't go up "too much", higher rates will ultimately be good for the economy, and it will be good for savers. People will earn more interest in their savings accounts, their money market funds, and earn more income from their bonds.

However, for current bond holders (that is those that already own bonds that won't be maturing for another several years or longer), this will be an uncomfortable ride. This is because as interest rates rise, the prices of current bonds in the marketplace will decline. The longer you have until your bond matures, the greater of a price decline you will experience. For those that want an explanation to this phenomenon, read here: https://www.investopedia.com/ask/answers/why-interest-rates-have-inverse-relationship-bond-prices/

Now many people hold some allocation to bonds in their portfolios because they provide income in the way of interest payments, and they are less risky than stocks. They also provide a cushion to an overall portfolio when the stock market is going down. Usually bond prices will go up in a declining stock market (as long as the bonds are of high quality, like the ones issued by the US Government).

Arguably, one of the worst types of economic environments that investors may find themselves in is one called "Stagflation". This is a term used for stagnant growth in the overall economy while at the same time experiencing higher than anticipated inflation where interest rates are going up at a quicker than normal pace. The only place to "hide" is cash. Stocks are declining significantly and bonds are declining too. While the US and other developed countries haven't really experience true stagflation since the 1970's/early '80's, it's certainly possible that we could experience some measure of this if this economic boom creates inflationary pressures that the Fed decides it needs to fight by lifting rates at a higher than expected pace. This will inevitably slow the economy, and if they raise them too far, too fast (and we see an inverted yield curve) it will push us into a recession. Let's hope that this board of Federal Governors has learned from the mistakes of its past.

But even on a smaller scale we can experience this as we, in fact, did earlier this year. In early February the stock market went into a decline. It was a much needed correction after such a huge run up, however, what pushed it off the cliff and started the process was the bond market's fears of higher inflation. At this time, over the course of a 4 week period, the yield (the interest rates being paid) on the 10-year US treasury jumped from 2.621% up to 2.928%. This might not seem like a lot to you, but to the bond market it was akin to a "flash crash" in the stock market. On a percentage basis, this represented a quick increase in yield of 11.71%. Owners of existing bonds saw their bond holdings decline in price by about 3.5%, which is a huge move down in the bond market, while their stocks were simultaneously declining as well.

Things seem to have settled down a bit, but year-to-date (through 6/29) the Morningstar Intermediate term core bond index is still down -1.19%. Intermediate term is defined as bonds that have maturities ranging from 2 to 10 years, so the 10 year treasury is on the longer end of that. To put it in perspective, the Long-term (maturities of 15 years or more) Core broad bond market index is down -4.25%, while the Short-term (less than 2 years) index is down only -0.17%.

So, unfortunately, in some ways (really the most important way) a typical diversified portfolio of 50-60% equities and 50-40% bonds didn't really provide much relief through that period.

Interest rates are going to continue to go up, so bonds will likely continue to see pricing pressures for the next 12 months or so. One thing that I did several months ago in all portfolios that have a fixed income allocation (which is pretty much all of you) is I reduced the maturities (from intermediate-term to short-term) on a large portion of the fixed income allocation. Any exposure to long-term maturities was already negligible as I have been anticipating this since putting a lot of your portfolios in place last year.

Lastly, weaving through all of this is the concern of what a full-blown global trade war might do to the markets and the overall economy. So far, all the saber rattling has been pretty innocuous. The S&P 500 is up almost 9% since finding a bottom toward the end of March, right around the time when the trade war rhetoric really began to heat up. This is mainly due to the belief that negotiations will be successful and agreements will be made before it has a real effect on the economy. Let's hope that's the case.

Fraudulent Tax Return Identity Theft On the Rise

I haven't seen any statistics yet released from the IRS for the returns that were filed this year for 2017. I think they wait until the end of the year to capture those stats on the people who are under an extension. But, it's looking like 2018 will be the worst yet for tax-return identity theft.

You probably have read something about this already, but for those that may not be fully familiar with what this is. A criminal who has obtained your social security number illegally, will use it to file a fictitious tax return on your behalf. At first, one might say "well, that's mighty nice of them since I hate filing my taxes!" However, they've made up all the numbers, ensuring that you're due for a nice big refund check, and they've changed your address and/or given the IRS their own account numbers for the destination of that refund check!

The reason for the huge increase in this type of crime is directly related to the Equifax breach last September. If you remember, cybercriminals were able to steal about 145.5 million people's social security numbers. Odds are yours was one of them.

I and my wife, Michele, were already a victim of this type of ID theft a few years ago. Amazingly, the IRS caught the fraud and shut it down before any money was sent out. However, it became a huge pain in the butt to file our real tax return. I worked with my CPA who helped me with the task. Otherwise I would have been the victim of another crime - the IRS tax-payer's help line!

Let me know if you want more details or some articles or advice on how to prevent &/or deal with identity theft.

The Strangest Thing

I want to end these newsletters with something fun, and perhaps sometimes a little strange. For now, I'm going to call it "the Strangest Thing" for the strangest, or craziest thing that I've seen for the

quarter. I'm on the Internet a lot - doing research, reading articles, etc... Every so often I come across something that really makes me shake my head, dumbfounded.

Early this year, I was on Twitter where a lot of these "Guru's" that I follow post charts and their thoughts on the market and whatnot, and I came across the craziest thing that I've seen in a long time. Eyeball Tattoos!!! What?!?!

Now, I personally don't have any tattoos, but I like looking at them on other people. I've seen some really cool works of art (and some not so cool ones). I have never judged anyone for choosing to permanently mark their body - to each their own. But, this one makes me really question the person's sanity. It literally involves injecting ink into the whites of the eyeballs. Here's what it looks like.

Go here if you want to see this guy's Tweet with his video explaining that it's perfectly safe if the tattoo artist knows what they're doing! (yeah right!) https://twitter.com/i/moments/917402104725213184

In closing, I hope that you've enjoyed and received value from this first issue of my client newsletter. Feel free to contact me with any questions or comments about anything I've shared - except the eyeball tattoo guy. It actually makes my stomach queasy to look at him and think about the procedure and I don't want to talk about him anymore.

Warm regards,

Matt

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Endnotes:

[1] GDP, or Gross Domestic Product is the market value of goods and services produced by labor and property located in the United States. It is widely used to gauge the health of the economy.

[2] Fiscal Stimulus refers to increasing government consumption or transfers or lowering taxes. Effectively this means increasing the rate of growth of public debt. Source: https://en.wikipedia.org/wiki/Stimulus_(economics)

[3] FOMC: Federal Open Market Committee is a committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

[4] CPI-U: Consumer Price Index for All Urban Consumers measures the changes in the prices for a variety of goods and services purchased by urban consumers.

[5] Factset Article on 1st quarter earnings here: http://bit.ly/2Ol5svZ

[6] Factset report on 2nd quarter earnings here: http://bit.ly/2v77eYv

[7] https://www.morningstar.com/articles/871527/morningstars-take-on-the-2nd-quarter.html

[8] https://twitter.com/michaelbatnick/status/1019680856837849090