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FINANCIAL PLANNING | INVESTMENT MANAGEMENT

We have read through all the market commentaries and outlook narratives that were sent to us in the latter part of 2018 by our contacts in the investing industry. The repeated theme for the 2019 outlook was "Down but not Out." Many economists and fund managers are expecting growth and positive returns for 2019, but at a slower pace than we have seen. We want our clients to feel confident that they (and we) understand the major drivers at work, so we have put together this summary of the analyses that we have pored over.

Global Economic Fundamentals

Compiled by Tom Mallini / tmallini@togetherplanning.com

Even though the fundamentals of the economy look pretty good, the recent volatility of the stock market doesn't make you feel good. The fundamentals of growth in GDP, inflation, unemployment, corporate earnings and dividend payouts are solid. Yet the market is a roller coaster from most openings to closing. What's an investor to do? Let's examine where some of the key metrics are today, where they appear to be headed in 2019, headwinds and tailwinds to growth in GDP and how we should manage our portfolios in this environment.

GDP Growth: Since the Great Recession (2008), the US economy has grown, but at a sluggish pace. The first two quarters of 2018 were relatively strong, but we have seen some weakening in the last half of the year. However, retail sales for the holiday season appear to be the best in the last five years. The consensus is that the economy will continue to grow in 2019, but at a slower pace than 2018. Global economic growth is expected to slow also as we saw Germany and Japan's economies slow in the last half of 2018.

Earnings growth: Corporate earnings should also grow this year but at a slower pace than last year. Remember 2018 earnings got a huge boost with the tax cut.

Unemployment: Unemployment is at historically low levels, and could decline a little more, and we are finally seeing some wage growth

Inflation: Inflation has stayed around the federal reserve's mandated level of 2% and the deflationary fears of not-too-many years ago have been replaced with an expectation that inflation will remain somewhere between 1.5% and 2.5% in the near term. This is a healthy level.

Consumer confidence: The Conference Board's Index of Leading Indicators is positive. However, their Consumer Confidence Index declined slightly in November and December, but remains positive. According to Lynn Franco, Senior Director of Economic Indicators for The Conference Board, "Consumer confidence declined in December following a moderate decline in November. Expectations regarding job prospects and business conditions weakened but still suggest that the economy will continue expanding at a solid pace in the short term. While consumers are ending 2018 on a strong note, back to back declines in expectations are reflective of an increasing concern that the pace of economic growth will begin moderating in the first half of 2019."

So, if the economy remains "solid" why is the stock market so volatile?

1. Part of the shock of the recent volatility comes from the fact that volatility has been lower than normal. In 2017 we experienced volatility that was well below historical levels. So, to some extent the market is just moving closer to its typical behavior.

2. The ultimate impact of Brexit on both the UK and European Union is of concern especially because the UK and EU have not been able to reach an agreement on terms of trade, the Irish border, regulations, etc. in a post Brexit environment. Disruptions in financial payments and trade could significantly impact their economies. It is unfortunate the UK and EU are not able to reach agreement and it appears that a "hard" exit is inevitable. The world's economies are more intertwined than ever as a result of globalization, and we have never experienced a break up of this magnitude. This is another contributor to market uncertainty.

3. Trade wars between the U.S. and China are certainly causing volatility as we watch markets surge on encouraging news and collapse when the news is pessimistic, and when tensions accelerate.

4. Central Banks are beginning to remove support to their economies by raising interest rates and reversing quantitative easing. This should indicate that their economies are healthy enough to continue growing without the level of stimulus that has been applied since the Great Recession. The market reacted negatively to the federal reserve's FOMC meeting outcome in December as it raised rates and clarified its outlook for future increases. On one hand, the market does not want the federal reserve to choke off growth with higher rates, and on the other hand it interpreted their more dovish outlook as a forecast of a slowing economy. The federal reserve has stated repeatedly that their decisions would be based on economic data as it evolves. So far, the data indicates continued growth.

5. The threat of yield curve inversion is weighing in on investors' minds as it is a predictor of recession. While the yield curve is flattening, the two-year/ten-year spread has not inverted. This, however, is a data point that bears close monitoring.

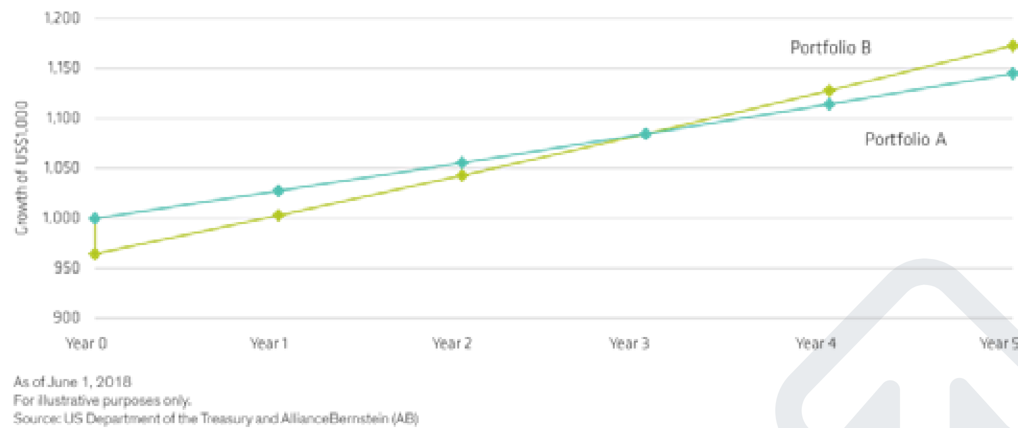
6. Programmed or algorithmic trading is certainly adding volatility. Initially used to smooth out the purchase of large blocks of stocks with minimum price impacts, it has evolved into active trading, even feeding off social media posts. Blackstone's Byron Wein explains "Recent research suggests that 60% to 90% of daily equity trading is performed by algorithmic trading, up from 25% in 2004."

Many different factors are coming together to create this market volatility. Ultimately, stock prices are a function of fundamentals such as corporate earnings, cash flows, dividends and the macroeconomic outlook. But the market is certainly impacted by non-fundamental events such as geopolitical turmoil and trade wars. Historically, making investment decisions based on currently disruptive non-fundamental events has not led to successful outcomes.

A strategy of investing in a diversified portfolio within an investor's risk tolerance within a defined investment time horizon has historically achieved better results.

A Rising-Rate Portfolio Soon Outpaces a No-Rate-Rise Portfolio

Portfolio A Assumes No Rate Increase, While Portfolio B Assumes Rates Rise 125 b.p. on Day One and Remain Stable Thereafter



As of June 1, 2018
For illustrative purposes only.
Source: US Department of the Treasury and AllianceBernstein (AB)

Watch the consumer. Household consumption still makes up nearly 70% of the US GDP. When consumers slow their spending, our economy will slow and possibly enter recession. If you conclude that the level of consumer spending is at risk of declining, review your portfolio to determine if reallocation to less volatile assets, such as bonds or preferred stocks, is prudent. The key is to diversify and stay invested. Holdings that produce income can also mitigate volatility. In the long run, rising rates are good for fixed income investors as income is reinvested at higher rates. The chart above[i] demonstrates how holding a fixed income instrument can provide a positive total return in a rising rate environment.

Other income-producing assets such as energy mid-stream Master Limited Partnerships, REITs and Mortgage REITS and high-dividend common stocks are often overlooked by investors. They can produce good income for reinvestment. The advisors at Together Planning will be happy to discuss these alternatives with you.

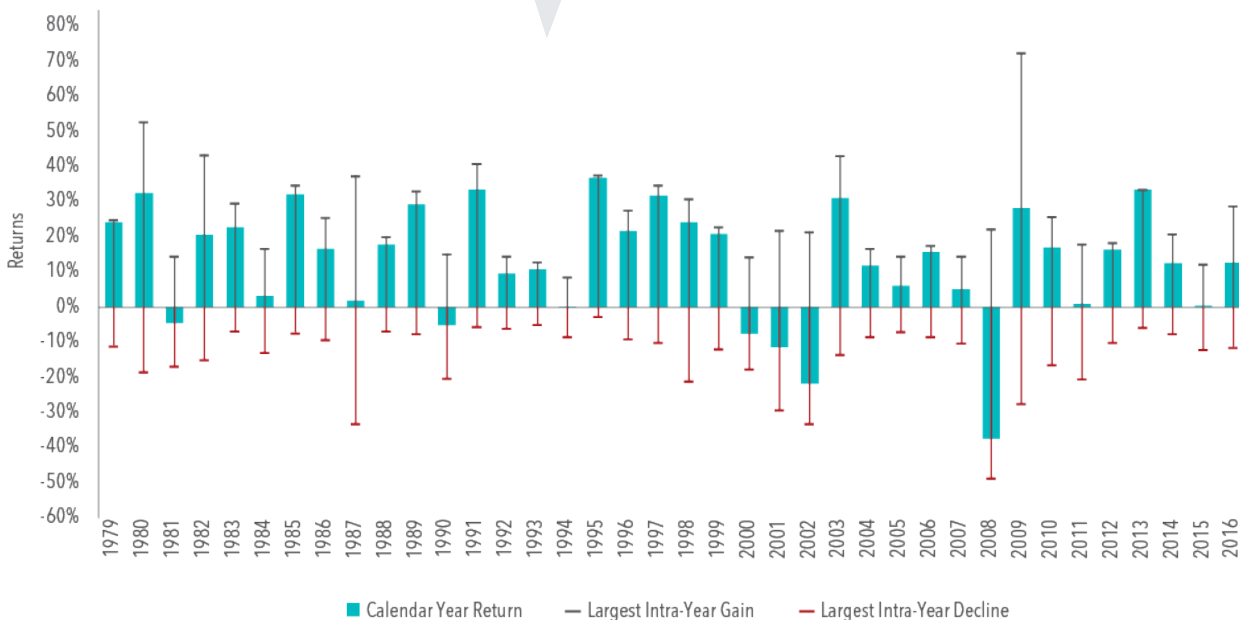
Continue reading for a few more highlights of the U.S. market outlook, as well as China and Europe.

U.S. Markets

Compiled by Jud Mallini
jmallini@togetherplanning.com

Much of what happens to the global economy hinges on what happens with the U.S. economy. While we saw some significant ups and downs in the U.S. equity markets in the latter part of 2018, we've seen a rebound so far in 2019. Over the past twelve months, market forces that could push us into recession haven't dented the U.S. economy. Hence, we are cautiously optimistic that 2019 will be another positive year for U.S. stocks.

In fact, this is true most of the time. The graph below[ii] shows U.S. market intra-year gains and declines vs. calendar year returns:



The gray and red bars represent how high and how low stock prices went for that year. The blue shaded bars represent how the market ended that year. Notice how the red bars went below zero most years, and yet the blue shaded bar (how the year ended) was positive. Volatility is very common with stocks, and thankfully the stock market goes up more than it goes down. This is a reason to choose an asset allocation that meets your needs and stick with it during all types of markets in order to get the best results possible.

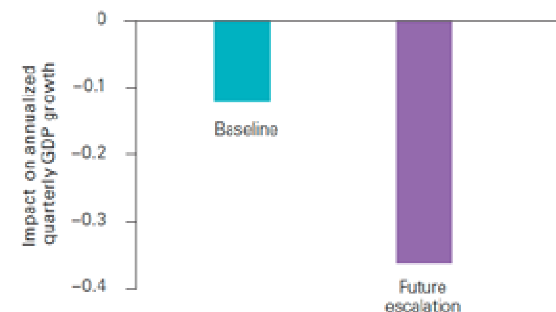
Let's look at what we consider to be the main risks going into 2019 for U.S. stocks:

1. The U.S. trade war with China continuing to hinder trade, lowering GDP.

Tariffs impact our economy because they increase the cost of the things we buy, causing a drag on the economy. The following graph[iii] represents the estimated impact to GDP caused by higher costs of goods due to trade wars:

Trade war impacts

GDP impact of higher costs of traded goods and financial market uncertainty



Baseline: A 25% tariff on $350 billion in imported goods (approximate amount of the U.S. trade deficit with China) and a retaliatory 25% tariff on $350 billion in exported goods along with a 25-basis-point widening of the credit spread.
Further escalation: A 25% tariff on a further $200 billion in imported goods (approximate amount of automobile, steel, and aluminum imports exposed to announced tariffs) and retaliatory 25% tariff on a further $200 billion in exported goods along with a 100-basis-point widening of the credit spread.
Notes: Tariff impacts are based on increasing prices of imports and exports by percentage indicated in the Federal Reserve's FRB/US model. The credit spread is the BBB spread. BBB spread impacts are based on shocking the yield spread of long-term BBB corporate bonds versus the 10-year Treasury bond yield by the indicated percentage.
Source: Vanguard calculations, based on the Federal Reserve's FRB/US Model.

If the trade war were to escalate, it could lower GDP by more than 1% per year. That is significant.

2. The Federal Reserve miscalculating the "neutral rate" by raising interest rates too quickly, causing recession.

For a healthy economy, the federal reserve would like to increase nominal interest rates to the "neutral" rate, or the rate at which real GDP is growing at its trend rate, and inflation is stable. Since the federal reserve members have no direct way to measure whether nominal interest rates are in line with the "neutral" rate, they must take information from indirect sources and make an educated guess. If they were to make an error, it could negatively impact our economy and markets. Raising rates too quickly can cause our economy to stall.

Further, if the federal reserve increases short-term rates while long-term rates decline, an inverted yield curve could result, and this usually indicates a recession is coming in the next 12-18 months.

Research shows that interest rates by themselves (whether they are high or low) show no correlation to U.S. market returns. In fact, even if you were perfect at forecasting interest rate changes, this would be of no benefit to you as an investor. Watch this interesting video[iv] from our friends at Dimensional Fund Advisors:

How do changing interest rates affect equity returns?

3. The U.S. economy slows, causing a corporate earnings decline, a corporate debt problem, and consequent sell-off in stocks.

If we are at the end of an economic boom, and corporations can no longer maintain the level of growth that they've had over the last decade or so, we could see a drop in their earnings. Since many companies have borrowed money to fund their growth, they may have trouble paying that money back if their revenues drop. This could cause some companies to go bankrupt, and further hinder growth of the economy.

These are the biggest risks we see going into 2019 for U.S. stocks. Keep in mind that there are always risks. Chances are good that our economy will continue to grow at a steady pace in the coming 5-10 years, and U.S. stocks will continue to be a great place to invest.

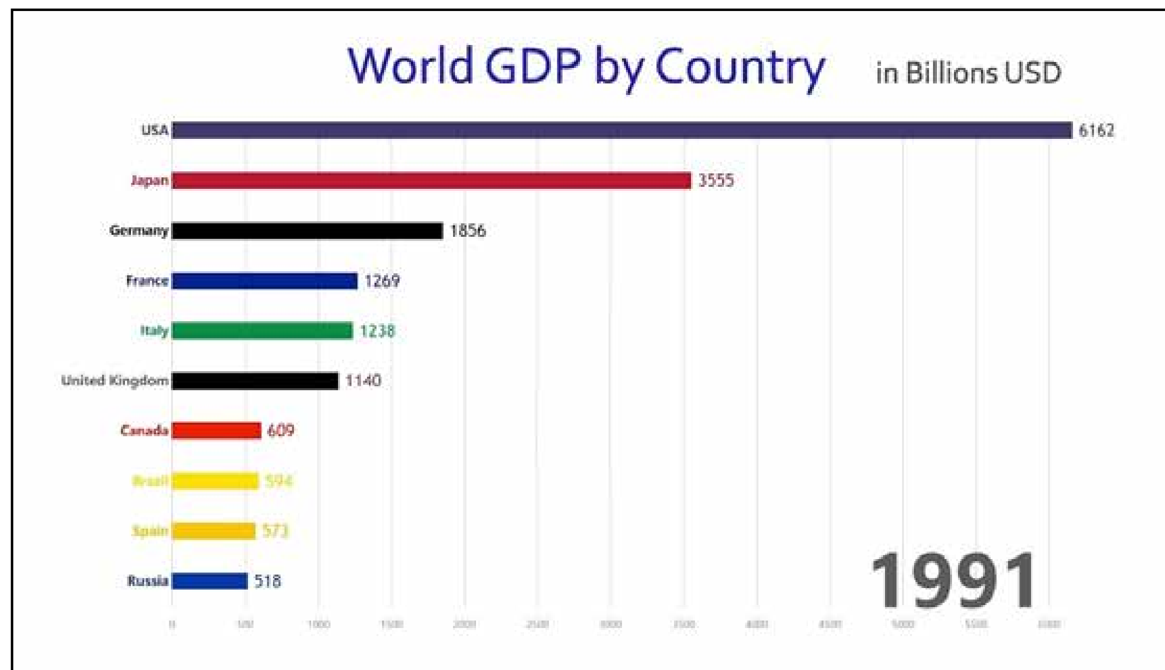
China

Compiled by Lia Bertelson
lbertelson@togetherplanning.com

China plays a very important role in the global economy, and there are many areas of potential risk to its economy, so it is at the center of the market outlook commentaries we have read for 2019. Here is what you need to know.

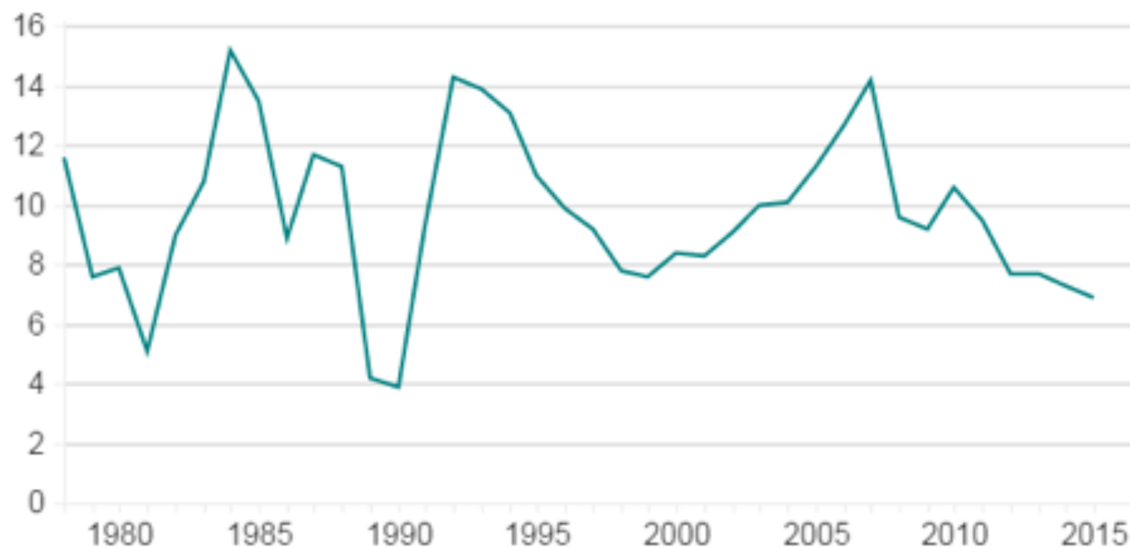
1. China is a dominant world economy. Since 1992, China has been steadily climbing in world rankings for GDP. It is now the second largest economy in the world, at about 63% of the size of the U.S. economy. The growth rate has been staggering. If you haven't seen this dynamic graph by WaWaMuStats[v] , prepare to be impressed.

2. Growth is slowing in China. China's GDP growth has been above 6.5% since it peaked at above 12% in 2010. The growth rate has been slowing, though. Most forecasts we have read predict 6.0-6.3% growth in China's GDP in 2019. That forecast is dependent on some stimulus by the Chinese government to ease the slowdown in GDP growth and credit growth. Some say[vi] there is significant risk that China's policy will not be effective enough in countering the slowdown. If that is true, the global economy will be pulled back by the China slowdown. The chart to the right[vii] shows the growth rate of GDP in China over the last ten years:



China's GDP growth rate

%, inflation-adjusted



Source: National Bureau of Statistics of China

3. The bilateral U.S.-China trade war is a drag on the global economy. From Vanguard : "We estimate the direct impact of current tariffs on China's GDP at a modest -0.15%, but this could accelerate to -0.60% with a 25% tariff on all imports from China."[viii] The effects of the trade war, as the Vanguard report acknowledges, extends to investment, technology, intellectual property rights , and industry policy[ix]. A bilateral agreement between the U.S. and China would reduce risks of global declines, while an escalation of tensions could impact GDP growth by 1% or more, as well as increase geopolitical risks.

4. Equity valuations in China are attractive, especially among small-cap stocks. As U.S. stock prices soared in 2017, many worried about the high ratio of price to earnings among many holdings, and in the market in general. Thanks to increased earnings in 2018, and the recent declines in stock prices, the P/E ratio of the S&P 500 has fallen from 24.97 to 19.06 in the past 12 months[x]. The P/E ratio of the Shanghai Composite, in comparison is 11.72 this month[xi]. Equities are less expensive in China. Value might be found particularly in small cap stocks, which will not be as affected by tariffs, and which will benefit from movements to buy domestic. China will continue to grow and gain importance as a global economic power. The short term is quite uncertain due to the trade disputes with the U.S., but the long-term growth potential is significant.

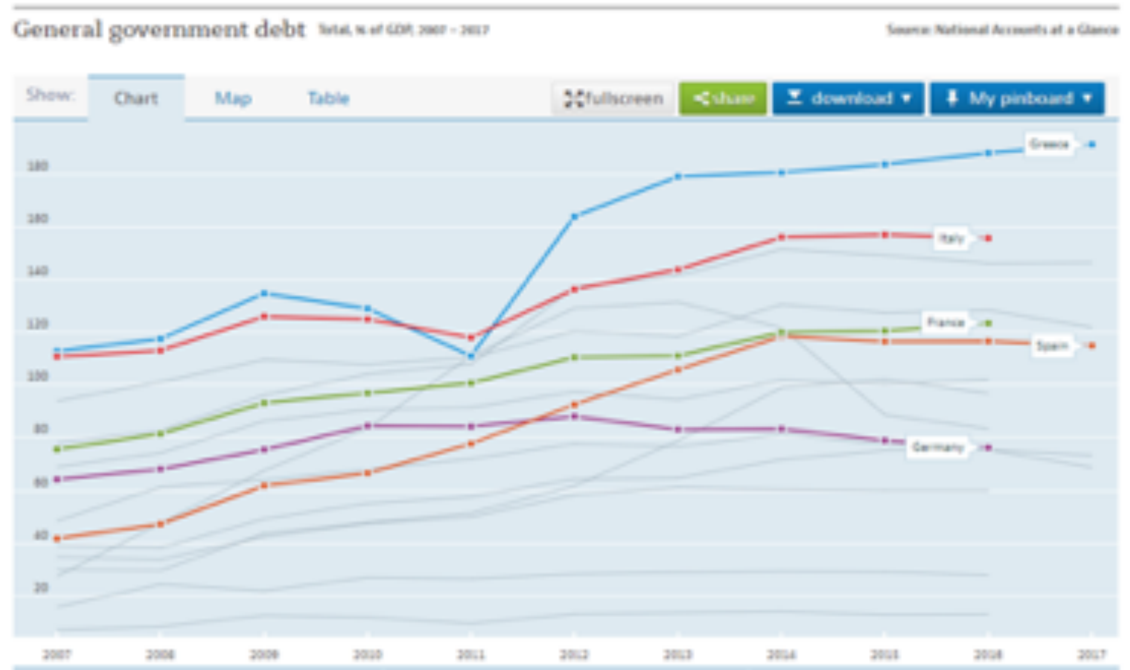
Europe

Compiled by Together Planning Intern John Abernethy
jabernethy@togetherplanning.com

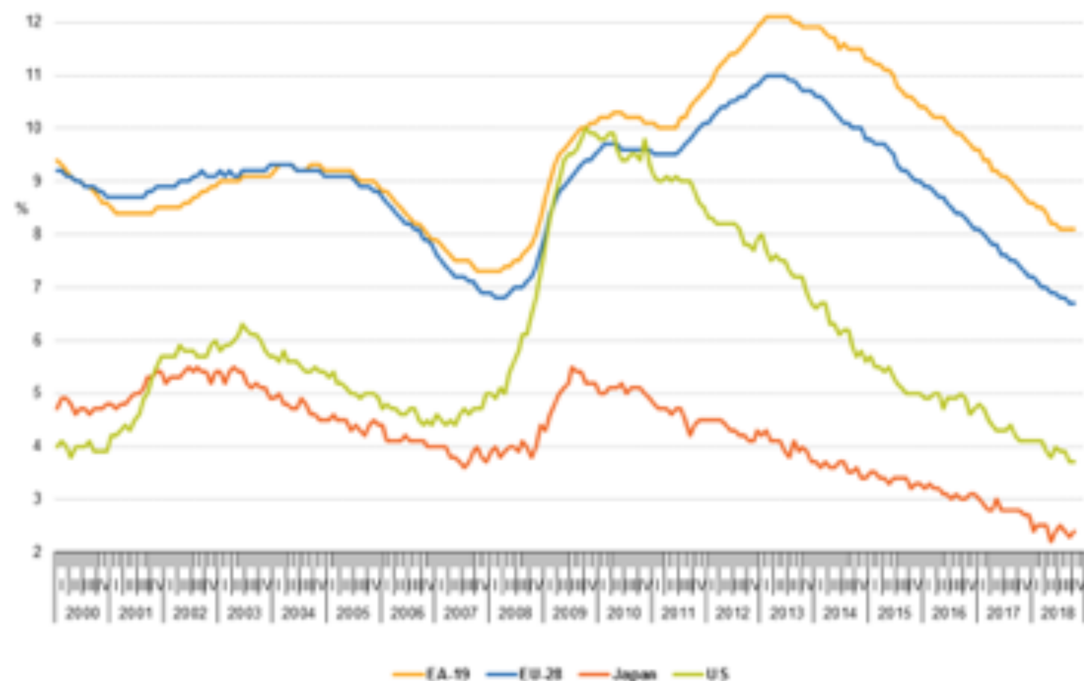
Brexit and the rise of populist parties in Europe have led to economic uncertainty and anticipation of a slower rate of economic growth in 2019.

1. Brexit is having a negative impact on U.K. economic growth. The U.K. Government estimates a 3.9% reduction in GDP in 15 years due to immigration and trade disputes with the EU. This estimate could be more or less severe depending on the deal Britain is able to reach with the EU, if one is made at all[xii]. The negative result of the vote on May's proposal on January 15 puts further into doubt the prospect of a deal being reached before the deadline of March 29, 2019. If in fact there is a "no-deal" hard Brexit, the short and long-terms implications for the UK and its economy are unclear, and potentially more negative. The chart below shows the UK's GDP growth relative to Europe[xiii]. Since the Brexit referendum, the UK has realized slower growth than the rest of Europe.

2. The 2018 Italian general election sent shockwaves through Europe with the victory of a Centre-right coalition led by the anti-establishment parties the Five Star Movement and the League. The new Italian government has thus far been able to come to agreements with the European Union to slowly decrease government deficits in response to high levels of debt. OECD predicts slowed GDP growth in Italy from 1.4% in 2018 to 1.1% in 2019. The new Italian government faces several major economic challenges which are hampering growth[xiv]. The chart to the right compares the debt balances of central banks in Europe. Italy's debt is among the highest.[xv]



3. European economy has continued to see an overall decline in the unemployment rate and positive wage growth. As shown in the chart below, the European unemployment rate hovers just under 7%[xvi].



Meanwhile, wages rose 2.7% in the third quarter of 2018, only slightly slower than the 2.8% growth experienced in the second quarter of 2018.

The European Union had an inflation rate of 2% in November of 2018 and rates may rise slightly in 2019.

Overall, Europe's economy is likely to continue growing in 2019, but at a slower rate than in 2018[xvii]. What happens between now and March 29 may help to reduce the risk of the global economic shock that a no-deal Brexit could cause. We will have to wait and see on this one.

We leave you with this message from Josh Brown, a well-known finance blogger and member of the media[xviii]. You can read his work at www.thereformedbroker.com.

Josh says that it is often helpful to have this mindset when investing in stocks:

"The long-term looks really good, but something bad is about to happen."

This is helpful advice for staying in the right state of mind during the ups and downs of the market.

Thank you for reading our 2019 Outlook, and for being our clients and friends. We wish you a prosperous new year, and we are here to help. Please call on us when you have a question or a need. We appreciate your referrals and love to serve your family and friends as well.

i - https://blog.alliancebernstein.com/library/why-its-a-mistake-to-cash-out-of-bonds-when-rates-rise
ii - https://us.dimensional.com/perspectives/recent-market-volatility
iii - https://institutional.vanguard.com/iam/pdf/ISGVEMO_2019.pdf
iv - https://us.dimensional.com/perspectives/what-happens-to-stocks-when-interest-rates-change
v - https://www.youtube.com/watch?v=wykaDgXoajc
vi - https://www.bloomberg.com/opinion/articles/2018-11-19/china-stimulus-efforts-are-failing-for-good-reason
vii - https://www.weforum.org/agenda/2016/10/the-worlds-economy-without-chinese-growth
viii - https://institutional.vanguard.com/iam/pdf/ISGVEMO_2019.pdf
ix - https://www.forbes.com/sites/davidvolodzko/2018/11/11/the-trade-war-with-china-and-the-problem-with-intellectual-property-rights/#285c7aa1728e
x - http://www.multpl.com/table
xi - https://www.bloomberg.com/quote/SHCOMP:IND
xii - https://www.forbes.com/sites/lbsbusinessstrategyreview/2018/11/28/the-economic-impact-of-brexit-and-what-it-means-for-financial-stability/#57385f6383e7
xiii - https://insights.abnamro.nl/app/uploads/2018/10/181018-UK-ENG1.jpg
xiv - https://www.weforum.org/agenda/2018/06/5-charts-that-explain-big-challenges-facing-italy-s-new-government/
xv - https://assets.weforum.org/editor/XSKxKFbKeBPbv7rUd-cZbUqp-eJWzZVrV53u21sn-yk.png
xvi - https://ec.europa.eu/eurostat/statistics-explained/index.php?title=File:Unemployment_rates_EU-28_EA-19_US_and_Japan_seasonally_adjusted_January_2000_October_2018.png
xvii - https://www.imf.org/en/News/Articles/2018/11/07/na181107-europe-economic-outlook-in-six-charts
xviii - https://thereformedbroker.com/

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