Investment Tally & Perspective

MAJOR ASSET CLASS RETURNS				
	3rd Qtr. 2019	1-Year	3-Year	5-Year
Equities				
S&P 500	1.7%	4.3%	13.4%	10.8%
MSCI EAFE	-1.1%	-1.3%	6.5%	3.3%
MSCI Emerging Markets	-4.2%	-2.0%	6.0%	2.3%
Fixed Income				
Barclays Capital US Aggregate	2.3%	10.3%	2.9%	3.4%
Barclays Capital US Corp. Inv. Grade	3.0%	13.0%	4.5%	4.7%
Barclays Capital Emerging Market	1.3%	10.6%	4.4%	5.0%
Other Assets				
MSCI US Reit Index	7.7%	18.3%	7.3%	10.1%
S&P GSCI	-4.2%	-16.3%	1.5%	-11.7%
ICE WTI Crude Oil	-6.7%	-22.5%	-0.8%	-8.6%
Comex Gold	3.8%	20.2%	3.8%	4.0%
Source: Capital IQ		All returns greater than one year are annualized		

Market Overview - After experiencing a difficult August, the S&P 500 managed to end the third quarter in positive territory, gaining 1.7%. Value equities outperformed their growth counterparts, making up for some of the underperformance seen earlier in the year. Minimum volatility outperformed and small caps underperformed. Looking at returns for the S&P 500 sectors, Utilities and Real Estate were the big winners, while Energy and Health Care lagged.

Outside of U.S. equities, international developed and emerging market stocks couldn't generate positive returns. Bonds were a standout again, as the 10-year yield declined from approximately 2.0% in June to 1.7% in September. Investment grade bonds outperformed, as high yield bonds rose less than the Barclays Aggregate.

Crude oil ended the quarter in negative territory, despite the attack on Saudi Arabia's oil infrastructure. The decline in real yields were a contributing factor to REIT outperformance and the continued rise of gold.

Economic Developments - The third quarter saw a heightened level of market moving events, including:

- U.S. China Trade War – The U.S. administration announced tariffs on the remaining Chinese imports, while raising the rates on previously implemented tariffs. China responded with incremental tariffs on its U.S. imports. There has been additional activity since these actions were taken, and the next item is high level talks scheduled for mid-October.

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- Federal Reserve and Global Central Bank rate cuts- more details below.
- Further Yield Curve Inversion- Earlier this year the U.S. 10-year / 3-Month spread inverted. During the third quarter the 10-year/2-year curve inverted as the bond market continues to deliver the message that growth is slowing, and the Fed is too tight.
- Brexit – Yes, despite the initial referendum held in the summer of 2016, we are still talking about Brexit. A handful of events happened during the quarter, but the most likely outcome is an extension of the deadline (currently set for October 31st) and general elections shortly thereafter.
- Hong Kong- Protests in this financial capital have caused economic stress on that economy and remains a headache for Chinese President Xi Jinping. Initially sparked by a since tabled extradition bill, the protests continue to gain steam and increasing the chances of a heavy-handed response from the mainland. Though isolated at this point, China's economic policy and trade war discussions may be influenced by these events.
- Iran – Tensions between Iran and the U.S. are elevated relative to recent history. Iran's downing of a U.S. drone in mid-June and its attack on a Saudi oil facility appear to be an attempt to prey on the administration's desire to shy away from direct conflict while gaining leverage in sanction/nuclear discussions. Whether or not a meeting between Trump and Rouhani occurs is uncertain currently.

Meanwhile, the U.S. economy continues to muddle through, with the consumer holding the economy on its path despite softness seen in manufacturing. Jobs growth and wages continue to exhibit strength, which is flowing through to strong personal consumption expenditures (PCE) (approximately 70% of U.S. GDP). PCE grew at a 4.6% annualized rate in the second quarter, its strongest pace since Q4 2017 (Atlanta Fed projection for Q3 is 2.7%). However, business investment is slowing, likely driven by trade uncertainty. Nonresidential fixed investment declined at a 1% annualized rate in Q2, the biggest drop since Q4 2015, and the expectation is for something similar in Q3. Globally, economies are seeing a similar divergence between manufacturing and consumption, with particular weakness seen in German manufacturing.

Monetary Developments - Global central banks are focused on easing policy and the key question facing investors is whether the easing is enough to offset the weakness seen in manufacturing. Few would make the argument that rates were too tight when the Federal Funds Rate was 2.25%-2.50%. Nonetheless, the market is bluntly telling the Fed its policy is too tight, and aggressive cutting is in order. As of today, Fed Fund futures place a 70% probability that there will be at least two more 25 basis point cuts by March. Global central banks are, for the most part, following the Fed's lead and shifting to more accommodative policies.

Valuation & Investor Sentiment - Investor sentiment appears to be cautious now, not surprising given the headlines in recent months. Looking at the American Association of Individual Investors sentiment survey, the percentage of respondents bullish on the market is below the long-term average, and below the levels seen earlier in the year. Another gauge of sentiment is sector performance. Consumer Staples, Utilities, and Real Estate are all outperforming this year, corroborating the pessimistic survey data. Contrary to the mood seen in surveys and sector activity, the stock market is not completely pricing in a gloomy viewpoint in our opinion.

The S&P 500 is trading in line with its historical multiple of earnings, but this is based on the expectation of 10.5% earnings growth next year. For reference, 2019 EPS will likely be up marginally (currently expected to be up 1%) which is well below the long run average of high single digits. Without the expectations of future rate cuts, equities would likely be lower than they are today. If rate cuts are delivered, economic growth stabilizes and earnings growth resumes, multiples might be able to expand some, though just marginally in our opinion.

Investment Outlook

Back to the Future - When assessing the investment outlook, a review of the past often provides useful context and perspective. In the 1970s-early 1980s, inflation and interest rates reached double digit levels. Primarily through the fortitude of then Fed Chairman Paul Volker, the Fed tightened monetary policy to cause a painful, though necessary recession in order to extinguish the inflation spiral. The recession caused bloated businesses to change to survive, or go bankrupt, setting the stage for bull markets in following years. In the four decades since that time, interest rates declined from double digits to near or below zero providing fuel for stocks rising to record high levels.

In the past 25 years, our Federal Reserve has grown in responsibilities and in economic impact around the globe. The Fed was complicit in the buildup of the tech bubble in the late 1990s and the real estate bubble in early 2000s through easy money policies. They were also instrumental in cleanup operations when each bubble evolved into a bust. Since the Great Recession of 2008-2009, the Fed and other central banks have put monetary policies and actions on steroids in their quest to stimulate economic activity, and to avoid deflation. Despite these efforts the scent of deflation is manifested in negative interest rates in Europe, Japan, and elsewhere. With interest rates near or below zero, investors continue to be pressured to seek some type of return by extending further out on risk curves.

Economics, Demographics, and Technology - Data points on the economy indicate that the industrial sector has been weakening and is in a virtual recession. At the same time the overall economy continues to meander along, fueled by strength in the consumption and service segments of the economy which, as a percent of GDP, are much larger than the industrial sector. Consumer confidence is high, retail sales have been good, household net worth is near record levels, and interest rates remain low. Putting it all together and noting the added stimulus being injected by central banks and deficit spending around the globe, the U.S. economy will likely grow at trend rate (2% to 3%) following this slowdown, and corporate profits will likely move in sync.

Investment Outlook and Strategy - While actions and repercussions from Brexit, China, and Iran are of importance, the primary headwind for economic activity is a shortage of qualified workers. Aging baby boomers are retiring and the generations that follow pale in numbers – simple demographics. Yet we continue to see the glass as half full due to the continuation and acceleration of technology in all aspects of life. While beyond the scope of this writing, artificial intelligence, the decoding of DNA, robotics and other technological developments will disrupt and force change in all sectors of the economy which, in aggregate, will hopefully lead to higher standards of living around the globe.

We share the view of The Bank Credit Analyst (BCA Research) that U.S. growth will soon rebound as money and credit trends strengthen. The U.S. Federal Reserve will maintain an easing bias and expand its balance sheet, actions that will catalyze an underlying improvement in global liquidity conditions and boost the global economy. While it is possible the U.S. experiences negative interest rates, we give a higher probability that U.S. interest rates eventually "normalize" with inflation rising commensurately. With this background, stocks may well rise as corporate profits increase with stock returns exceeding bond returns. We maintain a neutral investment strategy with a defensive bias, and we remind clients that it is normal for stocks to periodically decline. The key for investment success is to stay invested and avoid being forced to sell equities during a period of weakness.

The Basics of 529 Plans

Since their creation, 529 plans have become the "go-to" tool for saving money for a child or grandchild's college education. Named after Section 529 of the Internal Revenue Code, which was added in 1996 to authorize tax-free status for "qualified tuition programs," earnings in 529 plans accumulate on a tax-deferred basis and distributions are not federally taxed when used for qualifying higher education expenses. Starting in 2018, families can now use up to $10,000 tax-free per year to pay for tuition expenses for grades K-12. There is no age limit as to when one must open an account and use the funds, so adults who decide to attend school later in life can also take advantage of this tax saving vehicle. There are two types of 529 Plans - savings plans and prepaid tuition plans. While both offer tax-advantaged education savings, the operation of the two are very different.

529 Savings Plans are the more popular of the two and, much like a Roth IRA, after-tax funds are contributed into mutual funds or similar investments. States operate their own 529 plans; however, the basics of the plans are virtually the same, and investors are not required to use their own state's plan though certain states give additional tax benefits for in-state users. 529 Plans have high contribution limits (currently at $350,000+ depending on the state), and contributions qualify for the annual gift tax exclusion of $15,000 per year by an individual per beneficiary ($30,000 per couple). A lump sum of 5-years' worth of contributions, or $75,000 ($150,000 per married couple) can be made in a single year and is eligible for gift tax exclusion. The account owner, who may be anyone who is over age 18, maintains ownership until the money is withdrawn, and controls the account including investment decisions and distribution of assets. Though they are offered by states, plan assets are managed by designated financial companies who are responsible for the plan's underlying investment portfolios. Distributions can be used for tuition, fees, books, supplies, approved study-equipment, and room and board. If the money is not used for qualified education expenses, earnings can be subject to federal income taxes at the recipient's rate, and a 10% federal penalty tax and possibly additional state or local tax. These plans also allow the account owner to change the beneficiary to a qualified family member of the beneficiary up to twice a year.

A 529 Prepaid Tuition lets you prepay tuition at participating colleges (mainly in-state public colleges) at today's prices for use by the beneficiary in the future. Instead of an investment portfolio, you purchase an amount of tuition credits or units that are guaranteed to be worth a certain amount of tuition in the future regardless of how much costs have risen. If your child ends up attending a college that doesn't participate in the plan, prepaid plans may not pay for the full price of tuition.

With tuition rates rising twice as fast as inflation, it's important for parents who plan to contribute to their children's education costs to save early. As part of our services, Lincoln Capital provides clients with educational planning, as well as assistance with account opening, management, administration, and distribution of 529 plans or other education savings vehicles. Please view us and our planning tools as a resource and, as always, please contact us if we may be of assistance.
