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Midland Wealth Management

Market Outlook

Contents:

Turmoil, Uncertainty, and Volatility Reign the Day!

It has certainly been an interesting year in many ways. The headlines have been covered with talks of trade wars, tariffs, Fed tightening, global slowing, bear markets and on and on. This year there were very few places to make money in the markets. Both bonds and stocks were flat to negative while money market rates finally provided an incremental return to investors.

The U.S. economy continues to show strength heading into 2019, despite fears of an impending recession. While we expect growth to be slower next year, we do not see a recession in the next 12 months. We believe the expansionary cycle that began in 2009 will become the longest in history in June 2019, exceeding the 120 month cycle in the 1990's. The consumer continues to be resilient with improving retail spending. The labor market continues to be strong with more jobs than people to fill them, and inflation is under control. U.S. households are in good financial shape with rising real incomes, lower debt burdens and a 6.5% savings rate.

While the market is worried about the debt balances and leverage on corporate balance sheets, the average S&P 500 company has lower net debt to market cap than the historical average, and long-term debt is 85% of the total debt. Much of this debt was issued at extremely low interest rates during the last 10 years. The Federal Reserve of St. Louis tracks the level of growth in commercial and industrial loans at all commercial banks, and both continue to demonstrate growth year over year. The most recent survey by corporate CEOs showed more concern about the economic environment due to trade uncertainty and global slowing. The overall outlook for continued strength in individual businesses and earnings growth, albeit at a slower pace than 2018, remains a positive. However, the looming challenges of tariffs and a slowing global economy may limit capital investment in the next 12 months, leading to slower growth domestically. Overall, corporate balance sheets and outlooks continue to be positive.

Globally, there are signs of a crack in the growth armor. European economies have experienced decelerating growth as shown by the decline in the purchasing managers' indices. The majority of European nations have seen declines from expansionary levels to levels closer to neutral. Germany's third quarter GDP contracted 0.2%, primarily due to a decline in auto exports, while the overall European economy expanded 0.2%. This was the slowest rate of economic growth since the second quarter of 2014. The Chinese economy has also shown signs of declining growth that have impacted Germany and many other European countries that depend on exports to China. The U.K. also faces economic pressures as the country attempts to move forward with Brexit. The overall impact on Britain's economic growth is hard to measure, but a lack of an agreement with the European Union could negatively impact growth.

There is little doubt trade negotiations and tariffs have caused turmoil in the market. While we agree that a more fair trade deal is needed with China, the current approach has caused chaos and disruption in the markets. The duration of this turmoil is hard to predict. Since China is a communist country, it is able to hold out on negotiating with the United States and can control the flow of information to its advantage. It could be a long, drawn out affair, or there could be a resolution by March. In any event, trade does add turmoil, angst and uncertainty to the U.S. economy due to tariffs and profitability.

The Federal Reserve (Fed) recently increased short-term rates by 25 bps but did state it is closer to a neutral position. The economic outlook is for slower growth in 2019, inflation near 1.9% and a labor market that will continue to be strong. Since the Fed realizes market volatility and global slowing may impact future economic activity, it has indicated a willingness to consider two rate hikes in 2019 but will dial back its plans if data supports an adjustment is necessary. This action leads us to be slightly underweight in fixed income but neutral in duration and maturity relative to the designated benchmark.

Looking at global equity markets, the most recent report has shown that approximately 30% of worldwide stock indices are in a bear market. Within the S&P 500 economic sectors, industrials, materials, financials, and energy are in a bear market. Is this oversold? Is the worst built in? The international and emerging markets have been in a downtrend since May when the dollar began to strengthen. Domestic large cap indices hit the most recent high in October and have declined approximately 17% since that time, while small and mid-cap indices have seen even larger declines. While we do see value in the market at these levels considering the forward Price/Earnings ratio on the S&P 500 is lower than 15x based on a 5% earnings growth rate, we do not know when the sentiment will change.

As was stated earlier, we do not believe a recession is on the horizon for 2019, and markets may be overreacting. In light of the current sentiment and global economic slowdown, we do believe it is prudent to remain neutral to our target asset allocations. We will continue to monitor the market and economic environment, making adjustments as needed.

The Yield Curve: What Is It Telling Us?

During the first nine months of the year, our forecast for higher interest rates and Fed rate hikes were on track. However, comments by Fed Chairman Powell in early October regarding the path of rate hikes and the expectation of further gradual increases substantially absent of economic data shocked the equity markets and drove prices lower. The fear of the Fed overextending its monetary tightening policy, which in previous cycles has led to economic downturns, increased. A flight-to-quality ensued as sellers bought safe haven Treasuries, mainly intermediate and longer-term maturities, resulting in lower yields in the longer end of the curve. While this was occurring, yields on the short end of the curve increased with every Fed rate increase. In addition, new issuance of U.S. Treasury short-term T-Bills increased yields on these and similar maturity securities.

These market actions led to a flatter yield curve and even a slight inversion between two and five year maturities. As we have discussed in prior newsletters, this particular inversion is not serious. However, if the inversion was to expand to the ten-year portion of the curve, where ten-year rates fall below two-year levels, we would become more concerned. This typically leads to more restrictive bank lending and slower corporate spending. Historically, this type of inversion has signaled a recession within 18 to 24 months. The media is well aware of this recessionary precursor predictor, and the risk that it becomes a self-fulfilling prophecy has certainly increased. As a reminder, monetary policy is a significant determinant of the length and strength of economic expansions. The length of the current business cycle is now the second longest in U.S. history. While the Fed may not like to admit it, well-intentioned monetary policies to slow economic expansion and inflation are usually responsible for ending U.S. business cycles. U.S. economic recessions usually begin when money/liquidity gets tight.

At the most recent Fed meeting in December, the Committee decided to raise the short-term rate by 25 basis points, reiterating its view of a strong economy. However, the Fed did water down its forecast for additional rate hikes by stating there may be some further gradual increases in the short-term rate. This was slightly more dovish than previous comments by Chairman Powell. He also stated that they would "continue to monitor the global economic and financial developments and assess their implications for the economic outlook." The Fed lowered its forecast of three additional increases in 2019 to two. Its decision creates a more moderate rate hike environment. While the market is concerned the Fed may be too aggressive in its actions, we do not believe the impact of the most recent rate hike will put the U.S. economy into a recession. We are well aware of the potential concerns of investors regarding the Fed.

One of the issues we are closely monitoring is the reduction in the size of the Fed's balance sheet. Under its post-recession policy of quantitative easing, the Fed increased market liquidity by purchasing bonds and expanding its balance sheet, which tends to inflate asset prices. While the amount of reduction on a monthly basis is relatively minimal, it is another form of quantitative tightening. During the press conference following the most recent Fed meeting, there seemed to be no intention of changing this reduction in liquidity if the economic or global situation deteriorates. The Fed believes the reduction in market liquidity from winding down or decreasing the size of its balance sheet has little impact on the markets. On the contrary, this reduction in total market liquidity is essential, especially at a time when the increasing U.S. budget deficit is also reducing market liquidity. Decreased liquidity leads to less risk-taking. There are signs that strains in market liquidity have already affected commodity prices and the weakest links of the global financial system. While there have been no signs of significant economic slowdown in the U.S., a change in the outlook would make it appropriate for the Fed to review this action and make adjustments as needed.

What do we do with the fixed income part of client portfolios today? 2019 is setting up to be interesting as the markets suggest the Fed has done enough, even though it is leaning toward two more rate hikes. The flat to nearly inverted yield curve indicates the Fed Funds rate is near the Fed's coveted target neutral rate, the rate that is neither accommodative nor restrictive to economic growth. Many global central banks have also begun to wind down their accommodative policies. If the Fed were to slow or pause its rate policy because of widening global market tensions or lower inflation expectations, it would be during 2019. Credit spreads across various fixed income securities have increased from extremely tight levels with the weakness in the stock market and concerns about the sustainability of global growth. This movement is mainly seen in the high yield market where concerns about falling energy prices will have an adverse effect on oil company credit. Considering the current market environment, we have positioned our fixed income portfolios at a neutral duration relative to the benchmark and have increased our credit quality by lowering our exposure to high yield securities.

Cautious, but Optimistic

As we enter the tenth year of expansion following the global financial crisis, market volatility is expected as we approach the end of this business cycle. This year has been particularly stressful for investors who have faced two stock market corrections (10% declines) and seen the growing fears of a bear market (20% declines) become a reality. In December alone, the S&P 500 is down ~10% as of this writing.

Stock market corrections and bear markets are normal and actually happen more frequently than realized. Historically, a stock market correction happens every 12 months, and a bear market correction happens once every three and a half years. It remains vitally important that investors are allocated in the appropriate stock allocation given long-term goals and risk tolerance and also that they avoid investing with emotion. Even if the bull market does end in the next few years, it is important to consider that late-cycle returns have typically been quite strong.

The stock market hates uncertainty, and there seems to be plenty of unknowns ahead in 2019. In fact, the stock market in general looks forward 6 - 12 months. So what has been driving all of this volatility? Investors are pricing in a slower global growth environment along with concerns over the Fed raising rates too quickly, which could slow down the economy. Let's also not forget China trade tariff talks and Brexit uncertainties.

Higher interest rates will likely limit a multiple expansion, leaving corporate earnings as the main driver of U.S. Equity returns. After remarkable earnings growth in 2018 (~24% year-over-year) and record stock buybacks of $1.1 trillion and counting, investors are gearing up for a much slower earnings season in 2019 as companies lose the boost from this year's reduction in federal taxes. However, S&P 500 earnings growth is still expected to be 5-7%, which is still positive. Continued stock buybacks, which are a sign CFOs believe their stock is undervalued, should help boost earnings growth in the long run. In fact, numerous companies have increased their buybacks despite the significant volatility. The S&P 500 price to earnings multiple is currently trading at about 15 times next year's expected earnings, in line with the long-term average and a far cry from the price/earnings ratio of 18x in January.

As stocks continue to slide to their lows of the year, the negative S&P 500 return will be its first yearly loss since the great recession in 2008. After leading the way last year, International developed and emerging market stocks have led the decline lower this year. Slower European and China economies, along with a stronger U.S. dollar have all contributed to underperformance this year. As of this writing, the MSCI All Country World ex USA Index is down ~18% year-to-date versus the Russell 3000 Index (U.S. stocks) down greater than 7%.

Given many of the uncertainties in today's global economy, our portfolios have been slightly overweight to equity targets. Going into 2019, we remain cautious and have allowed the portfolios to drift to a neutral allocation to equities. We continue to have an overweight to large-cap growth stocks, which typically outperform other sectors of the market since they are growing both their revenues and profits more quickly than the overall economy. Given valuations and potential for higher returns versus the U.S., we remain neutral on international stocks with a slight overweight to emerging market stocks. The investment team will be closely monitoring the Fed, China trade war discussions, the U.S. dollar, corporate earnings and growth outlooks as we continue to navigate another expected year of volatility, with anticipated opportunities along the way.

Tax Cuts & Jobs Act:
Changes In Itemized Deductions

Changes in itemized deductions for 2018 taxes

In January and February, as most Americans sit down to prepare their taxes for 2018, many of the changes resulting from the Tax Cuts and Jobs Act (TCJA) that was signed into law in December of 2017 will come into sharp focus. Included in the TCJA are several changes to deductions that affect whether a taxpayer can itemize and even what deductions are allowed. Unless Congress acts, these changes are subject to end after 2025 and revert back to their 2017 amounts beginning in 2026.

Increase in Standard Deduction
The TCJA eliminated personal exemptions and increased the standard deduction to $12,000 for individuals and $24,000 for married couples filing jointly. This means less people will itemize deductions on Schedule A. Because less people will be itemizing, there will be less tax incentive to make charitable donations. This might create planning opportunities to aggregate your donations in a single year or to add charitable giving to your IRA distributions.

$10,000 Limit on State and Local Taxes
Not only has the threshold for itemization increased for 2018 taxes, but one of the largest deductions used to reach that threshold has been reduced. There is now a $10,000 limitation on state and local taxes. For a taxpayer living in a high tax state, this could leave excess tax amounts that cannot be deducted. However, state and local taxes are still deductible on Schedules C, E and F for rental properties and sole proprietorships and are not subject to the limitations.

Miscellaneous Itemized Deductions
Previously, taxpayers were able to deduct miscellaneous itemized deduction items subject to the 2% floor. The TCJA eliminated the miscellaneous itemized deduction entirely. These include the following deductions:

- *Unreimbursed job expenses* including work-related travel, union dues, dues to professional societies, home office expenses and education expenses for maintaining or improving skills in your current job or profession.
- *Investment Expenses* including investment advisory and management fees and fees for legal and tax advice related to your investments.
- *Tax preparation fees.*
- *Hobby expenses.* A hobby is an activity in which you engage primarily for reasons other than to earn a profit. You could previously deduct your hobby expenses over 2% of adjusted gross income (AGI) against any hobby income that was earned each year. The TCJA eliminates the itemized deduction for hobby expenses for 2018 through 2025, but you still have to report and pay tax on any income you earn from this kind of activity.

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Home Mortgage Interest

Despite discussions during passage of the Act, the mortgage interest deduction remains. However, it was not untouched by the TCJA. As of December 15, 2017, there is a limit on acquisition indebtedness of $750,000. (Loans taken out prior to December 15, 2017 are subject to the old amount of $1,000,000.) This limit applies to all debt on all properties owned (e.g. vacation home).

Acquisition indebtedness is debt that was incurred in acquiring, constructing or substantially improving a qualified residence. Previously, home equity debt up to $100,000 secured by the mortgage was deductible. Under the TCJA, home equity debt is not deductible (except on Schedules C, E and F). Therefore, interest on a home equity line of credit (HELOC) used to pay off debt or other personal living expenses is not deductible. However, if a portion of the HELOC was used as acquisition indebtedness, that portion may continue to be deductible if it falls within the $750,000 limit. If you used your HELOC to go on vacation or payoff credit cards, interest will not be deductible in 2018.

Casualty and Theft Losses

You can no longer deduct personal casualty and theft losses unless those losses are attributable to a federal disaster as declared by the President.

Medical and Dental Expenses

The TCJA did make favorable changes to medical and dental expenses (at least temporarily). Prior to the TCJA, the floor for deducting medical and dental expenses was 10% of your AGI for taxpayers under the age of 65. The TCJA lowered that floor to 7.5% for the years 2017 and 2018. This gives the taxpayer a lower threshold to reach before expenses are deductible. However, in 2019, the AGI floor will return to 10%.

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Trust Officer

We believe a disciplined approach through prudent investing and diversification minimizes risk and enhances return to achieve clients' goals both financial and aspirational.

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