NEWSLETTER
FEBRUARY 2018

THE SUMMIT
Financial Strategies, Inc.

In this issue...

DISCONNECT BETWEEN BOND VALUES AND THE PACE OF OUR ECONOMY

by Brett Langer

For over 30 years now, bond yields have done nothing but go lower. The peak in bond values came in October 1981 when the 10 year Treasury was trading at 14.73%. Speed up to October of 2001 and that same ten year Treasury dropped down to 5.72%. Where things get kind of strange is comparing the 10 year yield from the start of 2010 to the end of 2017. January of 2010 the 10 year was at 3.83% while at the end of 2017 the 10 year Treasury finished at 2.42%. Why is this strange? Because bond yields in general will trend higher when the economy is growing or accelerating. In 2017, we finally saw a normalization within the economy that we haven't seen in over a decade, yet interest rates haven't risen.

Let's review the economic fundamentals of 2017. First, workers are finally getting paid more. Over the past year, incomes have risen by almost 4% and consumer consumption has risen by 4.6%. One area that's been missing for over a decade now is business investments. Since the down turn in 2008, businesses haven't had the confidence to invest in themselves or employees. In 2017, this has taken a dramatic change for the good. Business confidence levels are at a 15 year high. Small business confidence has broken the record with the highest reading ever recorded. In light of this, employees are finally getting raises and the tools to be more productive. Business investment for 2017 was up 6.3% from the previous year. The last point to be made for 2017 is in regards to the overall evaluation of the stock market. If we take the average price of stocks this time last year from the S&P 500 and divide it by companies earnings, we come up with a ratio. The ratio this time last year was close to 18. If that same calculation is made now, the calculation is still 18. This tells us that stock investors got the growth correct for last year. If stock prices went up and earnings didn't, we would've seen a much higher ratio. So we would argue that stock investors got it right and bond investors got it wrong last year.

Going back to bond yields, we should have seen the 10 year yield move higher because higher economic growth commanded higher interest rates. However, this wasn't the case. Investors and pension funds continued to purchase bonds which created enough demand to keep the rates flat. We can only speculate why the individual investor along with pension funds did this. The problem is that interest rates didn't adjust higher like they should have. Since we feel the economic fundamentals are so strong for a growing economy, we think interest rates will have to make this adjustment in three different installments - possibly during 2018.

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MAIL DATES FOR YOUR 2017 1099 TAX STATEMENTS

By January 31, 2018, BNY Mellon's Pershing will begin mailing Form 1099 tax statements. When you receive your Form 1099 depends on the holdings in your account.

Mailing Schedule for 2017 1099 Tax Statement

<u>Phase One: January 31, 2018</u>
Form 1099 will be mailed for accounts with holdings and income that typically do not require reclassification or additional information from issuers. Generally, this includes accounts holding stocks, bonds and options.

<u>Phase Two: February 15, 2018</u>
Generally, this mailing includes mutual funds, certain unit investment trusts (UITs), real estate investment trusts (REITs) and certain equities that were not included in the phase one mailing. If you hold positions for which issuers have not provided final 2017 tax information, you will receive a Pending 1099 Notice. This will identify the holdings impacting the mailing date of your Form 1099 and provide the anticipated mail date. If you received your Form 1099, you will not be sent this notice.

<u>Phase Three: February 28, 2018</u>
Form 1099 will be mailed for accounts for which income reclassifications were received after the February 15 mailing was prepared. Generally, this includes remaining mutual funds, REITs and certain equities.

<u>Phase Four: March 15, 2018</u>
Form 1099 will be mailed for all remaining accounts regardless of whether pending income reclassifications have been received from issuers. Generally, this includes certain complex securities, such as real estate mortgage investment conduits (REMICs), widely held fixed investment trusts (WHFITs) and some UITs.

Corrected Form 1099 Will Be Mailed as Needed

You may receive a corrected Form 1099. There are several reasons for this—for example, issuers of securities held in your account may provide updated or additional information after your Form 1099 is mailed to you. The IRS requires financial organizations to send corrected forms with revised information as it becomes available.

This information is subject to change without prior notice, and is not intended or written to be used as a substitute for specific tax, accounting or legal advice. Pershing does not provide tax, accounting or legal advice. Please consult your own tax professional.

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We are witnessing the first installment of higher interest rates today. An adjustment needs to be made now for what didn't happen last year. Eventually, investors will have to trust and see that this economic growth is real and then start selling bonds and buying stocks to help protect them against higher inflation and higher interest rates. We will see this pressure in the first quarter of this year. The second installment of higher interest rates will have to price in the higher economic growth for 2018. If 2018 grows as much or more than 2017, then the Federal Reserve will need to raise rates probably three to four more times. We will see this installment of higher rates occur as the year progresses. In our mind, there could be a third installment, which could potentially cause some issues.

What if the economy grows faster than we all think? The Atlanta Federal Reserve Chairman came out last week predicting we could have a first quarter pace of 5.4% growth in GDP for 2018. We think it may be overly optimistic to see our growth at 4% or higher for 2018, but if it is, expect a lot of pressure for higher interest rates. If we do head down this path, our other issue will be the large inventory of bonds that the Federal Reserve has acquired over the past eight years. This inventory will have to be sold off and possibly at a quicker pace than they would like. Our concern is that the Federal Reserve has never held trillions of assets on their balance sheet like they do today. We are hoping that they will be able to slowly sell these positions over time so that interest rates don't spike or credit tighten up too much with banks.

We believe 2018 will yet again, most likely end up with a growing stock market. However, we also believe we are going to see a lot more volatility in the stock market because of the adjustments in interest rates that are likely to occur.

Investors will become spooked from time to time fearing interest rates will go too high and therefore, slow our economy down. While this is possible, we don't think it's likely. Interest rates, as I showed earlier in this article, are still very low. While I don't think interest rates are normal today, over the coming 20 years we will see them normalize higher where they historically should be. I bring up 20 years because it took over 30 years for rates to get as low as they are today.

Since we haven't seen much volatility in the past two years, I think it's a good time to review what normal stock market activity looks like. On my desk I have a chart of stock market returns every year going back to 1980, or 37 years. In those 37 years, we had eight years where the market finished lower on the year. Two out of those eight years the market was lower by only 2% and 1% respectively. This chart also shows stock market sell offs each year. Out of the last 37 years, 32 of those years saw market declines of 7% or greater with the average decline of 15%. We also saw multiple years where the market had declines a couple of times within the same year. To phrase it another way, on average the stock market has averaged 10.29% each year from 1980 until 2017 with an average sell off of 15% in 32 of those 37 years.

Yes, more than likely, we will see volatility return this year. We have a lot of adjustments to make with interest rates that investors will need to get comfortable with. The economy also has strong fundamentals that we haven't seen in almost two decades. We will see a struggle between fear and greed as investors try to price in what's going to happen. It is our feeling that by the time we get to 2019, the economy will be growing at least as fast as it is now with higher interest rates to boot. Our job is to continue to look at trends and to make any adjustments needed in portfolios as the year goes on.

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FAVORITE RECIPES

Avocado Quinoa Salad
by Kim Langer

Ingredients

- 1 cup uncooked quinoa
- 8 oz. fresh cherry tomatoes (halved)
- 1 large cucumber
- 1/4 cup red onions, finely chopped
- 5 oz. fresh spinach, roughly chopped
- 2 large ripe avocados, chopped
- 1/4 of 1 bunch fresh cilantro
- 1/3 cup feta cheese

Dressing: 4 Tbls red wine vinegar, 2 Tbls Dijon mustard, 1 tsp dried oregano, 1 clonve minced garlic, 1/2 cup olive oil, 2 Tbls fresh lemon juice, salt, and pepper.

Instructions

- Cook quinoa according to package directions; fluff and set aside to cool
- Prep the dressing by whisking all contents together, then store in fridge.
- In a large bowl, add in all the prepped vegetables and quinoa
- Shake and pour dressing over salad and toss
- Top with feta cheese and serve immediately

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