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# THE ADVISOR

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## Could the Fed Shake Up Wall Street Even More Than Congress This Fall?

Say farewell to the lazy days of summer and hello to more serious, back-to-business days of fall and winter. The federal government certainly has plenty of business to attend to this fall, which could have major repercussions for the financial markets. This is especially true of the Federal Reserve's little-publicized plan to start unwinding quantitative easing by selling back the surplus of U.S. bonds it purchased as part of the experimental stimulus strategy. We see this as a last-ditch effort by the Fed to try to drive up long-term interest rates to ensure it has some "ammunition" left in case of another recession. The trouble is this "unwinding" process is just as experimental as every other aspect of quantitative easing. It has the potential to create a stock market tipping point whether it succeeds or fails.

You better believe Wall Street will have a close eye on the sell-back when it starts, given the stock market has been more dependent on the Fed's words and actions than on the economy these past eight years. Fed Chairman Janet Yellen has probably been the main force behind keeping the market artificially inflated since 2014 when she replaced Ben Bernanke.

Yellen inherited the job of trying to wean the markets off six years of addictive artificial stimulus — a.k.a. quantitative easing — which involved lowering short-term interest rates to nearly zero and trying to force down long-term rates by purchasing $4.5 trillion in U.S. Treasuries. Wall Street loved quantitative easing, because it created cheap money and forced everyday investors up the risk curve by making non-stock, interest-bearing options look less attractive.

Unfortunately, the strategy never worked as well with consumers as it did with investors, creating a wide division between market performance and economic realities — a division that continues to this day. Even though the Fed officially ended quantitative easing in late 2014, its influence on the stock market continues. Why? Because the entire undertaking was experimental. Even though many analysts warned that the

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## Ways to Save for Retirement

We all know we're supposed to save for retirement. But that's often easier said than done. There are many reasons for Americans' pitiful savings rates, including stagnant wages and an increasing cost of living. But our own behavior plays a role as well. How can you save more in a time when every dollar seems to buy a little less? Consider these suggestions:

**Get a budget and reduce spending:** If you're looking to save more, the first place to look is your current budget. Cutting spending where possible will free up more money to set aside for the future. While some of your expenses are fixed — most of us need to spend money on housing, food, and transportation — others are flexible. Spending a little less on dining out, canceling subscription services, or

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## Fed Shakes up Wall Street

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markets could become dangerously addicted to prolonged artificial stimulus, those warnings were ignored.

### A Tough Spot

So for the last two years, Yellen and the Fed have been desperately trying to "normalize" monetary policy again without sending the addicted markets into a panic. The Fed is especially eager to get short-term interest rates back up to normal levels. This would signal to Wall Street that the economy is really strong enough to justify all the irrational investor confidence, and it would give them ammunition to lower rates again if the economy stalls. But the four rate hikes that have happened since quantitative easing ended have been marginal, and the markets have remained more focused on the Fed's moves than on the economy.

Now Janet Yellen finds herself in a tough spot where a fifth short-term rate hike — even a marginal one — is nearly impossible for two reasons: 1) inflation is still below her stated goal of two percent, and 2) long-term interest rates still haven't returned to an upward trajectory like the Fed had hoped they would after quantitative easing ended. The latter is especially significant because the Fed needs long-term rates to rise ahead of short-term rates. Otherwise they risk flattening the yield curve, which creates a disincentive for banks to lend and can hinder economic growth. In fact, the Fed's yield-curve dilemma is even worse now than it was in December of 2015. Why? Because long-term rates have actually decreased from where they were two years ago. The 10-Year Treasury rate was at 2.31% in late December of 2015, and it's currently at 2.14%.[1]

This brings us to the quantitative easing "unwinding," in which Chairman Yellen is expected to announce a sell-off of those $4.5 trillion of bonds.[2] Although the move is being cast as an effort to normalize the Fed's balance sheet, we suggest it's a desperate attempt to try to get long-term rates to cooperate with its flawed experimental strategy. When the bonds are sold, flooding the market with supply, that should, theoretically, push bond prices down and long-term rates up. If that doesn't happen, the Fed's yield-curve dilemma will continue.

But if it does happen, it could still create problems, because companies and individuals would then have a disincentive to borrow money, which runs counter to economic growth. Plus, as was mentioned, low interest rates have been partly responsible for inflating the stock market by pushing investors up the risk curve. If the bond sale works and long-term rates rise, that could provide just the incentive nervous investors need to lower their risk, and a sell-off could ensue.

### The Trump Factor

And let's not forget the Trump factor and its potential to create a tipping point this fall. As discussed several times in this space, much of the market's post-election rally has been based on Trump's economic campaign promises. Yes, we've seen some positive economic news, but certainly not the kind of consistent bottom-line corporate growth Trump vowed to achieve. For that, he likely needs approval of his tax plan and that's hardly a "slam-dunk," given the chaos and controversy plaguing the Trump administration and widening partisan divisions on Capitol Hill.

Why is the tax plan so crucial? Think of it this way: If a company has $1M in profit and pays 35% in taxes currently, its net profit shrinks to $650K. If Trump can get the tax rate down to 20%, that same company will instantly see its net profit increase to $800K, a jump of about 22%. That would almost instantly align corporate earnings with overinflated stock prices and justify current price/earnings ratios. In other words, we believe the reason the markets soared with Trump's election is that institutional traders are thinking that if his tax reform can increase corporate earnings with the snap of a finger, stock prices can go up accordingly. The trouble is, they've put the cart before the horse, which means if Trump's tax plan fails or even stalls, the market could just as quickly fall by 22% — or much more.

Any way you look at it, the current overvalued stock market is like an artificially inflated balloon with the potential to burst. There are already plenty of pins in the geopolitical realm that could pop it — and when Washington gets back to business this fall, there are going to be plenty more.

1 *ycharts.com*

2 Crutsinger, M. "Fed Leaves Rates Alone but Moves Closer to Selling off Bonds." *U.S. News & World Report*. July 26, 2017. *https://www.usnews.com/news/business/articles/2017-07-26/fed-keeps-key-interest-rates-unchanged-amid-low-inflation.*

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## Ways to Save

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choosing a cheaper cell phone plan could free up $50 or $100 in your monthly budget to dedicate to retirement. That may not sound like a lot, but it's a good place to start.

**Get your match:** If you're lucky enough to work for a company that offers a 401(k) plan and matches employee contributions, make sure you take advantage of it. Not contributing enough to get your match is essentially turning down free money.

**Max out your 401(k) plans:** In 2017, most people can contribute up to $18,000 a year to their 401(k) plan. Not everyone can afford to save up to the max; but whatever your income, you should contribute as much to tax-advantaged retirement accounts as you're able.

**Contribute to an IRA:** If you can't contribute to a retirement plan at work or want to save even more for retirement, consider setting up an IRA. Assuming you meet certain requirements, you can save up to $5,500 a year in these accounts.

**Contribute to a health savings account (HSA):** For people who are really intent on maximizing their retirement savings, consider HSAs. HSAs are primarily intended as a way for people who have high-deductible health plans to save for medical expenses. But any money you don't use for healthcare costs now can be used to pay for healthcare in retirement.

**Make catch-up contributions:** Once you reach age 50, you're eligible to make catch-up contributions to 401(k) plans and IRAs. You can contribute an additional $6,000 a year to your 401(k) plan and an extra $1,000 a year to your IRA. If you consistently make those contributions over the next 15 years (assuming you retire at 65), you will have an additional $105,000 for retirement — and that's without taking into account any growth in your investments.

**Save in taxable accounts:** Most people focus on saving for retirement in various tax-advantaged accounts like a 401(k) plan. But if you can't save for retirement that way or want to save even more, consider saving in more traditional ways. You can invest in a well-diversified investment account, bonds, or other savings vehicles. One advantage of putting some money in nonretirement accounts is you won't have to worry about things like mandatory withdrawals when you reach age 70½.

**Take enough risk:** Saving as much as possible is key to having a healthy retirement portfolio. But squirreling away dollars alone isn't enough. To really make the most of your money, you need to invest it. That means investing more in stocks when you're younger and gradually dialing down risk as you get closer to retirement. Being smart about risk is essential to meeting your retirement savings goals.

**Don't take early withdrawals:** When times get tough, people often turn to the money they've set aside for retirement to close the gap. But if it's at all possible, avoid touching that cash. Not only would you fall behind on your savings — creating a gap that is nearly impossible to make up — you would also get hit with penalties. Unless you need that money for a true emergency, like the prospect of losing your home or a major health crisis, leave it alone. You'll be glad you did so when the time comes to stop working.

Please call if you'd like to discuss ways to save for your retirement.

## How to Make Saving a Part of Your Budget

If you want to make headway with your savings, you need to do a number on your budget. Many financial experts agree that you should focus on the 50/20/30 rule of budgeting.

**The 50/20/30 Rule**

The basics of this budget rule is that you divide your take-home pay into three categories:

- **Necessities** — 50% of your budget should go toward the things that you need to live day-to-day, such as housing, food, utilities, transportation, etc.
- **Savings** — 20% of your budget should go toward contributions to your 401(k) plan or IRA, cash savings, and also to pay down debt. While something like a car payment is part of your necessities budget, extra payments to reduce your debt faster should come out of this portion of your budget.
- **Lifestyle** — 30% of your budget should go to things you like to do, such as dining out, going to the movies, hobbies, as well as short-term savings for things like vacations.

**Priorities and Choices**

A 20% savings rate will help ensure that you will have a comfortable retirement. However, this is not an easy thing for most Americans to do, especially when you consider the personal savings rate was only 5.5% in January 2017 (Source: *Tradingeconomics.com*, January 2017).

The major issue is many can't distinguish between necessities and lifestyle choices. For example, a car is a necessity for most people, but the type of car you purchase is often a lifestyle choice. This is also true for the type of housing we choose and the type of clothes we wear.

As with most things, it all comes down to priorities. You need to look at where you are spending your money to make conscious decisions about what is a necessity versus a lifestyle choice.

The main point here is that for many, choices are made without thinking of the impact they may have on long-term savings. Please call if you'd like to discuss this topic in more detail.

## Business Data

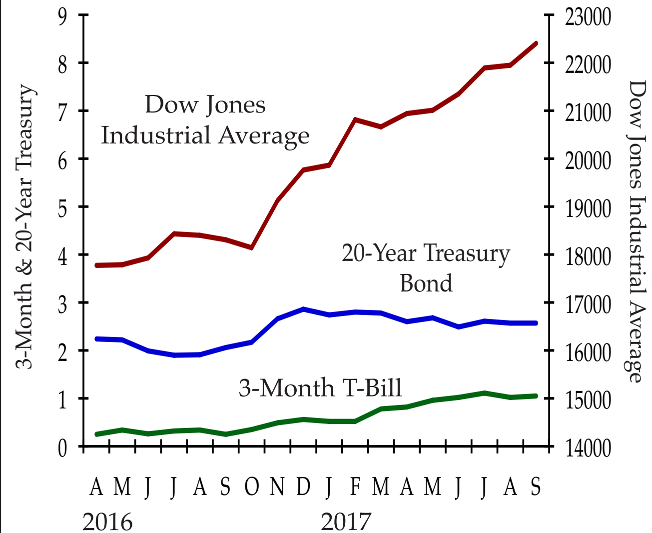
| Indicator | Jul-17 | Aug-17 | Sep-17 | Dec-16 | Sep-16 |
|---|---|---|---|---|---|
| | Month-end | | | | |
| Prime rate | 4.25 | 4.25 | 4.25 | 3.75 | 3.50 |
| 3-month T-bill yield | 1.11 | 1.02 | 1.05 | 0.56 | 0.25 |
| 10-year T-note yield | 2.27 | 2.22 | 2.26 | 2.55 | 1.66 |
| 20-year T-bond yield | 2.61 | 2.57 | 2.57 | 2.86 | 2.06 |
| Dow Jones Corp. | 2.96 | 2.95 | 2.97 | 3.17 | 2.57 |
| GDP (adj. annual rate)# | +2.10 | +1.20 | +3.10 | +2.10 | +1.40 |

| Indicator | Month-end | | | % Change | |
|---|---|---|---|---|---|
| | Jul-17 | Aug-17 | Sep-17 | YTD | 12-Mon. |
| Dow Jones Industrials | 21891.12 | 21948.10 | 22405.09 | 13.4% | 22.4% |
| Standard & Poor's 500 | 2470.30 | 2471.65 | 2519.36 | 12.5% | 16.2% |
| Nasdaq Composite | 6348.12 | 6428.66 | 6495.96 | 20.7% | 22.3% |
| Gold | 1267.55 | 1311.75 | 1283.10 | 10.7% | -3.0% |
| Unemployment rate@ | 4.40 | 4.30 | 4.40 | -4.3% | -10.2% |
| Consumer price index@ | 245.00 | 244.80 | 245.50 | 1.7% | 2.0% |
| Index of leading ind.@ | 127.90 | 128.30 | 128.80 | 3.9% | 3.8% |

# — 4th, 1st, 2nd quarter @ — Jun, Jul, Aug Sources: *Barron's, Wall Street Journal*
Past performance is not a guarantee of future results.

### 18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield

April 2016 to September 2017




# Pay Yourself First

The advice sounds simple enough — to force yourself to save regularly, treat those savings as a bill to yourself and pay that bill first every month. But when you're faced with a stack of bills, you're likely to skip paying yourself for at least another month. Unfortunately, those months can add up with little in the way of savings. If you're looking for ways to start paying yourself first, consider the following:

- **Reduce spending, diverting those reductions to savings.** One way to accomplish this is to cut back on your spending, perhaps reducing your expenditures for dining out, traveling, clothing, or entertainment. But for many people, this feels too much like sacrifice, making it difficult to stick with this strategy. Another alternative is to find ways to spend less for the same items. For instance, get quotes for your car and home insurance from several companies, placing any premium reductions in savings. Or find ways to reduce your borrowing costs. Just make sure any reductions in your costs go directly to your savings.
- **Save all unexpected income.** Immediately save any money from tax refunds, bonuses, cash gifts, and inheritances. Before you get used to any salary increases, put that raise into savings.
- **Make saving automatic.** Resolve to immediately set up an investment account that automatically deducts money from your bank account every month. Start out with small amounts. As you get used to saving on a regular basis, increase the amount periodically. Another good alternative is to sign up for your company's 401(k) plan. *(Keep in mind that any automatic investing plan does not assure a profit or protect against loss in declining markets. Because such a strategy involves periodic investment, consider your financial ability and willingness to continue purchases through periods of low price levels.)*

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