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THE ADVISOR

MAY 2019

Flat Yield Curve May Help Boost Stock Market Until Reality Hits

In last month's newsletter, we discussed how the recent flattening of the yield curve might actually help the stock market in the short-term. So far, that's proving to be true. The S&P 500 hit a new record high in April, and for the first time this year the Dow Jones Industrial Average spent an entire month over 26,000.[1] Naturally, some of this growth can be attributed to more good economic news coming out last month, including strong earnings reports for many companies and an early first-quarter GDP figure of 3.2%. However, in actuality, the yield curve issue is another driver, and it may continue fueling this latest short-term bull rally for many months until reality hits in the form of another recession and major market drop.

As we discussed last month, the yield curve flattened in March after a misguided move by the Federal Reserve. On the same day the Fed announced it will not approve any more short-term interest rate hikes this year, it also announced plans to discontinue the unwinding of quantitative easing by September. The second announcement almost immediately caused long-term bond yields to drop — and we believe the Fed's actions will continue to put downward pressure on long-term interest rates. That means even with short-term rates only at 2.5%, a flat or nearly flat yield curve will remain

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Making Sense of the Federal Deficit

The federal deficit is often confused with federal debt, though the two are closely intertwined and impact the U.S. economy in several ways. A federal deficit is simply defined as the shortfall that remains when the government's expenditures exceed its revenue.

Imagine if, at the end of this month, your bills exceed your deposits. You might dip into your savings, apply the deficit to a credit card, or borrow money from a friend, family member, or lender. Essentially, this is no different than how Congress manages the federal deficit, except at the federal level, borrowing money means selling Treasury securities to the public. These owed funds become part of the national debt.

So who decides what is spent and what is collected as revenue? Each year, the annual federal budget is established by the president, who submits a budget request each February for the upcoming fiscal year (beginning October 1) after consulting with federal agencies and the president's Office of Management and Budget.

The federal government has consecutively reported a deficit since 2002. Last year alone, the Congressional Budget Office reported a deficit of $779 billion, putting the national debt at over $21 trillion at the fiscal end of 2018. Compared to recent years, this deficit was relatively low: in 2009, Congress reported a record-setting $1.41 trillion deficit, and over a trillion dollars each year thereafter until 2013.

Deficits and national debt should really be analyzed alongside the gross domestic product (GDP), taking the true size of our economy into context. The GDP is the total value of final goods and services produced within a country, generally measured on an annual basis. If our GDP is growing at a higher rate than our national debt, there may be little cause for concern. The relationship between the two is measured by the ratio of national debt (in currency such as dollars) to the GDP. This debt-to-GDP ratio is a commonly used measure of a country's

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Flat Yield Curve

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in place.

Remember, a flat or inverted yield curve occurs when long-term rates drop or short-term rates rise until they are even; in other words, long-term rates are lower than short-term rates. Within a week of the Fed's announcement on March 20, the yield on the 10-Year Treasury rate dropped all the way to 2.39%, well below the Fed's current benchmark short-term rate of 2.5%. The 10-Year briefly got back above 2.6% in April, but has otherwise remained in the 2.5% range ever since the Fed's announcement, keeping the yield curve flat or nearly flat.

While we believe this situation could easily trigger the next recession and major market correction by 2020, in the meantime the stalled low-interest rate environment is forcing many everyday investors up the risk curve and into the stock market. It's also compelling corporations to continue increasing their use of stock buybacks. We believe both these situations are driving the stock market's recent gains as much as, if not more than, any strong new economic data, and that they may help expand the equity bubble even further in the months ahead.

2007 All Over Again

By 2020, however, if the flat yield curve persists as we believe it will, it may quickly go from being a classic symptom of a recession and market correction to being the main cause. This feels a lot like 2007 all over again. Back then, we knew about the sub-prime mortgage crisis as early as February, but it took until November for the stock market to really take notice and start dropping. We believe a similar situation may play out with the flat yield curve.

Remember, a flat or inverted yield curve is economically dangerous because banks depend on having a spread between long- and short-term interest rates in order to make lending worth their while. Banks typically borrow short-term and lend long-term, and need a spread in interest rates to make a profit on those loans. If there is little or no difference between long and short-term rates, banks of all sizes can end up taking a hit.

In fact, many big banks have already reported that the crunch from the inverted yield curve is hurting top-line growth and forcing them to scale back their earnings forecasts for 2019.[2] The impact on smaller regional banks might end up being even worse, because most have less types of financial services to fuel their revenue streams. They depend on things like home and auto loans, and on having a yield curve steep enough to make money off them.

With a flat yield curve, many smaller banks end up tightening their underwriting standards and approving fewer loans. Naturally, that's bad not only for the bank, but for the whole economy, and can start a domino effect toward recession. Fewer homes and cars are purchased, consumers start spending less, production falls with decreased demand, companies start laying off…on it goes. That's how we believe this flat yield curve could quickly go from being symptom of a coming recession to being a major cause. Naturally a recession would be the worst possible news for the stock market, which dropped by nearly 60% in conjunction with the last recession.

'This Time Will Be Different'

Now, it's possible you've heard or read some opinions in recent weeks about the inverted yield curve that have downplayed its significance. Most of these arguments fall into a familiar category for financial journalism: "this time will be different." It's the same message you hear touted by much of the financial media whenever warning signs are mounting that the next recession and major stock market correction might be around the corner.

Make no mistake: historically speaking, a flat or inverted yield curve is one of the most consistently reliable of those warning signs. According to one study by the San Francisco Fed, an inverted yield curve has preceded all nine recessions that have occurred since 1955. In each case, the recession hit in the following 6 to 24 months of the yield curve's inversion.[3]

Naturally, the analysts arguing that "this time will be different" always have plenty of data to support their argument. Some of it may even sound reasonable and make sense analytically. However, as we discussed in last month's newsletter, it's always important to make sure you don't get so caught up in data and left-brained analysis that you ignore common sense. Common sense is what might prompt you to ask: how likely is it that this time will really be different, if each of the last nine times in the past 64 years have all been the same?

[1] MarketWatch.com

[2] "Bank Investors Face a Conundrum in an Inverting Yield Curve," Yahoo Finance, April 23, 2019

[3] "One of the Most Important Recession Warning Indicators is Beginning to Flash," slate.com, March 26, 2019

Federal Deficit

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financial health, and the lower this ratio's percentage, the better. Countries wishing to join the European Union, for example, had to have a ratio under 60%. The U.S. Bureau of Public Debt reported a debt-to-GDP ratio of 105% in 2017, though this is still much lower than the highest reported U.S. debt ratio of 122% in 1946.

How Does the National Debt Impact Individuals?

High national debt can have several negative impacts on the economy, including the following:

Lower wages. Investing in government debt translates to money not being invested in companies, which can lead to stumped economic growth and wages.

Higher interest rates. With each new deficit, the government needs to sell more Treasury securities to finance the debt. In order to make these securities more attractive to foreign investors, banks, and the general public, the government will often increase interest rates.

Standard of living inequality for future generations. Lower wages, slower job growth, and higher interest rates all spell hardship for upcoming generations who may have to survive on less or prolong retirement dates.

Looming crises. If deficits and national debt growth go unchecked, U.S. debt investors could very well demand higher returns, ultimately leading to an unprecedented financial crisis.

Ironically, many people pay more attention to the federal budget and national debt than they do their own personal finances. When scrutinizing deficits and debt at an individual level, it's important to understand that managing personal debt, coupled with a sound savings and investment plan, should be your highest priority. Please call to discuss your individual financial health.

Don't Underestimate Inflation in Retirement

Inflation has been tame for so long that it's easy to ignore when planning for retirement. However, even inflation of 2% or 3% per year, over a period of many years, can seriously erode the purchasing power of your funds. At 2.5% inflation, $1 today will be worth 78 cents in 10 years, 61 cents in 20 years, and 48 cents in 30 years. That can have a major impact on those entering retirement for several reasons:

- New retirees are less likely to have defined-benefit pensions. Thus, they must rely more on Social Security benefits and personal savings.
- While Social Security benefits are still adjusted for inflation based on the Consumer Price Index (CPI), the methodology for calculating the CPI changed dramatically in 1999, reducing increases in the CPI.
- Retirees are living longer. As life expectancies increase, retirees are spending more years in retirement, so their retirement savings are subject to the impact of inflation over a longer time period.
- Healthcare costs are becoming more of a burden to retirees. More and more companies are reducing benefits or eliminating healthcare insurance for retirees, and healthcare costs tend to increase faster than overall inflation.

To combat the effects of inflation on your retirement income, consider these tips:

- **Use a conservative inflation rate for planning purposes.** Since your retirement is likely to span decades, consider inflation over long time periods.
- **Consider investment alternatives likely to stay ahead of inflation.** Thus, a significant portion of your portfolio would probably be invested in stocks.
- **Invest in tax-advantaged investment vehicles.** Look into 401(k) plans, individual retirement accounts, and other retirement vehicles. While each has different rules for taxing contributions and earnings, all provide some tax-free or tax-deferred benefits. Since you aren't paying income taxes on earnings throughout the years, that typically means you'll have a larger balance at retirement than if you were paying taxes throughout the years. Thus, you'll start out with a larger retirement base to help combat inflation's effects.
- **Keep fixed expenses as low as possible.** Try to enter retirement with as little debt as possible. If you aren't using a significant portion of your income to pay a mortgage, car payment, or credit card debts, you'll have more flexibility to deal with higher prices.
- **Decide how you will deal with healthcare costs.** While Medicare will help once you turn age 65, it still does not cover many healthcare costs. Look into Medigap policies and prescription coverage to help with those non-covered expenditures, especially if your employer does not provide health insurance after retirement.
- **Minimize withdrawals from your retirement assets, especially during the early years of retirement.** To counter inflation, you need to withdraw larger and larger sums just to maintain the same purchasing power. To make sure you don't run out of funds late in life, keep withdrawals during the early years to a minimum.
- **Be prepared for change.** After retirement, keep a close eye on your investments. If inflation increases and you are concerned that increasing withdrawals may deplete your investments, you may want to look for ways to reduce your living expenses or go back to work at least part-time.

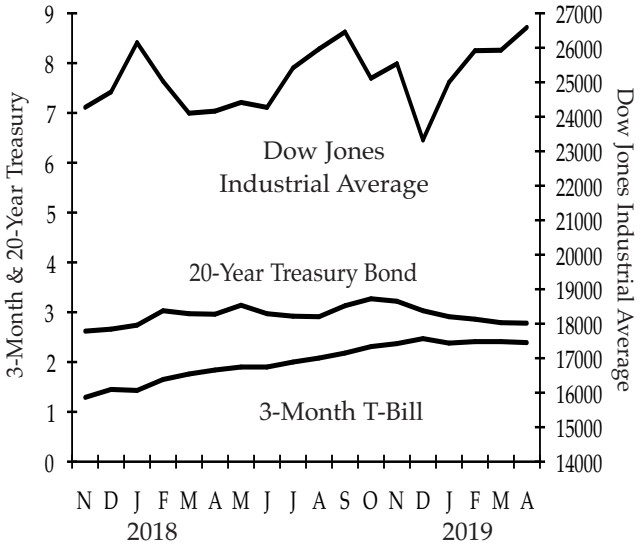
Business Data

Indicator	Month-end Feb-19	Mar-19	Apr-19	Dec-18	Apr-18
Prime rate	5.50	5.50	5.50	5.50	4.75
3-month T-bill yield	2.41	2.41	2.39	2.47	1.84
10-year T-note yield	2.66	2.55	2.55	2.89	2.88
20-year T-bond yield	2.86	2.79	2.78	3.03	2.96
Dow Jones Corp.	4.08	3.74	3.74	4.40	3.88
GDP (adj. annual rate)#	+3.40	+2.20	+3.20	+2.20	+2.20

Indicator	Month-end Feb-19	Mar-19	Apr-19	% Change YTD	12-Mon.
Dow Jones Industrials	25916.00	25928.68	26592.91	14.0%	10.1%
Standard & Poor's 500	2784.49	2834.40	2945.83	17.5%	11.2%
Nasdaq Composite	7532.53	7729.32	8095.39	22.0%	14.6%
Gold	1319.15	1295.15	1282.30	0.1%	-2.4%
Unemployment rate@	4.00	3.80	3.80	2.7%	-7.3%
Consumer price index@	251.71	252.78	254.20	0.9%	1.8%

— 3rd, 4th, 1st quarter @ — Jan, Feb, Mar 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
November 2017 to April 2019



Why Isn't Inflation Zero Percent?

One of the main goals of the Federal Reserve is to maintain inflation at a reasonable rate, currently targeted at 2% annually. Inflation is costly, causing the economy to operate less efficiently, hampering economic growth, and reducing the standard of living. So, if the Fed is trying to control inflation, shouldn't they shoot for a zero percent inflation rate? The answer is probably no, for a number of reasons:

- Current measures of inflation are believed to overstate inflation, so low inflation rates may actually be close to zero percent.
- A reasonable level of inflation may help maintain employment, giving employers room to reduce labor costs when needed. While it is usually difficult for employers to lower wages, they can accomplish the same result by not increasing wages as much as inflation.
- Deflation is considered more costly than a reasonable level of inflation, so low levels of inflation can help insure against falling prices. One of the main costs of deflation is increased debt-servicing costs. Debtors must make debt-service payments with dollars that are increasing in value, making it more difficult to make payments.
- At low levels of inflation, nominal interest rates are close to zero percent. The preferred strategy used by the Federal Reserve to stimulate the economy is to lower short-term interest rates. Once short-term interest rates are at zero percent, the Fed must resort to other strategies to help stimulate the economy. Thus, the economy may be less stable when inflation rates are close to zero percent.

FR2019-0118-0389

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