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THE ADVISOR

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As Summer Begins, Sideways Stock Market Remains Erratic as Ever

As summer gets into full swing, things haven't changed much in the financial markets. The yield curve is still inverted, uncertainty still surrounds the Trump Administration's trade war with China, and the stock market is still on the same sideways rollercoaster ride it's been on for a year-and-a-half.

The S&P 500 hit another new record high on July 1, and on the same day, the Dow Jones Industrial Average also briefly topped its all-time high from October of 2018.[1] Ultimately, though, neither index is much higher at the mid-point of 2019 than it was at the start of 2018. On January 26 a year ago, the S&P closed at 2,872, while the Dow hit 26,616. On July 2 of this year, the S&P was at 2,964 and the Dow at 26,678.[2] In the months between, the market has experienced bouts of extreme volatility, particularly through most of last year, and again in May.

You want more uncertainty? Well, even as Wall Street bounced back again in June, long-term interest rates dropped even further. The yield on the 10-Year Treasury rate dipped below 2% at one point and ended the month right at an even 2%.[3] With short-term rates still set at 2.5%, this means we've now had an inverted yield curve for about three

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Managing Bond Risks

All investments are subject to risk, although the types of risk can vary. While you can't totally eliminate risks, you can minimize them. For bonds, consider these strategies:

Interest rate risk — Interest rates and bond prices move in opposite directions. A bond's price will increase when interest rates fall and decrease when interest rates rise. This occurs because the existing bond's price must change to provide the same return as an equivalent, newly issued bond paying prevailing interest rates. The longer the bond's maturity, the greater the impact of interest rate changes. Also, the effects of interest rate changes tend to be less significant for bonds with higher-coupon interest rates.

To reduce this risk, consider holding the bond to maturity. This eliminates the impact of interest rate changes, since the total principal value will be paid at maturity. Thus, selecting a maturity date that coincides with your cash needs will help reduce interest rate risk. However, you may still receive an interest income stream that is lower than current rates. Selecting shorter maturities or using a bond ladder can also help with this risk.

Reinvestment risk — You typically know what interest income you will receive from a bond, but you must then take the periodic income and reinvest it, usually at varying interest rates. Your principal may also mature at a time when interest rates are low.

Staggering maturities over a period of time (laddering) can lessen reinvestment risk. Since the bonds in your ladder mature every year or so, you reinvest principal over a period of time instead of in one lump sum. You may also want to consider zero-coupon bonds, which sell at a deep discount from par value. The bond's interest rate is locked in at purchase, but no interest is paid until maturity. Thus, you don't have to deal with reinvestment risk for interest payments, since you don't receive the interest until your

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Sideways Stock Market

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months.

As we've discussed many times, an inverted yield curve occurs when long-term interest rates fall below short-term rates. This inversion can hurt banks and other lending institutions, which depend on long-term rates being higher in order to make money off loans. An inverted yield curve has preceded every US recession since WWII, and economists are increasingly sounding alarm bells over the current situation.[4]

A 'New Fix'

The equities rebound in June was driven partly by what appears to be a temporary truce in the Trump Administration's trade war with China, but the bigger influence was the Federal Reserve. At its June meeting, the Fed struck its most dovish tone yet this year, suggesting it would not be averse to lowering interest rates again or doing more quantitative easing if all the predictions about a new recession by next year prove to be accurate.[5]

As discussed in a previous newsletter, the Fed (for whatever reason) actually helped create the inverted yield curve by announcing in March that it would soon discontinue the "unwinding" of its last quantitative easing efforts. We predicted that announcement would put — and keep — downward pressure on long-term interest rates, and that prediction has proven accurate so far.

We also discussed that the inverted yield curve might give Wall Street a temporary boost, and that has mostly been the case so far. In the era of artificial stimulus, the stock market has become addicted to low interest rates, so in the current environment the market is like an addict getting a new fix. Never mind the potential danger and the fact that the inverted yield curve might quickly go from being a symptom of the next recession to a being major cause. Never mind all the other warning signs of slowing GDP growth.[6] For now, "irrational exuberance" is in control, much as it was in the months leading up to the last two major market corrections.

With all this in mind, now would be a good time to educate friends or family members who are retired or nearing retirement about the importance of reducing their stock market risk by switching their strategic focus from growth to income. Point out that with the market basically trading sideways for a year and a half now, and marked by bouts of extreme volatility, it's a classic sign that big investors likely have "one finger on the trigger," ready to pull out as soon as the next major sustained market correction takes hold.

Musical Chairs

An analogy for this situation is that it's like a game of musical chairs. When the music stops and next big drop hits, who do you think is most likely to get caught "without a chair"? Will it be the big institutional investor on Wall Street who has computerized algorithms that can instantly trigger trades on his behalf before the market even opens? Or will it be the everyday investor whose advisor still has most of his clients' retirement savings invested in stocks and mutual funds?

Remember, too, that history indicates the next major drop will likely range somewhere between 45 and 70%. That means, even if the market were to add another 10 or 20% before the next drop hits, that gain is minimal compared to the potential loss. It's like a casino game that pays you $10 if you win, but costs you $70 if you lose. Would any rational person really be likely to play that game? Probably not. However, investors still trying to wring every last possible dime out of the current cyclical bull market are basically playing the same game.

So, again, share some of these facts and insights with friends or family members you fear might be carrying too much market risk at this highly uncertain time. If you're not sure your own portfolio is as secure and focused on income as it might be, don't wait to take action!

[1] "S&P 500 Hits Record High Following G20 Trade Progress," The Hill, July 1, 2019

[2] Macrotrends.com

[3] Ycharts.com

[4] "History Tells Us Why Fed Should Take The Inverted Yield Curve Seriously," Forbes, May 30, 2019

[5] "Fed holds Rates Steady but Opens the Door for a Rate Cut in the Future", CNBC, June 19, 2019

[6] "The Stock Market's Biggest Risk is Still Alive: Slowing Economic Growth," Forbes, April 19, 2019

Managing Bond Risks

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principal matures.

Inflation risk — Since bonds typically pay a fixed amount of interest and principal, the purchasing power of those payments decreases due to inflation, which is a major risk for intermediate- and long-term bonds.

Investing in short-term bonds reduces inflation's impact, since you are frequently reinvesting at prevailing interest rates. You can also consider inflation-indexed securities issued by the U.S. government, which pay a real rate of return above inflation.

Default and credit risk — Default risk is the possibility the issuer will not be able to pay the interest and/or principal. Credit risk is the risk the issuer's credit rating will be downgraded, which would probably decrease the bond's value.

To minimize this risk, consider purchasing U.S. government bonds or bonds with investment-grade ratings. Continue to monitor the credit ratings of any bonds purchased.

Call risk — Call provisions allow bond issuers to replace high-coupon bonds with lower-coupon bonds when interest rates decrease. Since call provisions are generally only exercised when interest rates decrease, you are forced to reinvest principal at lower interest rates.

U.S. government securities do not have call provisions, while most corporate and municipal bonds do. Review the call provisions before purchase to select those most favorable to you.

Keep in mind the assumption of risk is generally rewarded with higher return potential. One of the safest bond strategies is to only purchase three-month Treasury bills, but this typically results in the lowest return. To increase your return, decide which risks you are comfortable assuming and implement a corresponding bond strategy. Please call if you'd like help with your bond investing strategy.

How Inflation Affects Bonds

While a little inflation is healthy for the economy, inflation has a direct impact on all of us in some way. For investors, the degree of impact varies, depending on their asset allocation. For example, the effects of inflation on stocks are often deemed negligible, since stock prices often rise in correlation with the price of goods and services. Inflation's effects on bonds, on the other hand, are more tangible.

When you purchase bonds, you're essentially lending money to either the government or a corporation with a promissory note in the form of a stipulated interest rate (coupon) and the maturity date when your principal will be returned. Because any given bond transaction occurs in today's dollars, there's always the likelihood that the principal you lend through purchasing bonds simply won't hold the same purchasing power by the bond's maturity date, particularly since many bonds have a 5-10 year life span, therefore increasing the probability of inflation. The relationship between inflation and bonds is an inverted one: the higher inflation rises, the less valuable bonds become.

When we consider a bond's cash flow from purchase to maturity, the effects of inflation become a bit more complicated, particularly because over the course of a bond's lifetime, its coupon and the current interest rates don't always align. While this can certainly work to your favor when interest rates are low, it can be problematic during times of inflation, when the Fed typically raises the interest rates in an attempt to slow inflation's pace. Remember: most bonds are similar to stocks in the sense that they're traded on the market. Even the slightest rise in interest rates affects their market price because they must now be traded at a discount lower than their face value. Therefore, in spite of the par value you've paid for a bond, it might sell for less or more than that value, depending on market interest rates. Bonds with a coupon lower than the current interest rate must sell at a discount to offset the interest rate hike.

If you own individual bonds, assuming you hold them to maturity, their par value is generally secure, excepet for the call or default risk. Likewise, your bond's interest payments will continue at the originally promised rate. Sell prior to maturity, however, and you'll incur the loss in face value. For this reason, many individual bondholders avoid selling; though, depending on inflation and interest rates at the time of your bond's maturity date, selling currently held bonds and purchasing new investments could provide better return in the long run.

Much of the impact of inflation on your individual bonds, too, depends on the term and even type of bond. Short-term bonds hold less risk when it comes to inflation for a few key reasons: a) there's less chance of inflation within a shorter investment period; b) the rate at which inflation occurs is likely to be less; and c) there's a greater chance you'll hold the bond to maturity. This comes at a price, since short-term bond coupons are typically much less attractive than those of long-term bonds. Your bonds' exposure to inflation also depends on the category of bonds you invest in. TIPS bonds, for example, are designed to rise in value with inflation.

Any fluctuation in the economy, regardless of the direction, can affect bonds and stocks alike, albeit in different ways. The inherent risk even in an investment praised for its stability only serves to highlight the importance of portfolio diversification. To discuss the relationship between your investment plans and changing interest rates, please call.

Business Data

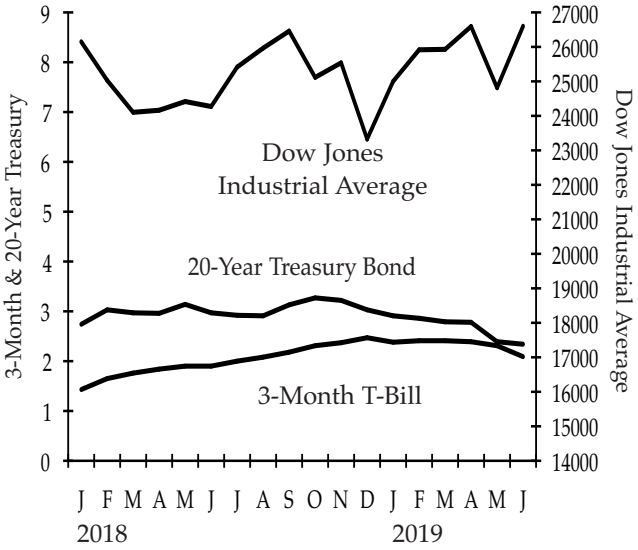
Indicator	Month-end Apr-19	May-19	Jun-19	Dec-18	Jun-18
Prime rate	5.50	5.50	5.50	5.50	5.00
3-month T-bill yield	2.39	2.31	2.09	2.47	1.90
10-year T-note yield	2.55	2.14	2.05	2.89	2.91
20-year T-bond yield	2.78	2.39	2.34	3.03	2.97
Dow Jones Corp.	3.74	3.63	3.22	4.40	3.94
GDP (adj. annual rate)#	+3.40	+2.20	+3.10	+2.20	+2.20

Indicator	Month-end Apr-19	May-19	Jun-19	% Change YTD	12-Mon.
Dow Jones Industrials	26592.91	24815.04	26599.96	14.0%	9.6%
Standard & Poor's 500	2945.83	2752.06	2941.76	17.3%	8.2%
Nasdaq Composite	8095.39	7453.15	8006.24	20.7%	6.6%
Gold	1282.30	1295.55	1409.00	9.9%	12.7%
Unemployment rate@	3.80	3.60	3.60	-2.7%	-5.3%
Consumer price index@	254.20	255.55	256.09	1.6%	1.8%

— 3rd, 4th, 1st quarter @ — Mar, Apr, May 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

January 2018 to June 2019



Bond Investing Tips

Consider the following bond investing tips:

- **Determine your objectives before investing.** Decide how much to invest in bonds.
- **Diversify your bond holdings among different bond types.** Consider government, corporate, and municipal bonds, as well as different industries, credit ratings, and maturities.
- **Understand the risks that affect bonds.** The most significant risk is interest rate risk. When interest rates increase, bond values fall, while values rise when interest rates decline. Other risks include default risk and inflation risk.
- **Choose bond maturity dates carefully.** When you need your principal is a major factor, but the current interest rate environment may also affect your decision. Rather than investing in one maturity, you may want to stagger or ladder the maturity dates.
- **Follow interest rate trends.** At a minimum, follow the prime rate, Treasury bill rates, and Treasury bond rates. Understand the significance of the yield curve and track its pattern over time.
- **Compare interest rates for specific bonds before investing.** Interest rates can vary substantially among different bond types and among bonds with different maturities or credit ratings.
- **Research a bond before purchase.** Review the credit quality, coupon rate, call provisions, and other significant factors.
- **Consider the tax aspects.** By comparing the after-tax rate of return for various types of bonds, you may be able to increase your return.
- **Review your bond holdings periodically.** Evaluate the credit ratings of all your bonds at least annually to ensure the quality hasn't deteriorated. Also, ensure your holdings are still consistent with your overall investment objectives.

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