JCN FINANCIAL & TAX ADVISORY GROUP, LLC

Advisory | Tax Planning | Investment Management

Q4 2019 NEWSLETTER

2019 Scorecard

2019 ended on a financial up note and will be remembered as a banner year for investors. Through December, the S&P 500 was up more than 27 percent. These gains are aided by the fact that stocks fell nearly 20 percent at the end of 2018 and bottomed out on Christmas Eve of that year. A fierce rally ended that year, which made many investors nervous that we were setting up for another leg down in 2019 in a similar fashion.

With over 97% of all asset classes posting gains in 2019, it represented quite a drastic reversal from the 2018. These types of gains are not uncommon. Since 1926, almost half of all calendar years have shown double digit returns going into the final quarter of the year. A surprisingly high number of those gains continued into year's end, as illustrated here:

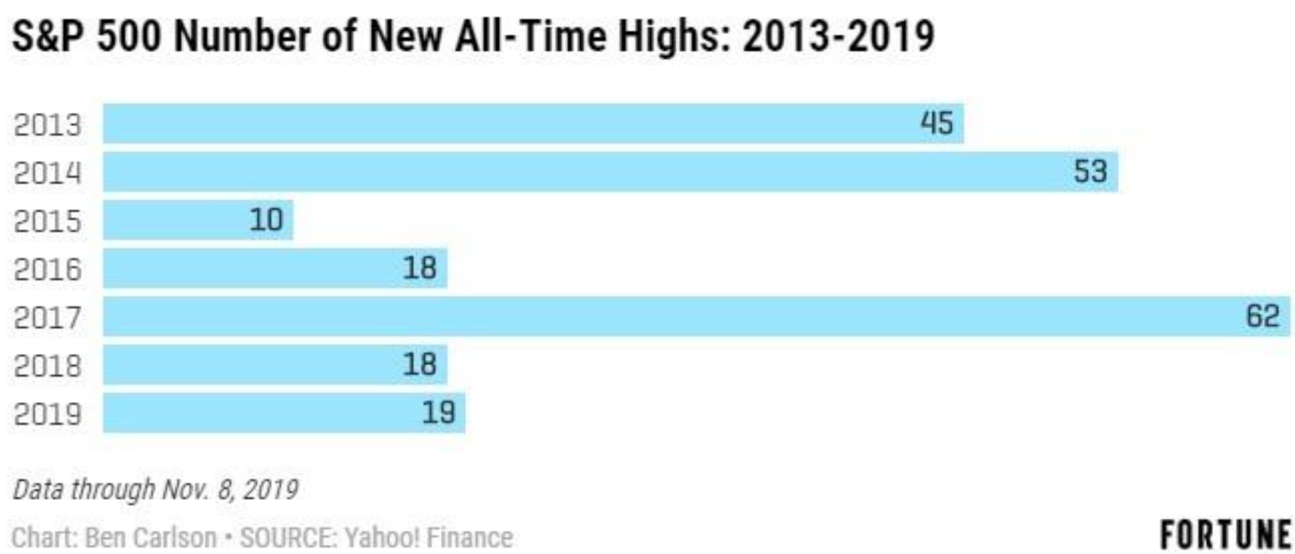
Source: Charles Schwab, Factset data as of 11/29/2019. Asset class performance is in US dollars and represented by the following indexes:S&P500® Index(US Large Cap), Russell 2000® Index(US Small Cap), MSCI EAFE® Index(Developed International), MSCI Emerging Markets Index(Emerging Markets), MSCI US REIT Index(US REIT), S&P GSCI®(Commodities), Bloomberg Barclays US Treasury Inflation-Linked Bond Index(TIPS), Bloomberg Barclays US Aggregate Bond Index(US Bonds), Bloomberg Barclays US High Yield Bond Index(High Yield Bonds), NYMEX Gold near term contract close (Gold).. **Past Performance is no guarantee of future results. Indexes are unmanaged, do not incur management fees, costs and expenses, and cannot be invested in directly. For additional information, please see schwab.com/indexdefinitions.**

WHAT THE "SECURE ACT" MEANS TO YOU

Two days after Christmas, President Trump signed into law the highly anticipated SECURE Act. Secure stands for *Setting Every Community Up for Retirement Enhancement Act* of 2019. The SECURE Act is designed to incentivize both individuals and employers to focus more on retirement savings. Although the Act has many facets, what may matter most to you is that the age for Required Minimum Distribution (RMD) is increased to 72 from the previous 70 ½ . Additionally, the Act eliminates "Stretch IRAs," and requires those who inherit and IRA to withdraw the money within 10 years. With this legislation many part-time workers will now be able to contribute to 401(k) plans, and small businesses will now have incentives to establish these types of accounts. Click **here** for our concise summary of the Act on The Neyland Report. Click **here** to read the entire bill. For more details about how the Act directly affects you, we invite you to meet with your JCN financial advisor.

ALL TIME HIGHS AND POLITICAL OUTLOOK

Since our last quarterly newsletter there have been seven additional all-time highs in the S&P 500, making it 26 for 2019. This image shows all-time highs for the past few years.



The good news is that statistically all-time highs are followed by more all-time highs. If you plan on being in the stock market over the long-term, be aware that stocks mostly go up over time and new highs are completely normal. In fact, following an all-time high, stocks are up roughly 70 percent of the time going out one, three and five years into the future.

Additionally, given the recent political happenings, many investors have a hard time figuring out how the stock market continues to charge higher in the face of trade wars and the impeachment of the President. To offer some perspective, in the year following President Bill Clinton's impeachment inquiry in 1998, the S&P rallied 39 percent. Clinton was acquitted by the Senate, and therefore not removed from office. It is generally expected the same will be the case for President Trump. However, In the year following Nixon's impeachment process, the S&P dropped 33 percent. Economists generally agree the downturn had more to do with the general economy and recession than it did with the inquiry into Nixon's alleged crimes.

As it happens, this is also an election year. Since, 1952, the Dow Jones Industrial Average has climbed 10.1 percent on average during election years when a sitting president has runs for reelection, according to the Stock Trader's Almanac, which traces historical stock market patterns.

EARNINGS

The estimated (year-over-year) earnings growth rate for 2019 is 0.3 percent, which is below the 10-year average (annual) earnings growth rate of 9.1 percent. If 0.3 percent is the actual growth rate for the year, it will mark the lowest annual growth rate for the index since 2015 (-0.6 percent). Six sectors are projected to report year-over-year growth in earnings, led by the Utilities and Health Care sectors. Five sectors are expected to report a year-over-year decline in earnings, led by the Energy and Materials sectors. S&P 500 companies with more international revenue exposure are expected to report weaker earnings relative to S&P 500 companies with less international revenue exposure in 2019. For S&P 500 companies that generate more than 50 percent of revenue outside the U.S., the estimated earnings decline for 2019 is -6.1 percent. For S&P 500 companies that generate more than 50 percent of revenue inside the U.S., the estimated earnings growth rate for 2019 is 3.5 percent.

As for 2020, whether the end-of-year run up in stock values translates to higher earnings this year remains to be seen. Market watchers will keep their eyes on wage growth, trade and the global economy to determine if the late 2019 rally translates into higher earnings.

ANALYSTS PREDICT S&P 500 TO CLOSE ABOVE 3400 IN 2020

For 2019, the S&P 500witnessed an increase in value of 26.4 percent (to 3168.57 from 2506.85) . Industry analysts in aggregate predict the S&P 500 will see a 7.5 percent increase in price over the next 12 months. This percentage is based on the difference between the bottom-up target price and the closing price for the index as of December 23, 2019. . The bottom-up target price is calculated by aggregating the median target price estimates (based on company-level estimates submitted by industry analysts) for all the companies in the index. On December 12, the bottom-up target price for the S&P 500 was 3407.46, which was 7.5 percent above the closing price of 3168.57.

VALUATIONS

Stock valuation is the accepted method of calculating the value of a company and its stock. Concerns about stock valuations stem from the fact that price to earnings (P/E) ratios are higher than those observed on average over the long history of several decades. *(The price-to-earnings ratio is the ratio for valuing a company that measures its current share price relative to its per-share earnings (EPS).)* It may be worthwhile to observe valuations across changing economic regimes. As an example, the duration of economic cycles, the effectiveness of monetary policy, and catalysts for inflation may all evolve over time as the economy adapts to changing growth dynamics. In this setting, we look at today's valuations relative to the most recent 25-year history. The Dividend Yield and the Price to Book (P/B) ratio (*calculated by subtracting liabilities from assets*) are valuation metrics that compare market prices to dividends and book value respectively. Similar to the P/E ratio, the dividend yield and P/B ratio are currently in line or slightly above their 25-year averages.

INTEREST RATES AND THE FEDERAL RESERVE

The Federal Reserve signaled that it wants to hold off on further interest rate cuts for a while. At its meeting December 10-11, the Federal Open Market Committee (FOMC) of the Federal Reserve kept the federal funds rate between 1.5 percent and 1.75 percent. Chairman Jerome H. Powell expects that the economy has stabilized, but again emphasized that the future path of Fed actions will depend on events.

The bond market has also been stable, as rates have changed little over the past two months. The yield curve – the gap between rates on short- and long-term bonds – has maintained its historically normal upward sloping line. This indicates that investors are minimally concerned about a possible recession occurring next year.

The Federal Reserve's three interest rate cuts in 2019 clearly supported asset markets, as well as interest-sensitive areas of the economy. The Fed currently expects to stay "on hold" in 2020; recently declaring that they have essentially set the bar higher for inflation to lead to rate increases; even if the tight labor market causes wage gains to accelerate. We do believe inflation could surprise marginally on the upside this year; which could be a cause of some market volatility.

We also think the Fed will stand pat in 2020. However, slower growth in the economy will mean that the Fed has a smaller margin of error. If market turmoil develops, perhaps related to trade, then the Fed will likely cut at least once more. It would like to resume gradually raising rates in 2021, but a lot can happen between now and then. Just after the second interest rate cut in September, 2019, Reuters published a concise, understandable piece about how interest rate cuts can affect your investments and other accounts. Click **here**.

RECESSION RISK

Recession risk has been a major factor through 2019, and chances are that most investors will remain concerned about the economic environment in the coming months. Some areas of the economy are clearly moving in the wrong direction, geopolitical risk is elevated, and some analysts are even considering that the global economy is stumbling towards disaster. Two recent developments seem to have calmed recession concerns of investors. The first is the pending trade agreement with China, and a reduction of previously announced tariffs on imports of Chinese goods. The agreement would boost exports, which bodes well for manufacturing. The other development that instills some confidence is the recent signing of the United States-Mexico-Canada Agreement (USMCA), or the "new NAFTA" as some are calling it. This agreement intends to further boost trade.

- With the economic cycle reaching extended levels and manufacturing activity being under pressure, economic growth will probably remain subdued over the coming months. Nevertheless, when looking at our data and models on a broad scale, a recession does not look like the most probable outcome over the next three to six months at a minimum.
- Until some of the above-listed agreements come to fruition, there is a clear weakness in sectors such as manufacturing and international trade, which is closely related to the trade war uncertainty. Manufacturing is the weakest spot in the U.S. economy and the biggest reason for concern over the coming months. We have already seen some material slowdowns in manufacturing activity in 2011 and 2015 during the current cycle, and the economy as a whole still managed to avoid a recession. Manufacturing is currently the weakest spot in the U.S. economy and important to monitor in the coming months.
- The Conference Board Leading Economic Index (LEI) is also moving in the wrong direction, with the index declining for three consecutive months and the growth rate in the index turning negative recently. *(The Conference Board is a think tank that forecasts future economic activity).* A big share of the weakness in the leading index can be explained by weak manufacturing data,

although employment also showed some weakness in October. The LEI index is not a full-blown red flag at this stage, but it is clearly a warning sign that we will continue watching.

MARKET RISKS

As usual, uncertainty will likely remain front and center in 2020. Here are the major themes to watch in 2020:

20 risks to markets in 2020

1. Continued increase in wealth inequality, income inequality, and healthcare inequality
2. Phase one trade deal remains unsigned, continued uncertainty about what comes after phase one
3. Trade war uncertainty continues to weigh on corporate capex decisions
4. Ongoing slow growth in China, Europe, and Japan triggering significant US dollar appreciation
5. Impeachment uncertainty & possible government shutdown
6. US election uncertainty; implications for taxes, regulation, and capex spending
7. Antitrust, privacy, and tech regulation
8. Foreigners lose appetite for US credit and US Treasuries following Presidential election
9. MMT-style fiscal expansion boosts growth significantly in US and/or Europe
10. US government debt levels begin to matter for long rates
11. Mismatch between demand and supply in T-bills, another repo rate spike
12. Fed reluctant to cut rates in election year
13. Credit conditions tighten with more differentiation between CCC and BBB corporate credit
14. Credit conditions tighten with more differentiation between CCC and BBB consumer credit
15. Fallen angels: More companies falling into BBB. And out of BBB into HY.
16. More negative-yielding debt sends global investors on renewed hunt for yield in US credit
17. Declining corporate profits means fewer dollars available for buybacks
18. Shrinking global auto industry a risk for global markets & economy
19. House price crash in Australia, Canada, and Sweden
20. Brexit uncertainty persists

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Source: DB Global Markets Research

THE STRONG ENGINES

- **Employment** is a key piece of the puzzle for the economy, and variables such as initial jobless claims and continued claims tend to increase when the economy is approaching a recession. Unemployment remains stable at 3.6 percent. The labor market is quite tight, which could be a reason for concern, but there is no visible sign of deterioration in the main trends.
- **The real estate sector** is also a major engine for the economy; variables such as building permits and housing starts tend to provide clear warning signs before a recession. Both indicators are clearly improving in recent months, so there is no recession in sight, judging by the available real estate data.

- **Consumer spending** proved resilient, bolstered by strong employment figures, low interest rates, and falling oil prices. But business investment remained muted by trade uncertainties. We expect consumer spending to continue to drive the US's GDP growth in 2020, as it has in recent quarters. Disposable income is up 4.6 year over year.

ECONOMICS: 5 IMPORTANT DATAPOINTS WE ARE MONITORING

- **There are not enough people to fill available jobs**, yet wage growth is slowing; after peaking at 3.4% y/y in February 2019, average hourly earnings grew by just 3.1% in November.
- **The U.S. manufacturing segment remains weak**. The ongoing U.S.-China trade war has taken its toll on global manufacturing, but with the signing of the above-described Phase 1 of the U.S.-China trade agreement on January 15, 2020, manufacturing could be bolstered. However, an end-of-year study by economists at the Federal Reserve found that all of the Trump administration's tariffs, including those on steel and aluminum as well as on Chinese imports, have cost manufacturers jobs and raised their costs.
- **The housing market** is getting a boost as a result of the Fed's three interest rate cuts in 2019. Housing starts are trending up.
- **Businesses have increased their debt**, a trend flagged by the Federal Reserve as a potential risk in the financial system. Fueled by low interest rates, not only is the credit-to-GDP ratio of the business sector at historically high levels, but there are growing concerns about the quality of some of this debt.
- **The Federal budget deficit** continues to grow. Even with the current economic expansion now in its 11th year and growth expected to continue to slow into 2020, the Federal deficit is projected to top $1 trillion this year.