A Registered Investment Adviser

1st Quarter 2019 Commentary

Stark Financial Advisers, Inc.

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Special points of interest:

- 2018, Scariest Time for Investors in Years
- China is Willing to Fight a Trade War
- Leading Indicators Positive for 2019
- Britain Faces a March 2019 Deadline to Exit the EU
- Interest Rate Increases Likely to Moderate
- Using QCRs to Save Taxes

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Overview

In this issue we briefly look back at 2018 but focus mostly on 2019. During 2018 nearly all asset classes declined in price and volatility returned. Four main issues being the primary cause: rising interest rates, the trade war between the U.S. and China, over exuberance for domestic equities and Brittan's exit from the European Union. These issues remain, with perhaps the most difficult to predict being the outcome of the trade war. The good news is that valuations are cheaper. We take a deep dive into 2019 expectations including our current views and investment strategy. Finally, we explore Qualified Charitable Distributions, a strategy available for retirees that may result in saving taxes when making charitable gifts.

You Couldn't Win in 2018—What About 2019?

2018 was a tough year across the asset-class universe: US stocks produced losses, bonds, especially high yield, are in a rut, and losses have piled up in oil, gold, and emerging markets—just about everything. The scope of negative returns is unusual. According to Deutsche Bank, 89% of the global financial indexes it tracks were negative for the year, in dollar terms, through the end of October. It only got worse in December, which produced the worst returns (down nearly 10%) for U.S. stocks since 1931. Investors may be rightfully disappointed as diversified portfolios holding U.S. stocks, fixed income, foreign stocks and other less correlated assets, such as REITs and commodities, are almost all down. Is current weakness a reason to give up on asset allocation or diversification as a tool to manage portfolio risk? We think not. We may be at the tail end of what is now the longest U.S. equity bull market in history. With excess liquidity being drained from the system, interest rates rising off crisis level lows, and global markets going through a difficult phase, to put it charitably, it's unlikely that putting all your eggs in U.S. stocks would produce satisfying returns. We are positive on U.S. stocks for 2019, but the variability of expected returns is high. Markets are likely to remain volatile as they react to day-to-day news about trade, BREXIT and monetary policy. Investors will need to look beyond the volatility and stay focused on fundamentals. Comparatively, there is probably more value in foreign markets. If the S&P 500 were to fall 20%, it would merely be at its median valuation over the past 30 years. But foreign markets, such as those in the MSCI EAFE index, could gain 10% just to get back to median valuations. With the Fed likely to moderate the rate of interest rate increases, it would take some wind out of the dollar, relieving pressure on emerging market currencies that have weighed on the sector.

"12/24/18 Dow Jones Industrial Average looses 653.17 points. It's largest loss on Christmas Eve ever."

The Trade War—the Elephant in the Room

The biggest issue facing the markets may be trade between the U.S. and China. China believes that since taking office in 2017, the Trump Administration has trumpeted "America First" and has abandoned the fundamental norms of mutual respect and equal consultation. China sees trade and economic relations between China and the US as of great significance. They also believe they are responding from the perspective of both parties common interests. They see the U.S. as being contradictory and constantly challenging. While China's position is one of hope of promoting business cooperation and develop stronger ties with the U.S., China is not afraid of a trade war and will fight one if necessary. They believe that mature political leaders in the U.S. will eventually come back to their senses and redress misguided behaviors so that the efforts to resolve the trade friction between the two countries will come back on right track. On the issue of Intellectual Property Rights (IPR), the countries are far apart. The U.S. alleges the theft of IPR by China. China's position is that they are firmly committed to protecting property rights. In China's words: "A just cause enjoys abundant support while an unjust one finds little support." In a world of increasing uncertainty, instability, and insecurity, China will remain true to its original aspirations. While China speaks of cooperation, the countries are far apart on issues, thus raising the prospect of an extended period of uncertainty. It seems possible that increased trade restrictions will hurt the average person in the U.S. and China. However, that's not the case for every nation. If China's exports fall, there is opportunity for other countries to fill the void. The World Bank sees Vietnam, Cambodia and the Philippines as beneficiaries. Vietnam is likely the largest winner. Other East Asian countries that export a large amount of goods to China, such as Taiwan and Malaysia, risk being collateral damage in the trade war.

"12/26/18 Dow Jones Industrial Average gains 1,086.25, 4.8%. The largest one day gain in history."

Cheaper Stocks Offer More Value

The S&P fell about 15% from its all-time high during the fourth quarter. The sell-off was unusual in its speed and severity. Emerging market performance "EM" was disappointing throughout much of the year but, on a relative basis, EM outperformed domestic stocks during the quarter. While all stocks did respond positively to soothing comments from Fed Chair Powell, volatility quickly returned on trade concerns, a government shutdown, BREXIT, and heightened recession fears. Despite strong 2018 earnings, and 2019 projections running above trend, price/earning multiples (a measurement of valuation) experienced the fourth greatest decline in 40 years, making U.S. stocks cheaper and, thus, more attractive. While 2018 produced above-trend growth, 2019 should return to more sustainable (and normalized) 2½% GDP growth and earnings growth of 7-8%. The health of the business cycle remains good and points to limited downside risk. All indicators, except inflation trends, remain expansionary. Inflation indicators are neutral. Inflation, as measured by the CPI, has been range bound since 2012. However, during the quarter, crude prices fell approximately 40%, indicating the near-term trend for inflation will be down. The employment market is tight and, eventually, could drive wages higher, putting upward pressure on inflation. Wage inflation is an indicator to watch in regards to a potential recession. Some fear that interest rates will rise significantly in 2019. We disagree. Indicators, such as the yield curve, imply that rates will be largely unchanged over the next 12-months. We expect the 2-year treasury to hover around 2.85% and the 10-year around 3.05%. The significance is that the bond market is not forecasting a recession and, historically, when the 10-year yield is below 5%, stocks have risen. Above 3.5% we would become more cautious. Despite the nerve-racking volatility of 2018 and the late year-end sell-off, indicators point towards a positive 2019. The economy remains solid, corporate earnings are continuing to rise, interest rates are likely to remain stable, and valuations following the recent sell-off are cheaper. A good argument can be made that U.S. stocks are now oversold. Currently, the S&P 500 is near 2500, well below our year-end estimate of 3,000. If fundamentals develop as we expect, a 2019 year-end target for the S&P of 3,000 to 3,100 is reasonable.

Brexit—Britain's Exit From the European Union

British Prime Minister Theresa May delayed a critical parliamentary vote on her government's withdrawal agreement from the European Union. By doing so, the U.K.'s plans to exit from the European Market is in question. News of the postponement added to current investor uncertainty and increased market volatility as the U.K. is set to leave the European Union in March 2019. The postponement derailed the possibility of a huge parliamentary loss that could topple her government and send the Brexit negotiations into even greater chaos. Widespread concern among lawmakers over the issue of how to manage Northern Ireland's border with the Republic of Ireland after Brexit had put the exit plan in jeopardy. This withdrawal agreement is the only agreement on the table. There are a number of scenarios that could develop between now and March 29, but the clock is running. A deal could be reached that would leave the U.K. in a close relationship with the European Union. There could be a deal resulting in a less close relationship be-

tween the two. It's possible there may be no deal at all that could result in a disorderly Brexit. And, quite possibly a second referendum resulting in a "remain" vote. Potentially disruptive political outcomes do not necessarily dictate investing fundamentals and investors should always remain focused on fundamentals. The current uncertainty has caused U.K. equities to be unloved, reasonably cheap, and fundamentally healthy. Offshore investors also have currency to consider since the direction of the pound will influence investment returns. As recent market volatility has reminded us, political outcomes drive short-term, knee-jerk reactions in markets. Brexit is difficult to analyze because of the indirect and tenuous connections it has on investment fundamentals. However, when we depart from long-term, fundamentally sound investment analysis, it's easy to drift into speculation. Since political circumstances are so difficult to predict, we would recommend putting them aside and focusing on valuation instead. And remember, investing is not about what happens in the next few days, weeks or even months, but over the next years and decades.

"Crude oil down 12% during 2018. Off 40% from its high in October."

Interest Rates— Fed's Rigid Approach May Be Flexing

Markets have been weighed down over the prospect of higher interest rates, a concern that has been fueled by the US Federal Reserve Bank. The Fed is evolving to a 'data dependent' strategy and has stepped back from the predictable path of quarterly raises. When Fed Chairman Jerome Powell said short-term rates are "just below" a range of estimates where a neutral rate might be achieved, markets rallied. During the Federal Reserve's meeting in December, the target range for overnight lending was raised by a quarter of a point. Officials now see fewer hikes this year and signaled that the tightening cycle is nearing an end. Recent interviews and public statements show that Fed Officials still see the broad direction of short-term interest rates to be higher in 2019, forecasting possibly two increases. But, as rates rise, it's less clear how far rates need to rise and how the economy will hold up under higher rates. How the Fed navigates these waters will depend, in large part, on the performance of the economy and markets in the weeks ahead. To underscore the importance of this issue, you needn't look any further than December 6. On that Thursday, the Dow Jones Industrial Average tumbled as much as 785 points before paring those losses. The rebound accelerated late in the session after The Wall Street Journal reported on the Fed's evolving thinking on rates. The blue-chip index ended down 79 points. Our view is that the fear of substantially higher rates is overdone. Recently, the Employment Report showed that 155,000 new jobs were created during November. While a good report, it wasn't a great report and raised questions regarding the strength of the economy. Aware that the economy this year may be far different than that of 2018, Chairman Jerome Powell compared the Fed's policy strategy to walking into a living room when the lights suddenly go out. "What do you do? You slow down, and you maybe go a little bit less quickly, and you feel your way more," he said in a recent speech. "So, under uncertainty of this kind, you be careful."

A Deep Dive into 2019 Expectations

Good riddance to 2018. It was a stressful year during which there were two market corrections, rising interest rates, and a lingering trade war. In addition, fears grew that the bull market had succumbed to the bear. The stock market's returns last year resembled a lump of coal. As measured by the S&P 500, it posted its first loss since 2015 having lost almost 7%. Last year was unusual in many ways. While earnings generally grew nicely, investors paid less for those earnings. There was a bull market in earnings and a bear market in valuations. The market's tumult last year has left stocks trading at about 14.5 times the next 12 months' expected earnings, in line with the long-term average. That's well below the S&P 500's price/earnings ratio of more than 18 on Sept. 20, 2018, when the index hit an all-time high of 2930.75. Rising interest rates get some of the blame for trimming stocks' valuations. The Federal Reserve has raised the federal-funds rate—the overnight interbank lending rate—four times in 2018. Recently, in December, to a range of 2.25% to 2.5%. Happily, the clock started afresh on Jan. 1, and if just a few things go right, 2019 could be a happier year. We view the range of possibilities for the S&P 500 to be from 3,100 to 2,500. Where we end up depends on a number of variables, including the outcome of the U.S. and China trade negotiations the rate of growth for the U.S. GDP, actual 2018 earnings reports (currently being reported), and, more importantly, future guidance. Trade friction has weighed on stocks for nearly a year. A resolution during the first quarter would put the market on good footing. To help support our higher target for the S&P 500, we will be watching for U.S. GDP growth to be 2.5% or greater and earnings growth to be in the area of 5% to 6%, or more. This scenario should produce corporate earnings around $172 per share for the year. Earnings growth in the area of 3% to 4% would lower the target to 2750. The U.S. Federal Reserve's interest rate policy will weigh on sentiment. Most investors expect the Fed to hold interest rates steady during the first quarter/half of 2019. Increases early in the year may cause investor sentiment to weaken as concerns grow that the Fed may drive the economy into a recession in 2020. Rate increases later in the year, concomitant with positive corporate guidance on earnings, would likely be viewed as normal and necessary. Red flags for the market would be the yield curve inverting (short rates higher than long rates) and the 10-year U.S. treasury exceeding 3%. An inverted yield curve is generally a leading indicator of a recession. When rates exceed 3%, fixed income becomes a more attractive alternative to stocks. The price of oil will also impact investor sentiment and, thus, stock prices. Oil has dropped dramatically in price to around the $50 per barrel level. Further price declines would heighten recession fears and temper investor confidence for stocks. The ideal case would be for oil prices to stabilize and/or move modestly higher. Energy costs have a significant impact on the rate of inflation and their weakness is likely to hold the rate of recession below the Fed's target, making it easier for the Fed to hold steady on interest rates. The most bearish case for stocks would be earnings missing expectations and an elevated risk of an outright earnings recessions during 2020. Under this scenario, the S&P 500 hitting 2,500 could be quite possible as earnings decrease as do price/earnings, "P/E" multiples. The P/E multiple is best described as the price investors are willing to pay per dollar of earnings. We assign the greatest possibility to a scenario that pushes the S&P 500 over 3,000. As we begin the year, leading indicators for the U.S. economy remain positive. Current trade tensions give us pause, but it is in the best interest of all parties to resolve differences. Our concern is that President Trump's leadership falters and that the Chinese see it in their best interest to continue to resist a settlement under the current Administration. Investors are rattled but both corporate and consumer confidence remains positive. Stock valuations are considerably cheaper than at their peak during 2018, despite higher earnings. To hit the 3,000 plus level and to produce returns of 20% or more, investor confidence must be strong enough to pay up for corporate earnings. This will mean that any positive trends in 2019 must be seen as continuing into 2020. Higher investor confidence will expand the P/E ratio. A return to the 18x level attained in 2018 would put the S&P 500 at about 3,100. Similar to domestic stocks, foreign equities look equally attractive. Expectations for world growth have eased but valuations have improved. With the strength of the U.S. dollar likely to moderate, the upward path for foreign equities becomes easier. We remain underweight commodities. It's noteworthy that cash is becoming more attractive. Cash yields today are higher than dividend yields for about 60% of companies in the S&P 500. By year-end perhaps, we will be close to 3% for cash with zero volatility.

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"Helping Clients Balance Risk and Return"

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We also understand the relationship between risk and return and seek to reduce risk through targeted asset allocation among numerous asset classes. Each asset class has separate and distinct characteristics, including returns and risk that can be measured over time. While all classes are cyclical, they often trend in different directions. Two portfolios, each having similar return prospects, may have substantially different short-term risk characteristics. Clearly, the lower risk portfolio would be the choice of most investors.

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Support Your Charity and Save Taxes

The Tax Cuts & Jobs Act has nearly doubled the *standard deduction* and, as a result, most taxpayers no longer benefit from itemized deductions, including charitable contributions. However, there are still ways for retirees over 70 ½ to further reduce their tax liability, such as a Qualified Charitable Distribution (QCD). A QCD is a direct payment of required minimum distributions (RMD) from an IRA account to a qualified non-profit organization, thereby satisfying the RMD without adding the tax liability that comes with additional income. Meet the Smiths, a retired couple age 72 who own invest-

ment accounts, including traditional IRA accounts. The Smiths are passionate about charitable giving and plan donations of $10,000 in 2019. Should they make a QCD from an IRA account or make the donations from a bank account and itemize it as a deduction? If they can make the donations and remain under the new standard deduction of $26,000 for married couples filing jointly, they are not a candidate for a QCD. However, if after the donations they would no longer be able to take the standard deduction, a QCD should be considered. If they make a QCD, the $10,000 donation would not be considered income nor added to their adjusted gross income as an IRA RMD would. It will also be counted towards satisfying an RMD. Using this strategy, the Smiths still get their $10,000 donation and reduce their tax liability. A QCD is available to retirees who have a traditional IRA, SEP IRA or Simple IRA.

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