A Registered Investment Adviser

3rd Quarter 2018 Commentary

Stark Financial Advisers, Inc.

Special points of interest:

- Commodity Markets are Firming
- Emerging Markets Undergo a Stress Test
- Growing Deficits to Push Rates Higher
- S&P 500 Target Raised to 3,000
- Court Decision Could Cost You
- Fee-based Vs. Commission Pricing. Which is right for you?

Inside this issue:

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Overview

In this issue we discuss the improving outlook for commodity prices. We take a look at Emerging Market securities, their recent price decline, and outlook. We explore the effect of government spending on interest rates and take a deep dive into the economy and what it may mean for stocks. We comment on a recent Supreme Court decision that could impact you. And finally, we discuss an unseen consequence of the new tax law and how it effects the deductibility of certain investment expenses.

The Outlook for Commodities

While the outlook for commodities is improving we remain Underweight. According to the World Bank more than half of commodity prices (and all non-coal energy prices) are expected to increase in 2018 but four-fifths of them will remain below their 2011 peaks. Energy prices are forecast to rise 20 percent in 2018 and stabilize in 2019. Non-energy prices are projected to gain more than 4 percent in 2018 before they stabilize in 2019. The current forecast includes upward revisions of more than 2 percentage points for both 2018 and 2019 from the October 2017 forecast. If additional tariffs or sanctions are implemented, they could change the outlook for commodity prices in the short-term; however, their effect would likely unwind over the medium-term, as producers and consumers find new distribution channels, export markets or sources of finance. Oil prices are anticipated to average $65/bbl in 2018 and 2019 on robust demand and continued production restraint by OPEC and non-OPEC producers, notwithstanding increases in U.S. shale oil production. Higher oil prices are expected to eventually feed into higher natural gas prices while coal prices will continue to decline as energy demand shifts towards less polluting sources. Metals prices are projected to increase 9 percent in 2018 due to a further pickup in demand. An 11 percent decline in iron ore prices—reflecting stronger production, especially in China—is expected to be more than offset by projected increases in all other base metals prices. Nickel prices, in particular, are expected to remain 30 percent higher than in 2017, despite a slight moderation from their recent sharp rise, that reflect hopes for buoyant electric vehicle demand and the risk of Russian sanctions. Agricultural prices are forecast to gain 2.2 percent in 2018 and a further 1.3 percent in 2019. Grain prices and oils and meal prices are projected to gain 8 percent and 4 percent, respectively, in 2018, mainly due to lower plantings. A key policy risk is the introduction of countervailing duties on soybeans by China in response to U.S. tariffs.

Emerging Markets Down Not Out

Investors have been buying U.S. stocks again. Allocation to U.S. stocks has reached an overweight position for the first time in 15 months. The bloom appears to have come off the Emerging Markets and Developing Economies rose. The trade war is the most commonly cited tail risk, followed by the Federal Reserve or European Central Bank erring on the hawkish side, and worries about a euro or emerging markets debt crisis. These tensions are creating a "stress test" for foreign markets. Current weakness may be a buying opportunity as we believe some of the fears may be overplayed. However, you can't ignore the tape and caution is definitely warranted. According to the Institute of International Finance, foreign investors pulled out an estimated net $12.3 billion from emerging markets in May. Money has been coming out about evenly between debt and equity markets. Even emerging Asian nations that have been a favored location have taken a hit with net outflows for the first time since 2014. The question is "are the outflows deserved?" Goldman Sachs' research team sees the fundamentals "mostly intact" and the bank continues to focus on relative values. According to the International Monetary Fund, global growth continues to strengthen with the greatest growth forecast for the Emerging Market and Developing Economies. Total World Output for 2019 is forecast at 3.9%. Advanced economies such as the United States and the Euro Area are expected to grow at 2.7% and 2% respectively. Emerging Market and Developing Economies should outpace other regions growing at a 5%+ rate. The highest growth expected in Emerging and Developing Asia (6.6%). The countries forecast to grow at the highest rates include China, 6.6%, India, 7.8%, and the developing Asia region in general, 5.4%. It is interesting that China's stock market is near bear market levels and may explain why Goldman sees significant value and rates China "Overweight" Emerging markets might be down, but they don't look out. It's likely that the sector will continue to be volatile and see its share of back and forth, especially if trade tensions linger.

Rising Deficits and Interest Rates

America's budget deficit is trending higher while unemployment is moving lower. At least one investment bank (Goldman Sachs) sees this as troubling and forecasts the yield on the 10-year Treasury note to be 3.6% (Currently 2.84%) by year-end 2019. The deficit increase is due to the recent barrage of fiscal stimulus from Congress, including a $1.5 trillion tax cut approved in December 2017 and a $1.3 trillion spending bill aimed at keeping the government operating through the end of the fiscal year. The unemployment rate as of May 2018 was 3.8% and falling. The budget deficit was at $668 billion in 2017 and is expected, according to the Congressional Budget Office, to top $1 trillion by 2020. Since World War II the only times the deficit has risen while unemployment has fallen occurred during the Korean and Vietnam wars. Normally and expanding economy would reduce the deficit. This hasn't happened as government borrowing continues to grow. To meet the growing debt load, the U.S. will have to issue more bonds at a time when the Federal Reserve is no longer a purchaser. More supply and fewer buyers will mean the government will have to pay investors more to buy U.S. debt. And that means higher interest rates. With the level of debt to GDP expected to rise from 4% to an all-time high of 5.5% by fiscal 2021 the public with need to absorb considerably more government debt in coming years. To entice investors Goldman estimates that rates will need to rise 30 of the 60 basis points. Some of the increase in rates will come from anticipated fed tightening. The remainder from free market trading. A 3.6% yield could become problematic as a 3.5% bond yield is generally seen as the point that could begin to slow the economy and influence stock prices.

Strength in the Economy Favors Owning Stocks

Credit to the strength of a strong world economy, stock returns have been extremely strong in the post-Brexit period. Since mid-2016 according to Standard and Poor's have risen 35%. Only 5% of the increase has been driven by P/E expansion. The bulk of the rise has been due to positive fundamentals. The rally has been truly global in nature. For the same period, emerging markets have risen 41%, domestic equities 35.2% and emerging Africa and Europe 30.6%. Of market sectors, technology, finance and discretionary have been the best performers. Laggards include utilities, REITs, staples and telecom. U.S. economics have been more robust than other developed markets, but all areas have been expanding. The PMI (Purchasing Manager's Index) for May 2018 globally stood at 53.1 versus 58.7 in the U.S. A sign of strength in the economy is that companies have materially ramped up spending in recent quarters, an expectation of anticipated future growth. The ISM Manufacturing Index (an Index tracking corporate capital expenditures) stands above 50. At this level economic contractions are highly unlikely in the subsequent 12 months. Industry sectors dominating the recent increase in capital expenditures have been technology, energy and discretionary. As a group they comprise over 75% of total spending. Also supporting a strong economy are consumer confidence readings. Both small business and consumer confidence point to continued economic health. While the current economic expansion is one of the longest in history, it is also the slowest. This should naturally extend the cycle. Rising interest rates are a risk but they are not forecast to reach recessionary levels. The futures market implies that the yield curve will flatten with the 2-year treasury note currently trading a 2.5% rising to 2.71% by year-end 2018. The 10-year is also expected to rise, (but at a rate slower than the 2-year) to 2.99% from 2.92%, thus flattening the curve. While the yield curve has flattened over the past several years it remains 40-45 basis points steep. Stock returns have been strongest when the curve is 0-100 bps steep. Historically, when the 10-year rate is below 5% the market has rewarded rising rates. History suggests that valuations should rise until yields hit 3.5%. Earnings trends remain positive. Reported earnings have been sparkling and companies have been rising guidance. Revenues and earnings are projected to remain strong throughout 2018-19. Volatility has risen. There have been far more 1% moves in 2018 than in all of 2017. For example, during February concern over inflation and rates caused a volatility spike. In March, Tech and traded spooked the market. Look for increased volatility to continue. The key takeaways from the expectation of a strong economy are 1) corporate earnings will continue to rise (estimate 18.8% in 2018), 2) P/E multiples are likely to expand (from 16.6x to 17x+), and 3) the outlook for stocks remains positive with the risk favoring being in the market. 2018 year-end target for the S&P is 3,000.

Decision Hurts Consumers and Online Retailers

A closely divided Supreme Court ruling that states can collect sales taxes from most online retailers. The ruling will boost state revenues at the expense of consumers and sellers. In our opinion it's a bad ruling and should have been left to Congress. Surely high tax states such as New York, New Jersey, and California will implement the tax. It becomes one more tax burden for already overtaxed residences and will be another reason for the population to migrate to lower tax states. Sellers could also suffer severe damage. Online retailers could face some 12,000 local tax jurisdictions. The typical retailer on eBay sells between $10,000 and $500,000 annually, with customers in more than 300 tax jurisdictions. Etsy's sellers are even smaller: Nearly eight in 10 are sole proprietors, nearly nine in 10 are women, and nearly all are based in homes. Average annual sales: $1,710. Greatest harm will be inflicted on small retailers as the compliance costs will be significant. Larger retailers will be less affected as most of the top 20 sellers already collect taxes in nearly all states, either because they have added local showrooms or warehouse, or because of state laws. Bottom line, this decision could detract from E-commerce's significant and vibrant part of our national economy.

About Stark Financial Advisers

Stark Financial Advisers is a registered investment adviser affiliated with R.M. Stark & Co., Inc., an SEC registered broker dealer. SFA seeks to achieve positive returns over a long-term investment horizon by creating and maintaining the optimum portfolio for each investor. We view the optimum portfolio as one having the highest potential return consistent with the risk tolerance and investment horizon of the owner.

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.

Of course, all investments contain risk and there is no guaranty of positive returns; losses can occur. For additional information and a complete performance history, please visit www.starkadvisers.com.

Fee-based Vs. Commission Pricing

Now is the time to refocus on how you pay your investment fees. In a little-noticed move, the recent tax overhaul repealed a deduction for investment-advisory fees. Before the change, fees paid for investment advice or to cover transaction costs could be deductible as "miscellaneous" expenses on Schedule A of the tax return. Now, they aren't deductible at all. To be sure, there were hitches to getting the tax break. One was that total expenses were only deductible to the extent that they exceeded 2% of a filer's income. In recent years, the trend has been toward fee-based accounts rather than commission-based accounts. Many brokerage firms offer commission-based and fee-based pricing for both taxable and tax-deferred accounts. Between 2010 and 2016, the percentage of total investment assets in fee-based accounts climbed to nearly 39% from just more than 30%. The end result is that under current law, payments to advisors who are compensated via commissions can be made on a pre-tax basis but paying advisory fees to advisors in lieu of commissions are not deductible. While commissions are not directly deductible, they do increase your cost basis upon purchasing a security and reduce your proceeds at sale. This lack of parity between commission and fee-based compensation is an unintended consequence of the law and it's possible that Congress will ultimately intervene. In the meantime, commission-based pricing may be the best pricing option for most taxable accounts. Since fees charged to retirement accounts such as IRAs are made on a pre-tax basis in the first place, the lack of parity between commission and fee-based pricing is not an issue. To the extent possible additional fees such as IRA advisory fees and IRA account maintenance fees should be paid from within tax deferred accounts. Each individual's situation varies so it is important to understand what investment related expenses you are paying and your payment options. You may wish to review your situation with your tax advisor. The goal is to develop the most tax-efficient pricing structure that will result in the greatest after-tax return.

As always, the professional staff at Stark Financial Advisers thanks you for your confidence and business

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