Making Sense of Finance

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Third Quarter 2019 Review

STOCK MARKET

The stock market again experienced a volatile third quarter, similar to the previous quarter. Stocks rose in July to all-time highs, only to take a tumble in August and rebound in September. After all of the ups and downs, the S & P 500 managed to register a gain of 1.2% last quarter. The Dow Jones Industrial Average performed similarly, however the Nasdaq Composite Index posted a slight loss in the third quarter. Coincidentally both in July and September the Federal Reserve cut the Fed Fund target rate by 25 basis points; the same months that stocks rose. Was that a knee jerk reaction by investors to the idea of the Fed signaling that they will do what they can to prolong this economic expansion? Perhaps. The other gorilla in the room is the ongoing trade war with China and the worry that this won't get resolved in the near future. Always something to worry about but a backdrop of low to negative earnings growth has contributed to investors' uneasiness.

Interest rate sensitive sectors (utilities and real estate investment trusts) were the two best performing stock groups last quarter as interest rates, especially on the long end, declined considerably. Utilities and real estate stocks benefit in two ways from lower interest rates: their dividend yields are more appealing compared to lower bond yields and both types of companies typically have large amounts of debt and therefore borrowing costs can be less in a lower interest rate environment. Technology stocks outperformed the overall market last quarter and are the leading performers year to date. For the second quarter in a row energy stocks lagged the overall market, and as a group declined over 7% in the third quarter as the price of oil decreased 6%. Healthcare stocks also declined in value as worries continued regarding what the future of healthcare in the US will look like after the elections of 2020.

Foreign markets had mixed results for the third quarter in local currency terms. However, as measured in US dollars, the majority of foreign stock market indices posted losses due to the strength of the US dollar. The exception being Japan; even though the yen had a slight decline against the dollar last quarter, Japanese stocks posted solid gains in terms of yen and US dollars. Hong Kong stocks were notable losers as trade tensions continued with the US. The German stock market also did not fare well given the weakness in their economy. The Brexit deadline of October 31st looms over the British markets, as those stocks were essentially flat last quarter while the British pound declined 3%. Emerging market stocks didn't perform well in the third quarter for the most part. Argentina saw their stock market decline by 47% in the quarter! Emerging markets tend to mirror and magnify what is happening in the global economies of developed countries, but also reflect their own

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Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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exclusive political and economic circumstances.

BOND MARKET

Bonds outperformed stocks last quarter; the Bloomberg Barclays Aggregate Bond index had a total return of 2.3%. Yields declined across all terms; the longer term and higher quality bonds had the highest returns for the quarter. Municipal bonds, though posting positive returns in the third quarter lagged taxable bonds. Foreign bonds declined in value, again due to the strengthening dollar.

The yield curve continues to be inverted. A 3 -month Treasury bill ended the quarter yielding 1.88% versus a 10 Year Treasury Note yielding 1.68%. The 30 Year Treasury bond hit an all-time low yield during the quarter of 1.94%. Investment grade bond yields also are near record lows. These yields are a far cry from the yields of 25 years ago. In 1994, you were able to invest in a 10 Year Treasury that yielded over 7%, at the same time inflation for the year was only 2.6%. Receiving 4% after taking into consideration inflation on a "safe" investment is every retiree's dream right now. However, that is not today's reality and with the Fed still cutting interest rates, it doesn't look like we will return to an attractive "real" return on a Treasury bond anytime soon. Our economy is increasingly tied to the world as corporations become more global in their revenue sources. Other foreign government entities have been cutting their interest rates to stimulate growth in their respective economies. Nearly $16 trillion in debt globally has a negative yield. Central banks, not only the Fed but overseas, engage in quantitative easing policies (purchasing of bonds to keep interest rates low as an economic stimulus). The question is how low will they go and will cutting interest rates make a difference anymore. Like everything else, it is not easy sustaining that perfect balance between low interest rate and having a healthy traditional yield curve and have what some like to call, a "Goldilocks" economy.

OUTLOOK

If you've been reading this newsletter for the past eight or nine years you'll notice that we have been bullish on equities the entire time and been proven right. We are now in the longest economic expansion in the history of the country, stretching past a decade. Every pundit who has predicted the end of the world has been wrong. Oh, it can happen, but if it didn't happen in their specified time frame; then sorry, it doesn't count. If they predicted a recession or market crash in 2014, 2015, 2016, 2017, 2018, 2019, and now 2020 and eventually get it right, then you are just like a broken clock being correct twice a day. We still do not see any obvious bubbles. We noted crypto currencies a few years ago which expectedly imploded but have recovered somewhat in the last 18 months, but otherwise, the only thing we are really worried about are rising consumer debt levels. Despite a fairly dismal global economy, the US economy is a shining beacon. Imagine if the rest of the world wasn't dragging U.S. company's profits down.

We want to remind our clients that we absolutely do not try to time or predict the market, but we still go through the mental exercise of seeing every possible scenario. At the end of the day, the government can only do so much to reverse a recession. Given that we are already at near historic low interest rates, lowering rates further becomes less effective should we actually need some kind of stimulus for the economy, in our opinion. The strong stock market performance in 2017 can be attributed to the lower corporate tax rates from the Trump administration. We think it is unlikely that the American public would allow even more tax cuts there. The sentiment seems to be for higher taxes on personal income not lower, so that looks limited too. Government spending is already heading in the wrong direction and even higher deficits could be good for the next few economic cycles, but eventually one hits a tipping point and the country will have to pay back debt. It should be pointed out that deficits by themselves are not necessarily detrimental. Germany, the fourth largest economy in the world, had a record budget surplus in 2018, yet their economy continues to weaken and is one fiscal quarter away from a possible recession. As usual, a balance of spending and responsible budgeting is probably the key to success.

That said, we think there could be a mild recession looming in 2020 and because of the lack of weapons to combat it, the economy could stay in a limbo, neutral state for a protracted number of months or maybe even years. Then again, if the world economy starts picking up again, this could lift the USA to new highs. To reiterate, we don't know where things are going in the short term, but we are confident that ownership in great companies (stocks) is the way to go. The current 30-year Treasury rate stands at just over 2% now. Do you think that companies like Disney, McDonalds, Google, Microsoft, can't do better than 2% per year over the next 30 years? I think they will exceed this. Furthermore, if interest rates do go to zero or even negative, won't the companies issuing this debt benefit even more? Real estate…? It's a great inflation hedge because land doesn't naturally degrade but put a building on a piece of land and you can get higher rents too. The historical rate of inflation is over 3%, so just as an inflation hedge, real estate would do 50% better than that 30-year Treasury. The world is only getting more crowded, after all. Worried about political scandal? There doesn't seem to be anyone more polarizing than President Trump, yet year to date the stock market is up nearly 20% (as of 10/12). How about Bill Clinton? During his impeachment the stock market was up 28%. Richard Nixon in 1974? Well, that was a bad year, down 25.9% but due to the economy already being in a deep recession from the Oil Embargo. Having no oil and gas has real detrimental effects on an economy. However, the very next year the S&P 500 was up 37% and in 1976 it rose another 23.8%. When economic fundamentals are solid, it pays to buy on the dips.