The COMPASS Chronicle

Winter 2020

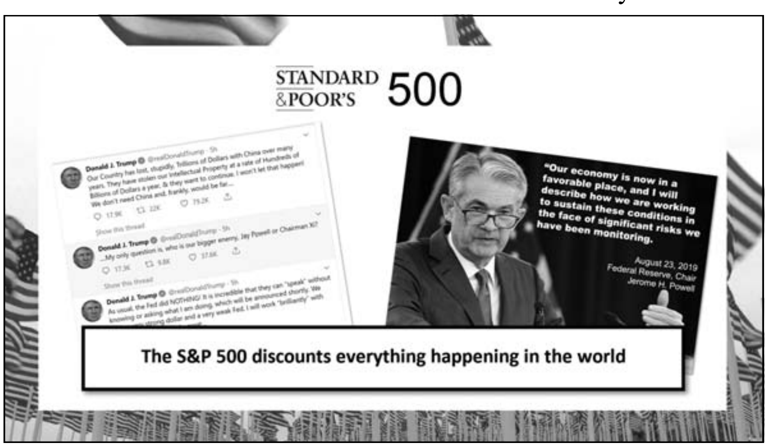
Highlighting important wealth management issues

The Reality Gap Widens

Stocks have been more volatile because the difference between perception and reality of financial economic conditions is growing wider.

The S&P 500 — the key benchmark of America — is supposed to price shares after discounting everything — the Federal Reserve's policies, politics, inflation, and population trends.

When fundamental facts grow harder to discern, stocks grow more volatile, and that's what has been happening lately, especially with the widespread misperception of the yield curve inversion in 2019.



A yield curve inversion is when the yield on 10-year US Treasury Bonds is less than the yield on three-month T Bills.

Since the 1960s, when investors thought the 10-year long term outlook for bonds looked worse than the three-month outlook, inverting the yield, recessions usually followed 12 to 18 months later.

While the recent inversion of the yield curve is perceived as evidence a recession is on the way, the reality is very different.

The inversion of the yield curve was driven by negative interest rates in Europe.

Negative yields in Europe and Japan — an unprecedented condition in the largest economies in the world — is a new thing and it's not widely understood.

Bond yields are set in a global market, and the U.S. and Germany supply globally-traded, highly-liquid, government-guaranteed securities owned by the world's largest financial institutions.

Because yields in Europe have been kept low by European central bankers to stimulate growth — and another round of quantitative easing is planned — it has

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COMPASS Corner

Louis E. Conrad II, CFA®

Stocks across the world finished 2019 on a strong note, despite lingering economic concerns. Trade issues continued to plague markets and global manufacturing was showing signs of weakness, but the U.S. consumer remained confident as the unemployment rate reached new lows.

U.S. stocks generally led, with the Russell 3000 Index, a broad measure of U.S. stocks, gaining 9.1% during the fourth quarter and 31.0% for 2019 overall. The growth-oriented technology sector was the strongest performing sector by far for the quarter and the year. Though they lagged U.S. stocks, overseas stocks, as represented by the MSCI EAFE Index, enjoyed solid returns with a total return of 8.2% during 2019's fourth quarter and 22.0% for the year.

During the fourth quarter, the income derived from bonds was generally offset by their decline in price as interest rates rose. The yield on the 10-year U.S. Treasury finished the year at 1.92%, 0.25% higher than at the beginning of the fourth quarter. Consequently, the return for the Bloomberg Barclays U.S. Aggregate Bond Index was just 0.2% during the final three months of 2019, though the return for the year was 8.7% due to the general decline in interest rates over the period.

COMPASS has reduced risk in client portfolios as a hedge against a possible recession as the current U.S. economic expansion is the longest in the post-World War II era.

Three Major Investing & Tax Planning Trends For 2020

No one can predict the future of markets, but spotting major new trends in personal financial planning is quite doable. Here are three important new trends to consider in managing your wealth in 2020.

Delaying Distributions Until Age 72. Postponing required minimum distributions (RMDs) 18 months is a new thing you want to consider. The SECURE Act, which was signed on December 20th, 2019, delays RMDs on IRAs and other federally qualified retirement accounts from age 70½ to 72. This small change can amount to big bucks because your IRA can compound without being taxed for an extra 18 months. Deferring taxes 18 months on a large IRA is a no brainer, if you can afford it. This step in your retirement income plan should be part of your overall strategy to not outlive your money and create a legacy for your family.

New Retirement Income Planning Choices. The Setting Every Community Up for Retirement Enhancement Act of 2019 will enable more lifetime income annuities to secure retirement. This will be good generally, but there is one huge caveat: annuities can be expensive. Lifetime income backed by an insurance company's creditworthiness makes for a great sales pitch but are best advised on by a professional who places your best interest above all else, including their sales commissions.

2% U.S. Growth & Low Rates. The latest indication of what to expect on interest rates and economic growth came on December 17th, 2019, in an interview with Robert S. Kaplan, President and Chief Executive Officer, Federal Reserve Bank of Dallas. "We expect, again, 2%-plus growth, 2% growth for next year, unemployment rate around 3.5%," Mr. Kaplan told the Council on Foreign Relations. "We'll have some firming in inflation gradually toward 2%.And I think with that profile, I think the right—at 1.5% - 1.75% fed funds rate—I think the right thing for us to do is stay right where we are unless something changes materially on the upside or the downside." In addition, on December 11th, the Federal Reserve released its latest expectations for growth, inflation, and unemployment for 2020, which are highlighted in the chart.

Economic Projections Of Federal Reserve Board

December 2019

Percent

Variable	Median[1] 2019	2020	2021	2022	Longer run	Range[3] 2019	2020	2021	2022	Longer run
Change in real GDP	2.2	2.0	1.9	1.8	1.9	2.1–2.3	1.8–2.3	1.7–2.2	1.5–2.2	1.7–2.2
September projection	2.2	2.0	1.9	1.8	1.9	2.1–2.4	1.7–2.3	1.7–2.1	1.6–2.1	1.7–2.1
Unemployment rate	3.6	3.5	3.6	3.7	4.1	3.5–3.6	3.3–3.8	3.3–4.0	3.3–4.1	3.5–4.5
September projection	3.7	3.7	3.8	3.9	4.2	3.5–3.8	3.3–4.0	3.3–4.1	3.3–4.2	3.6–4.5
PCE inflation	1.5	1.9	2.0	2.0	2.0	1.4–1.7	1.7–2.1	1.8–2.3	1.8–2.2	2.0
September projection	1.5	1.9	2.0	2.0	2.0	1.4–1.7	1.7–2.1	1.8–2.3	1.8–2.2	2.0
Core PCE inflation[4]	1.6	1.9	2.0	2.0		1.6–1.8	1.7–2.1	1.8–2.3	1.8–2.2	
September projection	1.8	1.9	2.0	2.0		1.6–1.8	1.7–2.1	1.8–2.3	1.8–2.2	
Memo: Projected appropriate policy path										
Federal funds rate	1.6	1.6	1.9	2.1	2.5	1.6	1.6–1.9	1.6–2.4	1.6–2.9	2.0–3.3
September projection	1.9	1.9	2.1	2.4	2.5	1.6–2.1	1.6–2.4	1.6–2.6	1.6–2.9	2.0–3.3

Source: Federal Reserve release December 11, 2019.

Strategic tax and financial planning can boost an individual's retirement fund year after year but requires personal attention from a qualified professional. ●

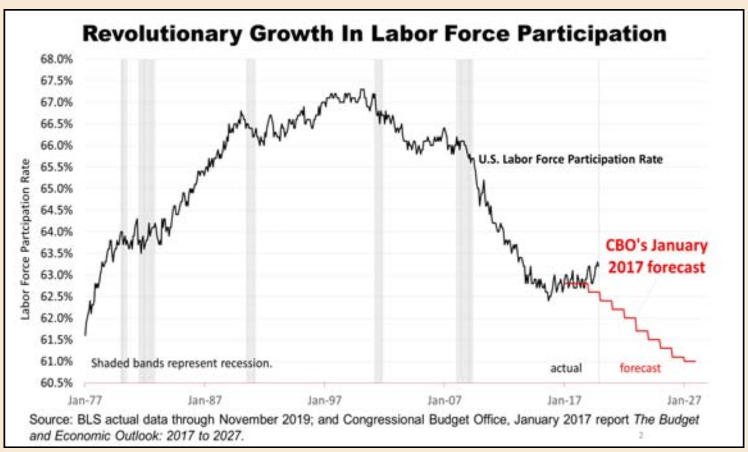
Boomers Working Past Age 65 Are A Surprise Boost

Americans over age 65 are staying in the labor force more often than expected, brightening the U.S. economic forecast and the outlook for U.S. stocks.

It turns out that the offspring of The Greatest Generation, those who served in World War II, deserve respect too. Baby boomers are characterized by a strong work ethic and they are electing to work longer than government experts expected. Boomers are a key reason the economy continues to grow even as the labor market has tightened.

The Congressional Budget Office's long-term growth forecast did not count on so many boomers working past age 65. With new jobs continuing to be filled by a larger than expected number of workers in the 65-plus age group, U.S. GDP (gross domestic product) is benefitting from an unexpected boost, and it's no small thing.

Labor force growth is a key fundamental in math economics: total growth of the U.S. economy is the product of the labor force growth rate and productivity growth. The unexpected addition of workers in the labor force improves forecasts for economic growth



Source: BLS actual data through November 2019; and Congressional Budget Office, January 2017 report *The Budget and Economic Outlook: 2017 to 2027.*

Education Tax Credits Primer

The American Opportunity Credit (for college students) and the Lifetime Learning Credit — for undergrad, graduate and vocational students — are the two education tax credits available from the federal government. Students can claim either of the two credits for schooling costs, or their parents can — provided they don't opt for married filing separately.

Even if you paid education costs with a student loan, you are eligible to take these credits. You can claim both benefits on the same return but not for the same student or the same expenses.

The benefits aren't huge, but a tax credit reduces your tax bill dollar for dollar, making it much more valuable than a mere deduction. Some key details about the two credits:

American Opportunity Tax Credit (AOTC)

Worth up to $2,500, you can take the AOTC credit if you paid at least that much in undergrad education expenses in 2019: tuition, fees, books and equipment. Expenses not included in the qualifying formula: transportation, living and medical expenses.

With a credit, should you owe $4,000 in taxes, then you need to pay just $1,500 to Uncle Sam.

What's more, this benefit is better for college students than the lifetime credit because it is refundable. Meaning, if the amount of the AOTC exceeds the tax you owe, then up to 40% of the credit (to a maximum of $1,000) will be refunded to you.

You can claim the credit for up to four years. Parents take the credit if they ponied up for a student's education costs and the student is listed on their tax return as a dependent.

It does have income limits: To get the full credit, your modified adjusted gross income (MAGI) must be $80,000 or less, and $160,000 if you're married filing jointly. You get a reduced benefit if the MAGI is up to $90,000, or $180,000 if married filing jointly.

MAGI is the total of your household's adjusted gross income — income minus deductions — with any tax-exempt interest income added back.

Lifetime Learning Credit (LLC)

This one is worth a little less, $2,000, and there's no ceiling on the number of years you can take the LLC. That's why it makes great sense for a grad student, who faces years of course work. Ditto for someone who goes back to school to develop new aptitudes, even if the person took the AOTC in previous years.

Like the AOTC, the LLC also doesn't cover living expenses, medical care or transit, but does allow you to claim supplies and books that the school requires.

The MAGI ceilings are a little lower than with the AOTC. Namely, $57,000 for singles and $114,000 for marrieds for the full benefit, and $67,000 and $134,000 for the reduced credit. Another downside: The LLC doesn't have a refundable feature.

The real cost of education has risen for decades, and these two federal tax credits are a single instrument in a strategy to pay for private school or college costs. For information about other tax breaks and advice on strategically planning to finance education, call our office, as financial and tax planning are highly dependent on your personal situation. ●

in the years ahead.

Historically, the economy is unable to continue to create new jobs because we run out of people to fill them. Newly-created positions drive wages higher, increasing inflation, and then the Federal Reserve makes a monetary policy mistake, which results in two consecutive quarters of shrinkage in economic activity, aka, a recession. But these times are different.

This chart captures a snapshot of Americans choosing to continue working past age 65 more often than expected by forecasters. The Congressional Budget Office, a federal agency widely recognized as an authoritative non-partisan source, in January 2017 forecasted a decline in the labor force along the lines in red. The stair-step decline in the labor force that the CBO expected is not happening! The labor force participation rate has continued to grow since 2017, when it was expected to flatten and start a long decline, and no one is certain how long the trend will continue.

The labor force participation rate is reflecting the improved longevity of Americans, which the CBO economists did not figure on in their estimates of the future. If the trend since 2017 were to continue, the U.S. labor force could contribute a totally unexpected boost of growth in consumer spending in the years ahead, and consumers account for 70% of GDP. Higher consumer spending boosts earnings of corporate America and that's good for stocks. ●

The Fed Cut Rates Three Times in 2019; What's Next?

The Fed reduced the federal funds rate three times in 2019. What does it mean to your long-term financial plan?

The rate cuts are a reversal in policy and not what the Fed had expected to do, which is worrisome because the Fed has contributed to every recession in modern U.S. history by making a policy mistake. However, admitting its previous financial plan had been wrong, the Fed's abandonment of its earlier forecast, that inflation was a danger, is encouraging.

Federal Reserve policy has grown far more responsive to economic fundamentals and market sentiment. Former Fed Chair Ben Bernanke, who had studied financial crises for decades before becoming the nation's top central banker, was the right person to guide the economy when the global financial crisis occurred in 2008. He implemented policies never-before tried in a major world economy. His successor, Janet Yellen, a labor economist, who fatefully had spent her professional life studying how to increase employment, continued Mr. Bernanke's quantitative easing plan and deftly extended the expansion.

Although opinions about the direction of interest rates or stock prices in the next year or two will always vary, it is clear that the Federal Reserve has made progress in achieving its dual mandate to promote employment and control inflation. The Fed — led by Jerome Powell and backed by a deep team of the world's best minds—has abandoned its long-held forecast for a 2% inflation rate—and in admitting its mistake when it raised rates in December, 2018, its change of policy should be viewed in the context of the Fed's progress. The third interest-rate cut of 2019 signaled that the Fed is no longer worried about inflation and determined to defend the 10½-year long expansion in 2020 and beyond, even if it means admitting it made a mistake and is changing course. The Fed expressed that its change of course during 2019 was an insurance policy in response to decelerating global growth. While welcomed by the capital markets, the move also abandoned its commitment to be data dependent. ●

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depressed yields on long-term U.S. Government bonds.

That's a market problem, a "technical" issue of supply and demand of government bonds, and investors will want to consider the effect of lower returns on their bond allocations in the years ahead.

However, this inversion is not a fundamental economic problem!

It won't cause a recession, though it has led to a widespread misperception about current economic conditions.

The underlying cause of negative yields in Europe is its aging labor force which is an important fundamental trend affecting Japan and China as well as Europe.

A nation's economic growth potential is a simple equation, driven by the size of its labor force — the working age population — and its rate of productivity.

The working age population trends in China, Japan, and Europe, the world's largest economies after the U.S., are unfavorable relative to the United States.

GDP growth potential in Europe is limited by its aging working population.

To increase growth in Europe, China and Japan in the face of this demographic headwind would require higher productivity but productivity gains are hard to plan.

The U.S. has favorable long-term demographic prospects compared to the world's major economies.

The baby boom peaked from 1957 to 1961, and peak retirement for the boomers will occur from 2022 to 2026; then, growth in the working age U.S. population picks up.

Although you often hear that the next generation of Americans won't have a standard of living comparable to ours, the U.S. demographic trend compared to the other developed economies — Europe, Japan and increasingly China — is very favorable.

The U.S. has a large echo boom population coming — and they don't.

This fundamental driver of economic growth is one reason why the U.S. will likely continue to be a magnet attracting foreign investment capital in the years ahead.

As markets continue to piece together the puzzle driving financial economic reality, expect stock market volatility. ●

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