Wimmer Associates

Quarterly Report

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Letter from Kathy

Dear Friends:

We want to bring you up to date on how the markets and the economy have been faring through the first six months of the calendar year. With significant developments bringing added volatility since the end of the second quarter, we will conclude this missive with commentary encompassing the US-China trade standoff, the seizing of oil tankers in the Strait of Hormuz and Gibraltar, the disturbing situation in Hong Kong, and Brexit. But first, let's start with the good news.

The first three months of 2019 saw the broad-based S&P 500 index rise 13% (the highest equity return since 1998), while the second quarter ending June 30, 2019 provided a 3.8% gain, giving a 17% total return year-to-date! The ten-year Treasury bond closed the second quarter at a 2% yield, down 0.5% from the end of March. The low interest rate environment encourages investors to shift their holdings to equities from fixed interest bonds in order to keep ahead of inflation. We credit the continued strength of equities in 2019 to a number of factors. Principally, the Federal Reserve has signaled that it intends to remain "accommodative", meaning it is likely that the central bank will lower interest rates in the coming months in order to prolong what has been the longest economic expansion in US history (over 121 consecutive months). One must temper this remarkable fact by noting that the actual growth rate during this prolonged expansion has been a muted 2% annual growth rate, compared to the typical 3-4% average growth rate after recessions. Nonetheless, the ongoing recovery from the Great Recession is good news for the economy and the stock market.

There are significant signs of headwinds to the global economy, with Germany, Italy and Britain showing indications that they may already be in the throes of recession. In the United States, the economy is still growing, while at the same time the rate of growth is slowing. For example, the US GDP growth rate fell nearly a third in the second quarter, to an annual 2.1% annual gain, compared to 3.1% increase in the first quarter. We are in the longest economic expansion ever registered (since records have been kept) and we continue to believe that we are still a way off from the next recession. We share our thoughts below and wish you a blissful end of summer.~

Cordially,

Kathy Wimmer, CFA, CIC
President

Key Facts for 2019

- *Annual gift exclusion $15,000*
- *Estate, gift and generation-skipping tax exemption $11,400,000 per individual*
- *Highest marginal estate tax rate 40%*
- *IRA contribution limits $6,000, plus another $1,000 for those over fifty*
- *SIMPLE IRA and 401(k) contribution limits $13,000, plus another $3,000 for those over fifty*
- *401(k) contribution limits $19,000, plus another $6,000 for those over fifty*
- *SEP IRA contribution limits 25% of compensation, max of $56,000*
- *Top Federal tax rate is 37% on income over $510,300 (single filers)*
- *Top Federal tax rate is 37% on income over $612,350 (married filers)*

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SECOND QUARTER 2019

As noted in my letter, the second quarter of the year saw the broad-based blue chip index, known as the S&P 500, add 3.8% to its stellar first quarter performance, giving a year to date return of 17%. This is the best start of the year for equities since 1997! We attribute the strong second quarter performance to a brief pause in the US/China trade skirmish, in hopeful anticipation of an accommodation between Xi Jinpeng and President Trump at the G-20 Osaka summit. While the superpower leaders did not make progress in moving trade talks forward in Osaka, investors breathed a sigh of relief that both the US and China negotiated a temporary ceasefire on tariffs, which opened up the possibility for more substantive discussions going forward. The second major factor bringing cheer to investors was the perception that the Federal Reserve would back off on their planned rate hikes for 2019 and, in fact, reverse stated policy and lower rates. Indeed, the Fed decreased the Fed Funds rate at its July 19th Open Committee Meeting, due to a general assessment that the US economy was slowing amidst a weakening global outlook.

According to FactSet, S&P 500 companies are indicating annual revenue growth of 4.1% in the second quarter, while earnings are projected to decline by 0.7% during the same period. Large US multinational companies are facing dual headwinds of trade protectionism abroad and a strengthening US dollar *vis-a-vis* weakening foreign currencies. It should be noted that tariffs on materials increase input costs to US manufacturing and lower profit margins for sellers. This helps explain why revenues are higher in the second quarter, while earnings are lower on trimmed profit margins.

The equity markets continued to reward "growth" over "value" stocks as the S&P Infotech index climbed 5.6% in the second quarter, giving a 26% year to date overall return. The Russell 1000 Growth Index was up 21% for the first six months of 2019, while the Russell Value Index has lagged, but still climbed 15% during the same period. The new S&P Communications Index, which includes social media titans such as Facebook, Twitter and Google, climbed 4.2% in the second quarter, giving a half year return of 26%. As famed venture capitalist Mark Andreesen wrote some eight years ago, "Software is eating the world." To wit, Amazon's software replaced Borders Bookstore, Netflix streaming products eviscerated Blockbuster VCR rentals, while iTunes, Spotify and Pandora have disrupted the major label record companies. Google Maps provides the software and GPS coordinates so Uber and Lyft can bundle passengers from one locale to another, while UPS and FedEx direct packages worldwide through a global network driven by software. Historically, investors have swayed between "growth" and "value" stocks, but growth seems to be taking a persistent lead at this juncture. Sentiment, however, may shift as investors seek out companies with steady dividends and lower volatility when stock markets swoon, as they inevitably do. A balanced portfolio is usually the safest choice.

While US GDP slowed to an annual rate of growth of 2.1% in the second quarter, down from 3.1% in the first quarter, there is much good to say for a "slowing but growing" economy. The US economic expansion is the longest on record since 1854, when economic statistics were first kept, according to the National Bureau of Economic Research (NBER). In contrast, the UK saw GDP decline 0.8% in the second quarter amid the uncertainty of a hard "Brexit", i.e., Britain leaving the European Customs Union (ECU) without a trade deal. Germany's export driven economy stumbled in the second quarter as the country is especially sensitive to the slowdown in China, the potential fallout of a chaotic Brexit, the retooling of the domestic auto industry to meet tighter emissions standards and the fear of threatened tariffs on car exports by the United States. Elsewhere in Europe, Italy's GDP recorded zero growth in the second quarter and France saw its economy slow to only a 0.2% gain in the same period. France's *gilets jaunes* (or yellow vest protestors) have disrupted commerce in France's major cities and have demanded, and been granted, extra deficit spending from the Macron-led government.

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The US unemployment rate edged up to 3.8% in June, compared to the historically low rate of 3.7% in May of 2019, as the labor participation rate expanded, bringing in workers who had previously dropped out of the labor force. An expanding workforce is positive, because it means workers who had previously given up looking for employment have ventured back to the job market by the allure of greater wages and benefits. Wages were up 3.1% year over year as of June 30, 2019, a result of employers having to

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incentivize the existing work force and attract new employees in a tight labor market. There are currently more job openings than job seekers in the United States!

As noted in our introductory remarks, the yield on ten-year Treasury notes fell 0.5% quarter-over-quarter, to 2.0% at the end of June. It has subsequently fallen further to 1.6%, as we go to print. With geopolitical turmoil on multiple fronts, investor anxiety over trade protectionism and a slowing global economy, domestic and foreign US equity holders are reducing their exposure to US stocks and making a "flight to quality" by buying US Treasury bonds, the debt backed by the "full faith and credit" of the United States government. The strong demand for US Treasury debt from at home and abroad has the untoward effect of raising the value of the US greenback and makes it harder for domestic manufacturers to export their goods. The strengthening US dollar also has the net effect of lowering the real price of oil, because "black gold" is priced in US dollars. Add in tensions in the Middle East and fears of a slowing global economy and we have seen the US dollar price of oil fall 2.8% quarter-over-quarter at the end of June.

US manufacturing remained positive in the second quarter, but declined for the third month in a row at the end of June. The Institute of Supply Management's Producers Manufacturing Index (PMI) tallied a 51.7% reading, substantially down from the January reading of 56.6%. Anything over 50.0 is a sign of an expanding industrial base in the United States. However, the downward arc of the PMI Index is concerning.

Reasons for Concern

Financial pundits have been sounding a warning of an impending recession for months now. Inevitably, there will be a recession, which is a normal aspect of the business cycle. A recession is usually defined as two consecutive quarters of declining GDP (negative economic growth). Some believe that declining equity prices can signal recessions. But, the noted economist, Paul A. Samuelson, joked famously in 1966, that "The stock market has predicted nine out of the last five recessions!" A more accurate predictor than the stock market, the inverted yield curve for bonds has predicted eight out of the last seven recessions. An inverted yield curve occurs when short-term interest rates exceed long- term interest rates. The two-year Treasury note has only recently overtaken the ten-year note in yield for a single day. Economists need to see an inversion of the yield curve that lasts for a quarter or two before prognosticating a recession. Even with a couple of quarters of interest rate inversion, there is usually a sixteen-month lag between the interest rate inversion and the onset of recession. It is worth noting that equity returns often appreciate before and during a recession.

Consequently, we advise against pulling investments out of the stock market in anticipation of a recession or perceived market downturn. Several classic investment maxims are now especially applicable: 1) No one can consistently pick tops and bottoms of the stock market; 2) Time spent in the market is more important than timing the market. 3) If one missed out on just ten of the best days of market returns from 1980 to 2018, equity appreciation would be reduced by 50% (Source: FMRco.)

We attribute much of the recent volatility in the markets to inconsistent or poor policy choices, both domestically and abroad. It seems one day the US Administration is imposing new tariffs on Chinese imports and then the next day backs off to ensure a blissful Christmas shopping season for the US consumer. On the flipside, the Chinese government initially agrees to fair trade concessions, only to renege on their assurances at a later date. The UK and the EU are also bereft of sound policymakers, as both Britain and the Euro-Continent hurl towards a messy Brexit, without a trade deal, which will sunder supply chains built up over decades.

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We strive to optimize our clients' financial well being by coordinating investment decisions with other professionals in the fields of taxation and estate planning.

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This past December, the Federal Reserve increased the Fed Funds Rate and signaled that three more rate hikes were in the works for 2019. At the end of July, however, the Fed instead reduced rates and indicated one or more rate cuts look likely this year.

Moreover, we see the Bank of Japan (BOJ) and the European Central Bank (ECB) manipulating negative interest rates, which weakens the Yen and the Euro in relation to the dollar, and thus gives those countries an unfair currency advantage versus the US. As a matter of sound financial policy, central banks and treasury departments should not be manipulating the value of their currencies in "beggar thy neighbor" strategies, which are invariably counter-productive. The problem with competitive currency devaluations is that it can lead to a race to the bottom, where no one knows how it will end.

We think Europe, China and Japan are seeing a slowdown in economic expansion; this has negative repercussions for the global economy. It is in the interest of all parties to work in concert to find trade and currency accommodations to grow the global economic pie for all parties, rather than protecting national slices of a diminishing global pie.

Despite the current bout of market volatility and the gloom and doom in the financial press, it is of paramount importance to: 1) recognize that US equity markets recently reached all-time highs; and 2) remember that stock prices are subject to periodic price "corrections", no matter how unwelcome they may seem as they occur.

We continue to view pullbacks in the equity market as valuable opportunities for investors to reallocate capital and "buy-in" when individual company share prices are on sale. These are volatile times. As conservative, long-term investors, we continue to perceive volatility as an environment full of investment opportunities. To quote the "Oracle of Omaha", billionaire investor, Warren Buffett, "The true investor welcomes volatility … a wildly fluctuating market means that irrationally low prices will periodically be attached to solid businesses." ~

Disclosure: "Be careful about reading health books, you may die of a misprint." Mark Twain Keep that in mind as you read these articles. We obtain data from sources we believe are reliable but they should not be relied upon for making life-changing decisions.