Demming Financial Services Corp.

David W. Demming CFP®
David W. Demming Jr. CFP®
Karen Bordonaro CFP®
Patrick Justice CFP®
Kevin Coholan CFP®

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2nd Quarter

Heads Up…

As a result of recent regulation changes, certain account paperwork will need to be updated in the coming months. Thanks in advance for your cooperation!

Please be sure to send us a copy of your 2018 tax returns to info@demmingfinancial.com as they're completed!

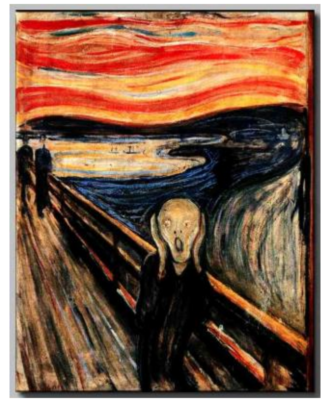
Please note, the main inbox for prompt email correspondence is info@demmingfinancial.com!

As a friendly reminder, for your protection, it is our ongoing policy that any requests for funds sent to us via email will also be confirmed by phone.

Please be sure to let us know if there are any changes to your contact information (address, phone number, email, etc.)

Also, please be sure to check out our website at www.demmingfinancial.com!

Time to Panic?



There's almost zero chance that you missed the alarmist headlines on Friday, March 22nd about the inverted yield curve, which (you probably also read) inevitably signals an upcoming economic recession. So, the smart move is to retreat to the sidelines until the economic bust is over and get back into the market once the yield curve has developed a healthy steepness. Right?

Investors certainly thought so. The S&P 500, on that Friday, dropped 1.9%, as people reacted as if a recession would happen on the Monday following.

It would be nice if investing were that simple. But in the current case, it is much further from simple than normal.

Why?

The yield curve is a line plotting out the interest rate (yield) that is paid to investors across maturities, from three month to 30 year. An inversion happens whenever the shorter maturity bonds provide higher yields than longer-term ones—which is counterintuitive since the risks of holding bonds longer-term are greater than if you're parking your money for a few months. Longer-term, you could experience inflation, default or a rise in interest rates that will make you look stupid for committing your money at a particular rate for 10 years or longer.

This current so-called "yield curve inversion" really looks more like a flat line stretching from short-term to intermediate-term bonds. What was widely reported was a (probably brief) moment when the 3-month Treasury note offered higher interest than the 10-year bond—by (get ready to be shocked) 0.022%. You could see roughly the same spread difference around the beginning of 2006, which was not a very clear signal and did not result in a recession until a year and a half later. Some months afterwards, the yield curve inverted with a vengeance, although it righted itself before worst carnage of 2008.

The lesson here is that, yes, we have experienced a yield curve inversion sometime before each of the last seven recessions. However, there have also been two false positives—an inversion in late 1966 that was followed by economic growth, and a largely flat curve, like the one we are experiencing now, in late 1998 that also didn't presage a recession.

Moreover, even if we accept the idea that a yield curve is a recession signal, the actual timing is almost impossible to predict. Data from Bianco Research has shown that over the last 50 years, a recession followed, on average, 311 days later—roughly a year. This is an average of some pretty broad fluctuations. Following that brief inversion in 2006, the economy didn't experience recession for another 487 days. An inversion in December of 1978 was followed by a recession—389 days later. In contrast, it took just 213 days for the U.S. economy to enter recession territory after a July 2000 yield curve inversion. Based on this evidence, selling the day after an inversion seems like a poor strategy. Selling a month, or six months after doesn't make sense either.

Finally, some economists think that the yield curve is not nearly the accurate signal that it once was. The reasons are a bit technical, but they have to do with the increasing control that the central banks—including the U.S. Fed—have on the shorter end of the yield curve. The Fed and other central banks have been buying up government bonds for their balance sheet, which means the shorter-term yields can no longer be seen as market driven.

So, what *IS* an accurate signal of upcoming recession? There are some tried-and-true signs, including an overheating rate of GDP growth (which we haven't seen at all in this long, slow recovery), rising unemployment (nope) and spiking interest rates (no sign yet). Another sign that directly impacts the yield curve is a sudden demand for longer-term bonds as a safe haven for nervous investors, causing the bond rates to drop below shorter-term paper. There has been no indication of a shift in demand for bonds over stocks.

What does all that mean? **The simple lesson is: don't fall for clickbait**. We are still as much in the dark about what the economy and markets will do in the future as we were before 3-month Treasury bills returned a shocking 0.022% more than 10-year Treasury bonds. We might experience a recession this year, or next, or in 2022. All we know for sure is that we WILL experience one, possibly with a few unexpected market ups and downs in the meantime.

Unintended Consequence?

Sometimes the popularity of a particular investment is driven by unexpected forces. One example is the so-called SALT (state and local tax) limitation that was imposed in the recent tax legislation, which basically says that you can only deduct $10,000 on your federal tax return for state taxes, including state income and local property taxes, no matter how much you actually paid.

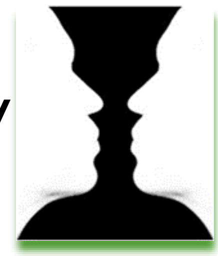
"I'M GOING TO MAIL THIS TAX RETURN AND THEN GO TO CONFESSION."

In states like Florida, Alaska and Texas, where no state income taxes are imposed, this new limitation on deductibility didn't cause a lot of scrambling. But in some higher-tax states, higher-income taxpayers have been looking for ways to reduce not just their federal taxes, but also their state taxes that could no longer be deducted.

One obvious solution was to invest more heavily in municipal bonds, which—if they qualify and are issued in the state of residence—provide income that is free of both state and federal taxes. Munis have always been an attractive alternative to taxable bonds in taxable accounts, but they became slightly more attractive in states where the SALT limitation works like an added tax on residents.

This helps explain why California state bond mutual funds have attracted $1.2 billion in inflows in the first two months of this year, while in New York, an additional $382 million have been invested in municipal bond mutual funds. New Jersey residents have driven $71.5 million in net inflows into munis, and Minnesota, with the fourth-highest top state income tax rate in the country, has seen $90 million worth of muni fund inflows in the first two months of 2019. That's compared with $17.6 million during the same period last year.

The Two Faces of Volatility



Buried in a recent report by Fidelity Investments was some remarkable news. Last summer, the mutual fund and retirement plan provider noted that there were more than a million people with more than $1 million in their 401(k) accounts. Then December hit, wiping out almost 20% of the value of the S&P 500 index, with many overseas markets suffering larger losses. The result: the number of 401(k) millionaires fell by 28% in the fourth quarter.

So, this is a great argument for avoiding stocks in the first place, right? Actually, according to an article that analyzed these results, the reverse is true. It is precisely the volatility of stocks that accounts for their higher returns—and the fact that there were so many millionaires in the first place. The market drop was perfectly normal yet, swings like these are what keep many people from trusting their retirement savings to stocks. Those brave souls who manage to ride out the downturns are rewarded with higher long-term returns.

The analysis posits a world where stocks offer a placid low-risk, low-return pattern over time. The overall returns would be modest, because returns are a direct function of risk. Many people would never be able to achieve their retirement goals.

And anyway, people craving less risk know where to find it. We already have a Treasury bond market, which provides a safe, modest return with minimal risk and a very high expectation of delivering on the nominal returns promised. They are not risk-free; historically, the 10-year government bond market has experienced declines of as much as 5 percent. But chances are very few of those 401(k) millionaires were heavily invested in Treasuries during their accumulation periods.

2019 First Quarter Investment Market Report

The long, painful market decline in the last month of 2018 seemed to promise more of the same for the new year of 2019, but at the end of the first quarter, the results couldn't have been more different. The U.S. market, measured by a variety of indices, posted its biggest one-quarter gain since the third quarter of 2009. This proves once again (as has been proven many, many times over) that you cannot extrapolate market returns from one month to the next or expect that down or up trends will lead to more of the same.

Just about every investment asset rebounded in the early months of 2019. The Wilshire 5000 Total Market Index—the broadest measure of U.S. stocks—rose 14.23% in the 1st quarter.

Looking at large cap stocks, the Wilshire U.S. Large Cap index gained 13.96% in the first quarter. The widely-quoted S&P 500 index of large company stocks is up 13.07% so far this year.

As measured by the Wilshire U.S. Small-Cap index, investors in smaller companies gained 15.51% in the first quarter. The technology-heavy Nasdaq Composite Index appears to have regained some of its mojo, gaining 16.49% in the first three months of the year.

International investors are experiencing somewhat smaller gains. The broad-based EAFE index of companies in developed foreign economies gained 9.04% in the first quarter. In aggregate, European stocks are up 9.42% so far this year, while EAFE's Far East Index has gained 6.89%. Emerging market stocks of less developed countries, as represented by the EAFE EM index, gained 9.56% in dollar terms in the first quarter.

Looking over the other investment categories, real estate, as measured by the Wilshire U.S. REIT index, posted a 16.02% gain during the year's first quarter. The S&P GSCI index, which measures commodities returns, gained 15.97% in the 1st quarter, boosted by crude oil's 32.44% gains, and held back by a low 1.34% gain in gold.

In the bond markets, we are experiencing a very slight inversion in the yield curve. Coupon rates on 10-year Treasury bonds have dropped to 2.41%, while 6-month bonds are now yielding a higher 2.42, and 3-month bonds are yielding 2.38%. Five-year municipal bonds are yielding, on average, 1.89% a year, while 30-year munis are yielding 2.72% on average.

These are, by any measure, extraordinary returns for a short three-month investment horizon, and nobody should expect that returns will continue at this pace for the full year. But the remarkable upsurge in stock prices does offer a lesson. Investors who took the December opportunity to buy stocks when they suddenly (and rather unexpectedly) went on sale are doubtless cheering their good fortune, but the larger number of investors who held on through December to reap the gains of 2019's first quarter should be similarly cheerful. Selling into the downturn, hoping to avoid more losses, was a losing strategy.

It is also possible that the U.S. market is starting to get over its skis. Overall, American investors came out ahead of just about every developed or developing economy. The U.S. market performance finished only behind Ireland (up 30.5%), Greece (17.5%) and Italy (15.1%), well ahead of the U.K. (up 8.2%), Japan (5.3%) and India (5.3%).

Why are stock prices rising despite concerns about the yield curve inversion and persistent predictions of an upcoming recession? The answer could lie in some pleasant surprises that were contrary to what many investors were expecting. The Federal Reserve Board startled long-term market observers, in a good way, when it abandoned plans to continue hiking interest rates. Higher rates are considered impediments to higher market valuations for two reasons: they create more competition in the form of bond yields, and they raise borrowing costs for companies looking to expand.

Will the party continue? Who knows? The next few months will see many companies post their first quarter earnings per share, and negative growth (which is expected for many companies) could chill the surprisingly hot market. Nevertheless, slower profit growth is still growth, which suggests that a recession may not be on the immediate horizon. Economists are still reluctant to predict an economic downturn when unemployment is at record lows, but it may be worrisome that the World Trade Organization's leading indicator of global merchandise trade dropped to its lowest level in nine years. Many are watching the new round of U.S.-China trade negotiations, hoping for a breakthrough that would re-integrate disrupted corporate supply chains around the world.

It is worth remembering that some of the steepest rises in market indices come right before a bear market, when investors become over-enthusiastic despite declining fundamentals and high valuations. We do not seem to be in that territory yet, but nobody knows for sure. It's always best to be cautious when the markets are rising fast, and optimistic when stocks go on sale. Actually, doing these things is counterintuitive and very difficult emotionally, but for the intrepid, it has historically been a winning investment strategy.

Contact Us

Demming Financial Services Corp.

David W. Demming CFP®

David W. Demming Jr. CFP®

Karen Bordonaro CFP®

Patrick Justice CFP®

Kevin Coholan CFP®

13 New Hudson Road
Aurora, OH 44202

Phone: (330)562-2122
Toll Free: (877) 841-2122
Fax: (330) 562-6086
Email: info@demmingfinancial.com
Web: www.demmingfinancial.com

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If you have not already done so; please send a copy of your 2018 Tax Returns. Feel free to send them or request your preparer to send them to info@demmingfinancial.com.