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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

The Federal Reserve finally changed their interest rate policy, raising rates for the first time since 2006. During that period of tightening, Fed Chairman Alan Greenspan characterized falling long-term interest rates to be an unexpected "conundrum" after the Fed raised short-term rates. More recently, the Fed has produced a succession of subsequent conundrums. The markets looked forward to the recent policy change to finally remove uncertainty about the timing, after several years of speculation and punditry. Unfortunately, it seems we are still facing continued uncertainty and our own conundrums. We will try to sort it out for you.

The Economy

Economic performance is mixed. The services sector continues to be reasonably strong, but manufacturing is contracting in most regions of the country, and the energy sector is facing significant stress from overproduction. It all nets out to 2.0% GDP growth officially measured in the third quarter, but the Atlanta Fed's current real-time estimate is now lower at 1.3%. A slower growth trend has existed since mid-2014.

The group of economic indicators that tend to lead the economy by 6 to 12 months or so, are still heading up, suggesting the trend will continue to be positive for a while. This is good for employment, which lags the economy, as well as for politicians running for office in 2016, but is not necessarily helpful for investors. The stock market itself is a leading indicator and can be expected to turn up or down before the economy does.

Homeowners continue to benefit from a rebound. The Case-Shiller index suggests an annual 5.16% increase in home prices, while realtors report a 4% increase since last year. Both measures are better than inflation and most investment asset classes, including stocks and bonds.

The Markets

The S&P500 index closed down a smidgen for the year, after recovering most of the drop registered in the August-September sell-off. Interestingly, the performance of the S&P 500 index, which gives more weight to companies with greater market value, like Amazon and Alphabet (Google's new name), has performed 4% better than an index of the exact same companies that is weighted equally. In addition to being misleading, a concentration of performance among a few big stocks like this has historically not been a good sign.

Likewise, Treasury bonds out performed investment grade corporate bonds by 3.1% and bettered high-yield (junk) bonds by 6.5%. The preference for size and quality in the stock and bond markets suggests a reduction in the willingness of investors to take risk occurred during the year.

The Conundrums

Through the 1980s and 1990s, the US economy was in a long-term growth phase. Annual GDP growth regularly peaked over 4%. Expectations of inflation were still embedded in the national psyche, remembering the 14% rate in 1980. Standard Fed policy was to raise short-term interest rates to cool down inflation as the economy grew. After the 2000 bubble blow-off peak, growth began to fade, despite a Fed stimulus policy that was intended to return the economy to "normal" levels. This downshift appears (in hindsight) to explain

Greenspan's conundrum, explaining why long rates did not rise along with the short. Unfortunately, the Fed's stimulus also led to risk seeking in mortgage loans, which led to the subsequent real-estate boom and bust.

The Fed responded to the 2008 bust, flooding the economy with even more money, and instituted a policy of 0% short-term interest rates. The easy money had the positive effect of strengthening banks and reducing government interest payments at the expense of savers, while increasing the US income gap. Savers and other investors were then faced with a conundrum of their own. In order to earn the income that they required, they were forced to invest in riskier assets. CDs, bank accounts, and money market funds were no longer an option.

As more investors chased yield, the price of risky assets like stocks and junk bonds rose, becoming ever more highly valued. Continuing Fed policy, through successive Quantitative Easing (QE) iterations, continued to multiply banks' free reserves by 1,400 times from $1.8 billion in 2008 to $2.5 trillion today! All this unused money kept interest rates anchored at zero. It is widely argued that the policy has encouraged the misallocation of capital from economically valuable purposes to risky speculation.

Just as credit cards allow consumers to bring forward an improvement in their current lifestyle at the expense of their future, so is it with businesses. With such low-cost money, speculative investment has taken growth from the future to prop up the economy today. Eventually the process will run its course. Companies have built the infrastructure they need for a slow economy. They have bought back company stock to improve reported per share earnings as their profits lag. Simultaneously, investors are becoming ever more wary of risk assets. Junk bonds and smaller company stocks have turned out of favor.

One argument that the risk-seekers made is that the Fed would rescue them if the economy and markets get into trouble. That argument provided continuing confidence as the stock market continued its Fed-induced rise. The Fed has now very publicly changed policy, embracing higher rates. Desiring policy normalization, and foreseeing a stable economy, it is likely they would not now reverse themselves quickly. If that is true, we are left with a continuing low growth economy, over-valued markets, and investors who are shying away from risk. This convergence of these factors could become a real conundrum.

All this raises the question, "What should a person who is planning and investing for their future do?" This too is a conundrum. A simpler view, however, may help to clarify the bigger picture. Stock and bond investments can go three ways – up, flat, or down. If you are a younger investor accumulating for the far future, and you do not care about volatility, then the often-advised strategy of consistent accumulation and dollar cost averaging can make sense in any of those conditions.

If you are nearing or in retirement, and both investment returns and capital preservation are important for your future, chances are that preservation will have a greater impact than return. Of the three outcomes, taking risk only makes sense for the "up" result. While the current flat trend is in place and the potential exists for an economic downshift at some point, it is wise to review the sensitivity of your financial plan to the risk of lower asset values, versus the risk of insufficient growth, and develop an appropriate strategy to balance the two.

If you are not comfortable addressing this question yourself, it could be worthwhile to enlist the aid of an advisor that has developed and follows a strategy that is comfortable for you. If you would like help managing your investments, looking into your financial future, or planning to manage your income effectively, please call or e-mail. We invite you to visit our website www.linnardfinancial.com.

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