COLORADO
FINANCIAL
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Economic & Market Review

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"Last year we said, 'Things can't go on like this', and they didn't, they got worse."
— **Will Rogers**

October 1, 2019

SUMMARY:

We mourn the passing of our friend and Partner Patty Meneley.

Returns have been very good this year, but much of that return is a rebound from the drop in last year's fourth quarter. Trailing 12 month returns are much more modest.

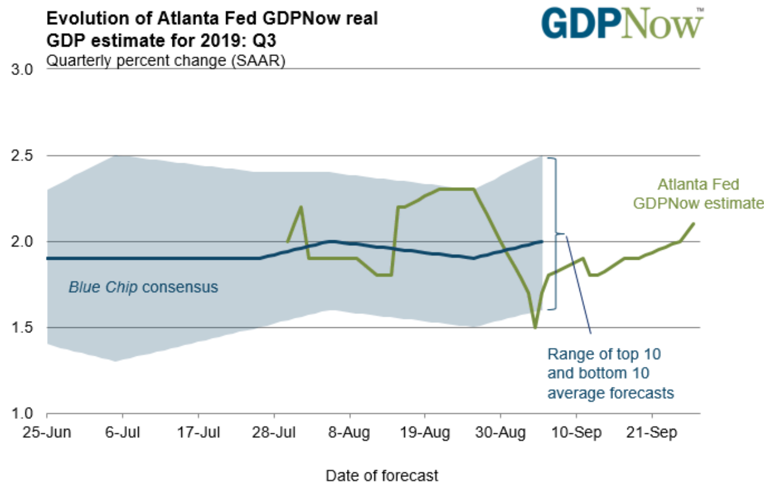
The federal government has a debt problem, and nobody seems interested in doing anything about it.

The economy is growing, unemployment is low, inflation is low as are borrowing costs. What to worry about? Earnings, valuation, impeachment, Brexit, Iran, China, trade war ---- to name a few.

As Of 9/30/19 (annual returns)	YTD	1 Year	5 Years
60/40 Balanced World Index (VSMGX)	13.5%	5.1%	6.2%
World Equity Index (ACWI)	16.4%	1.6%	6.9%
U.S. Equities (Wilshire 5000 - VTI)	19.9%	2.9%	10.5%
Foreign Equities (ACWI ex-U.S. - ACWX)	11.7%	-0.9%	2.9%
U.S. Bonds (Bloomberg Barclays AGG)	8.3%	10.3%	3.3%
Global Bond Index (BNDW)	8.9%	10.8%	n/a

We begin by reporting with great sadness the passing of our Partner and friend Patty Meneley. She lost her battle with cancer last month. Patty was the third employee of the firm and she and I worked together side by side for 30 years. For a few years we were neighbors and raised our kids together. It is impossible to define exactly why our firm has grown and prospered more than most financial services firms, but there is no doubt that part of the reason was the graciousness, integrity, and magic that Patty brought. She will be missed greatly.

The economy is growing at about a 2% annual rate.



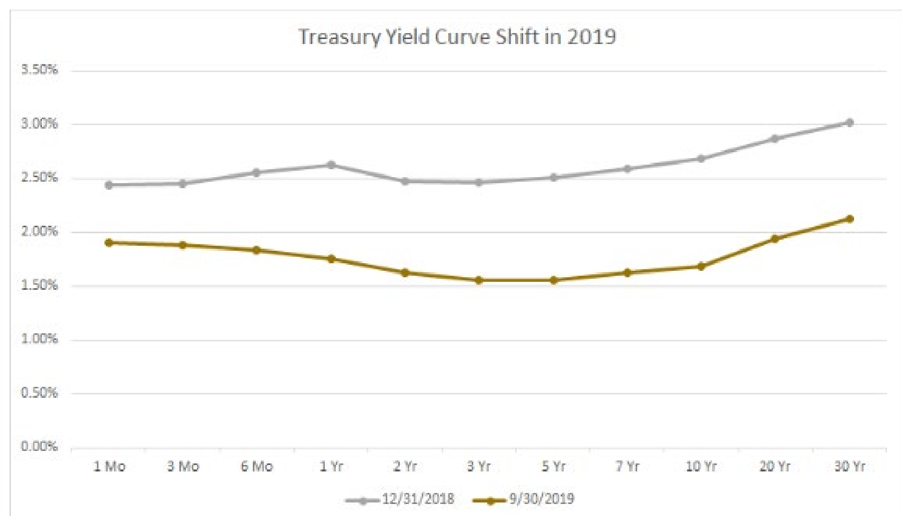
This is lower than 2018's 3% growth rate, but is believed to be about what the normal growth rate should be for our economy. The tax cuts that were passed in late 2017 provided a temporary boost to economic growth last year, but have faded. Those tax cuts did add a trillion dollars of debt to the national balance sheet. There does not appear to be anyone in Washington who is serious about paying down our debt or controlling deficits. We are often asked whether the national debt will cause a recession, or increase interest rates, or have some other negative implications. The answer is yes…eventually, but probably not yet. We discuss the U.S. government debt in depth later in this letter.

As mentioned, **the economy** is growing at about 2%. We think this is still a goldilocks environment. We have steady growth, low unemployment, low inflation, low borrowing costs, low tax rates, and a strong housing market. The risks to the economy appear to be principally from the trade war, which has led to a slowing manufacturing sector and lower global trade. As we have discussed several times, the U.S. is less dependent than other countries on trade, so we expect a slowdown but not a recession. But, recessions are usually not identified until after the fact. There are knock on effects from trade and manufacturing that could lead to a wider slowdown. The trade war is largely a self-inflicted wound. If the Administration backs off of its aggressiveness, there might be some rebound in global trade, but it may not be immediate. This is the biggest risk to continued economic growth.

Earnings growth has slowed to a crawl. Annual earnings growth was 27% for the twelve months ending September 2018 (in large part due to the effect of lowered corporate tax rates). Earnings growth is now only 2% versus a year ago. This reflects the slowing economy, the strong dollar, and other factors. The direction from here will be critical to the direction of the stock market.

Valuation is okay… a little higher than average. Because we are unsure about the coming earnings picture, today we prefer looking backwards. The P/E on trailing earnings today is 19.3x. That compares to an 18.8x average since 1988. Similarly, the earnings yield today is 5.1% versus an average of 5.5%. These valuation levels can hold if interest rates remain low, the economy keeps chugging along, and earnings begin increasing.

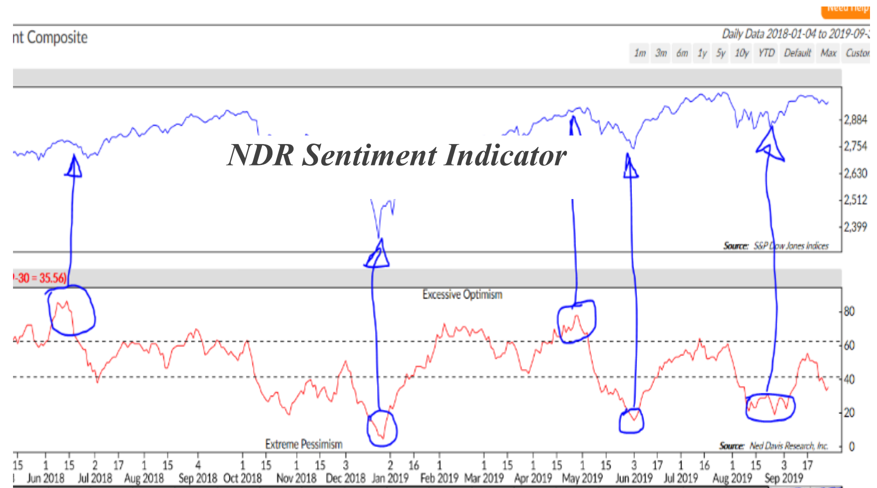
Interest rates have fallen this year as shown in the following chart. Historically, and generally, falling interest rates are good for the economy and good for the stock market. In fact, the change in direction of rates is the single biggest factor in predicting/influencing stock market returns. There are a number of reasons, but two primary ones. First, lower interest rates stimulate the economy. We can see that in the housing market for example, and housing is currently improving for both existing and new home sales. The other reason is present value math. When rates fall, the present value of future cash flows rises. Think of a 10 year bond yielding 3%. Ignoring compounding for a moment, the present value of that bond would be 100 – (3% x 10) = 70. If yields fall to 1.5%, then the bond value increases to 100 – (1.5% x 10) = 85. This affects all financial assets, and is what happened this year. As rates have fallen, the returns on bonds have been much higher than the interest rates paid on those bonds. Going forward, returns on bonds will be lower unless rates continue to fall.



There is a point where falling rates become a negative. If rates continue to fall, then the returns on bonds will increase… this part of the process will remain true. However, falling rates are also a sign of slowing economic growth and inflation. I believe that if we see rates fall further, it should not be seen as a positive, but the opposite. I think the trillions of dollars of bonds around the world with negative rates are not positive for the global economy, savers, or investors in the longer term. It is sign of the limitations of monetary policy. I hope it works, but like our debt it is unprecedented.

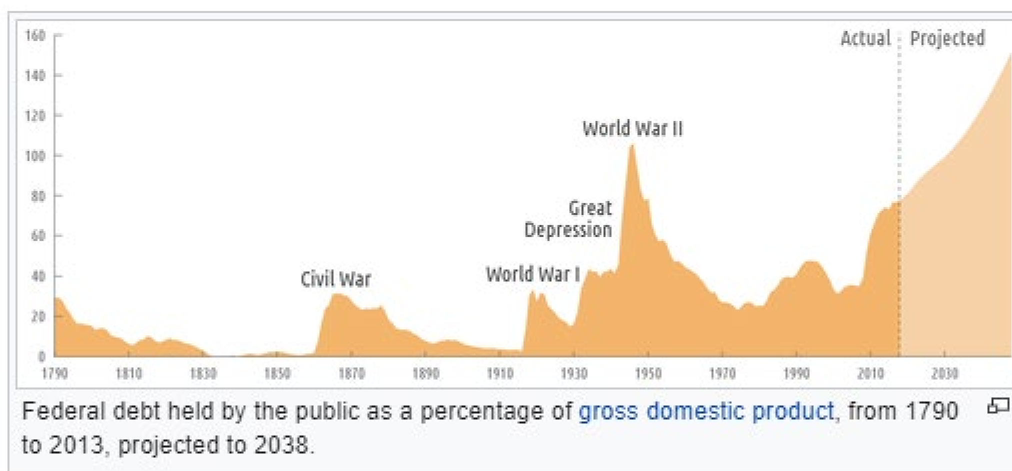
Bubbles, Sentiment, Trends, & Crisis Risks

Sentiment is a fickle thing, and changes rapidly. Shown in this chart is NDR's sentiment indicator. You can see that it has made several round trips over the last year between excessive optimism and excessive pessimism. When everyone is going one way, the market tends to reverse direction. For example, we reached a level of extreme pessimism at the end of last year after the market had fallen 20%. Then, the market reversed course and rose almost 25% before reversing course again in May. These sentiment cycles usually last only a few weeks or months, but they can drive the market in the short term.



Like sentiment, geo-political events have short term effects on markets. Of course, news and sentiment are often related. The U.S. Congress has upgraded its investigations of President Trump to an "Impeachment Investigation", and yet the stock market is within 2% of its all time high. Why is the market showing so little concern? It could be because of investigation fatigue, but is probably because the rules for impeachment require 2/3rds of the Senate to vote in favor. Republicans show little sign of breaking ranks at this time, so impeachment is unlikely. What about the election? The typical pattern is for the market to go into a consolidation pattern before the election and then rally afterwards. It is a little early for this relative to prior election cycles, but there is so much that is not normal in the political, economic, and market cycle that this could be influencing investor behavior even now.

The financial bubble and crisis risk we worry about relate to government debt and negative interest rates. While these issues cause us concern, they are probably not risks that will result in stock market crashes or runaway inflation and interest rates anytime soon. Global central banks seemingly have control over these issues for now. Here is what our debt looks like as a % of GDP over time:

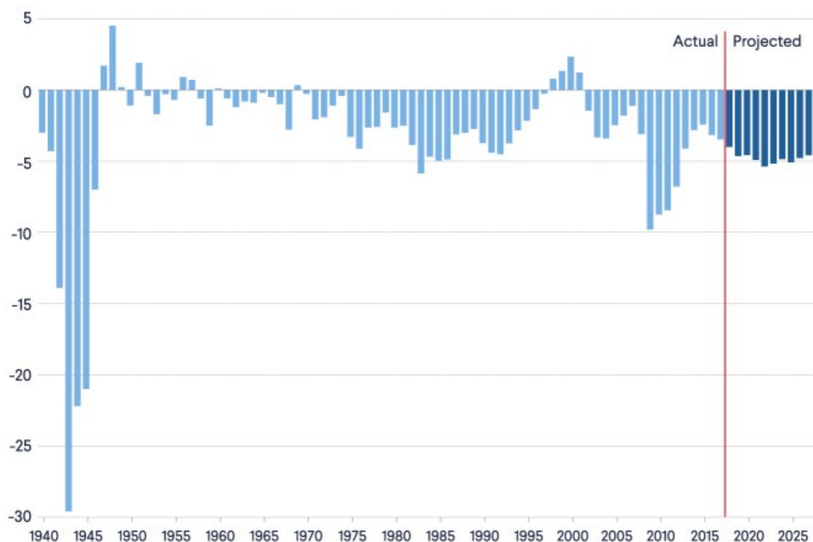


Federal debt held by the public as a percentage of gross domestic product, from 1790 to 2013, projected to 2038.

The only time our debt reached this level in the past was during World War II when the country was borrowing and spending vast amounts to fund the war. Otherwise, the current level is unprecedented. As you can see, this includes the Civil War, the Louisiana Purchase, and the Great Depression.

The cumulative debt is the result of annual deficits. Some people confuse the debt with the deficit. The deficit is spending more than is received in tax revenue in a given year. The total debt is the accumulation of all the borrowings over time. Shown below is the annual deficit as a percentage of the economy. It is not uncommon, and is in fact desirable to increase spending and deficits during periods of recession. The error, in my view, is to increase the deficit during a period of strong economic growth such as we have today.

The theory behind the 2017 tax cut law was that lower taxes would increase economic growth and be enough to make up for the reduced rates (bring in more income), but few economists believe that will really happen. Gary Cohn, the former Goldman Sachs COO and Economic Advisor to the President and designer of the law, would argue that we're only one year into the new tax cut regime, and their analysis was for a ten year period. We shall see.



Why hasn't the debt caused problems? The U.S. debt to GDP ratio is one of the highest in the developed world, so why hasn't it created a problem? The answer is probably due to a) the U.S. is still the largest economy in the world; and b) the U.S. dollar is the world reserve currency. Since the financial crisis of 2008-2009, the rest of the world has gotten weaker on a relative basis rather than stronger; so there has been little risk to the dollar's preeminence. But that could change. China and Japan each own more than $1 trillion of U.S. Treasuries. It's one thing when you owe yourself, but quite another when you owe foreigners. For an example, take a look at Greece. The thing about financial markets is that things are often fine until they are not. Nobody knows what straw will break the camel's back or change the prevailing mood from complacency to fear.

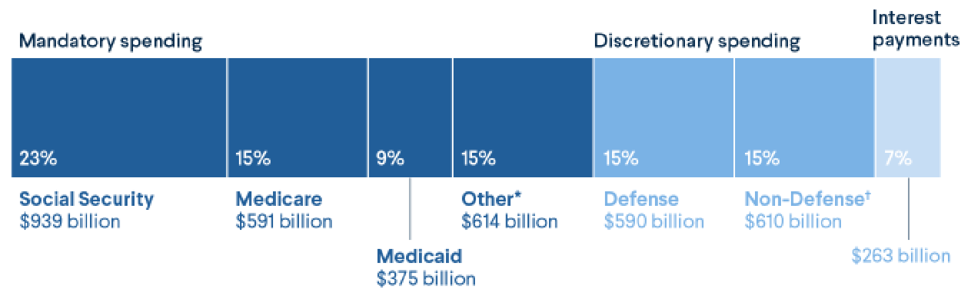
What could happen if debt rises unabated?
It could divert money from productive investments. As the debt grows larger, the amount of the federal budget that goes to paying interest grows. If interest rates rise, it will compound the problem.

To the extent the debt is owned by foreigners we are making ourselves poorer and other countries richer. We are simply borrowing and paying others for over-spending and tax cuts.

It could become a drag on the economy. Historically, countries that have reached our levels of debt have seen slower future economic growth.

It could lead to a financial crisis. The U.S. has been the stabilizing factor to the world's monetary system since World War II. If this is threatened it will almost assuredly create volatility and uncertainty.

Is the risk imminent? *Probably not.* Pundits have worried about deficits and debt for decades, and there are few problems to identify. Changes can be made, so the current projections could be wrong. Budget reform is possible (theoretically). A realistic budget reform plan is going to have to include some combination of higher taxes, and lower spending on Social Security, Medicare, Medicaid, and maybe even Defense. These make up two-thirds of the budget.



This isn't a partisan issue, it's a math problem. There is too little coming in and too much going out. It will require Americans to recognize the problem honestly. We cannot provide unlimited healthcare benefits and free education without paying for it; and Social Security is not solvent in its current form. We either have to limit benefits or increase taxes, and probably both.

A summary of our investment pillars:

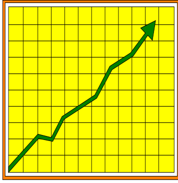
I. The Economy is growing slowly. Recession risk has risen since last quarter, but is still unlikely.
II. Earnings growth has gone from positive to neutral. We will monitor 3rd quarter earnings reports closely for clues about the remainder of 2019 and 2020.
III. Interest rates have moved from being a negative for the economy and markets to being a positive. The Fed has lowered rates twice this year and is leaning toward further easing.
IV. Valuation is slightly above average, but not likely to move the market one way or the other.
V. Geo-political risks are high. Impeachment, Brexit, Hong Kong, trade wars, Iran and other Middle East tensions… all have the potential to cause investor anxiety.
VI. Sentiment is swaying back and forth quickly.

Strategy While we view the risks as heightened, we recognize that the most likely result is that the economy and markets continue to muddle through this period.

- We have unwound our "Bear Market Playbook" and returned to almost normal allocation targets in most accounts and strategies. We remain slightly underweight.
- We have a slight emphasis on less risky strategies such as low volatility.
- But, our equity style weighting favors growth vs. value. This is due in part to favoring technology and communication services over industrials, financials, and energy.
- We maintain an underweight to investment grade bonds. Despite the high one year return, average returns over the last five years are only 3% and likely to be lower going forward.
    - We have been too short in our duration targets but have moved closer to neutral.
    - We maintain positions in high yield bonds and low volatility equity strategies.
        - We added an infrastructure fund to our low volatility strategy.
- We remain underweight international investments relative to the global equity index ACWI.

As always, we welcome your questions and input. Please contact your Advisor or Service Manager if there is anything we can do to help you, and thank you for your patronage.

Happy returns,



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And Your Entire Colorado Financial Mgmt. Team

Index Definitions

Standard and Poor's Index

- **S&P 500**: The S&P 500® is an unmanaged index that is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and captures approximately 80% coverage of available US market capitalization.

Morgan Stanley Capital International (MSCI)

- **MSCI All Country World Index**: The MSCI ACWI Index is designed to represent performance of the full opportunity set of large- and mid-cap stocks across 23 developed and 24 emerging markets. As of September 2018, it covers more than 2,700 constituents across 11 sectors and approximately 85% of the free float-adjusted market capitalization in each market. The index is often used as a benchmark for global equity portfolios. Investments in international and emerging markets include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.

- **MSCI All Country World Index Ex US:** The All Country World Index Ex-U.S. (MSCI ACWI Ex-U.S.) is a market-capitalization-weighted. It is designed to provide a broad measure of stock performance throughout the world, apart from U.S.-based companies. The MSCI All Country World Index Ex-U.S. includes both developed and emerging markets. For investors who benchmark their U.S. and international stocks separately, this index provides a way to monitor international exposure apart from U.S. investments.

Bloomberg Barclays Indices

- **Bloomberg Barclays Global-Aggregate Total Return Index (Hedged):** The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

- **Bloomberg Barclays U.S. Aggregate Bond Index**: The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).

- **Wilshire 5000:** The Wilshire 5000 Total Market Index is widely accepted as the definitive benchmark for the U.S. equity market, and measures performance of all U.S. equity securities with readily available price data.

- **HFRI Fund of Funds Composite Index:** This index is a composite made up of multiple hedge funds via funds or managed accounts. The strategy designs a diversified portfolio of managers with the objective of significantly lowering the risk (volatility) of investing with an individual manager. The Fund of Funds manager has discretion in choosing which strategies to invest in for the portfolio.