



June 2019

“Chaos is inherent in all compounded things. Strive on with diligence.”

– Buddha

SUMMARY:

Note: we are separating our Investment and Financial Planning Newsletters. You can expect to receive a Financial Planning Newsletter next month.

The economy is showing a few signs of weakness due to the trade war, but we still believe a recession is unlikely.

Most fundamentals continue to favor a growth strategy.

Geo-political risks are the biggest risk to economic growth and equity markets.

Strategic Models are returning to ‘normal’ equity allocations. Tactical Models remain slightly defensive.

As Of 5/31/19 (annual returns)	YTD	1 Year	5 Years
60/40 Balanced World Index	6.8%	-1.1%	2.5%
World Equity Index (ACWI)	9.1%	-2.4%	5.2%
U.S. Equities (Wilshire 5000)	11.4%	2.7%	9.4%
Foreign Equities (ACWI-ex U.S.)	7.2%	-6.3%	1.3%
U.S. Bonds (Barclay’s AGG)	4.8%	6.4%	2.7%
Global Bond Index (Global AGG)	4.4%	6.6%	4.1%
HFRI Fund of Funds Composite	3.3%	-1.5%	1.9%

Dear Clients and Friends,

The economy grew at a 3.1% rate in the first quarter, but it was artificially boosted by inventory building and trade that was accelerated due to pending tariffs. The second quarter growth is currently forecast at 1.4%. The 2.2% six month average is about the same as the 10 year average. There’s nothing wrong with 2% growth. In fact, we think it’s a goldilocks growth rate... not too hot, not too cold.

There are some signs of a slowing economy. Manufacturing has slowed, and so has housing and trade; but we still believe the risk of outright U.S. recession is low.

If the economy continues to grow at 2% - 2.5%, and inflation averages about 2%, then the nominal rate of growth is 4% - 4.5%. It is reasonable to assume corporate sales will increase at least at this rate. They have done even better the last few years. **Earnings growth** will usually be a little better than sales growth as companies maximize profits and reduce outstanding shares. Currently, S&P forecasts earnings growth for large companies at 9% for 2019, 16% for mid-size companies, and 24% for small companies.

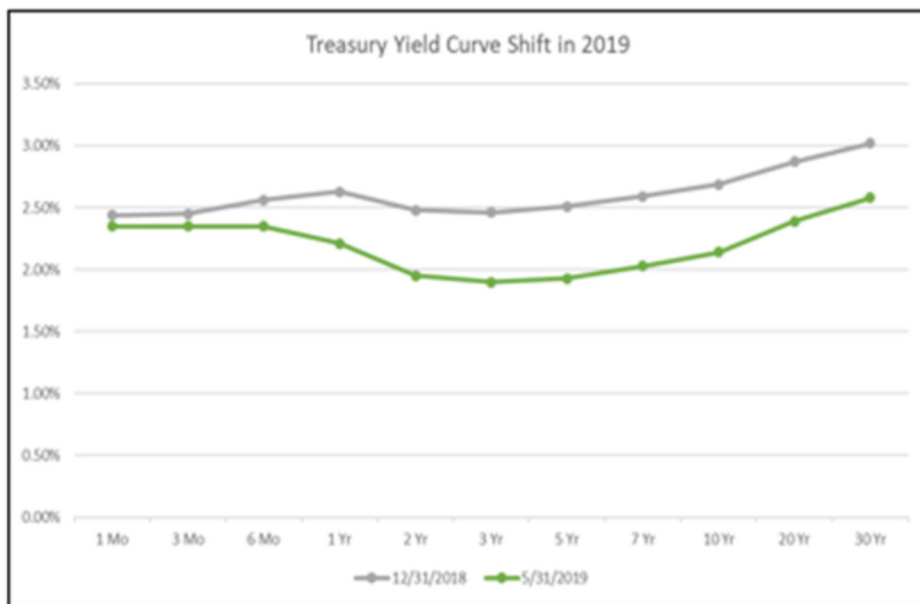
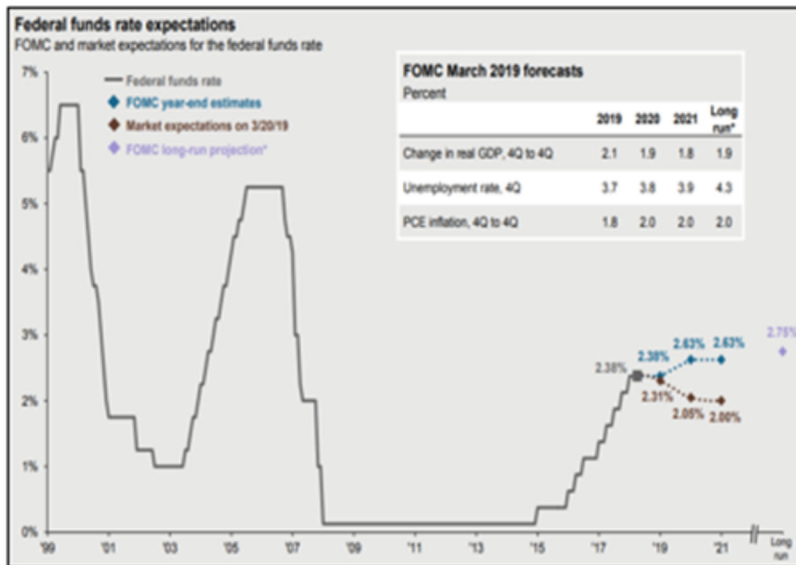
S&P estimates 2019 earnings for the S&P 500 will be \$165, and for the 12 months ending June 2020 to be \$175. Using a current price of 2,850 the P/E ratio is 17.3x 2019 earnings, and 16.3x next twelve months.

These are average **valuation** levels relative to history, and should not drive market performance one way or the other.

Federal Reserve (the Fed) policy is a big driver of financial markets. The Fed began raising rates in late 2015 and continued through 2018. Rising rates leads to

low returns on bonds, and the 4th quarter 2018 selloff in stocks was also due to concerns the Fed's policy would ultimately lead to a recession. Instead, the Fed changed course and signaled they would pause before changing rates... waiting to see how the economy would react to their previous increases, and due to the trade war. That pivot is mostly responsible for the 10% gain in stocks this year.

Market pundits and the futures markets have begun to speculate the Fed will begin lowering rates soon. We think this is premature. Based on our view of the economy and inflation, we expect the Fed to stay on hold until a directional change in the economy is clear. If the trade wars are settled, the economy could accelerate and rising rates could be back on the table.



For the last few years **geopolitical risks** have supplanted financial risks as a market mover. Risks to the banking system are unlikely to return soon. There remain concerns about the viability of the Euro, which is a financial risk but it is politics that would kill it. We think it is unlikely the Euro will fail.

It is ironic that on the 75th anniversary of D-Day that many of the alliances and international institutions

created after World War II are under threat. NATO, the IMF, the World Bank, the World Trade Commission, and others were all created to protect the peace and encourage economic integration. If confidence in these institutions erodes, expect ever greater volatility in economic growth and market reaction. Likewise, the European Union was created to ensure the free movement of people, goods, services, and capital.

Britain leaving the EU is but one example of the world moving away from these ideals. Shown below is Blackrock's geopolitical risk index, and you can see it remains at an elevated level.

Sentiment has vacillated between extremes over the last six months. Last December we reached an extreme level of pessimism, followed by extreme optimism in late April, and then another bout of pessimism by the end of May.

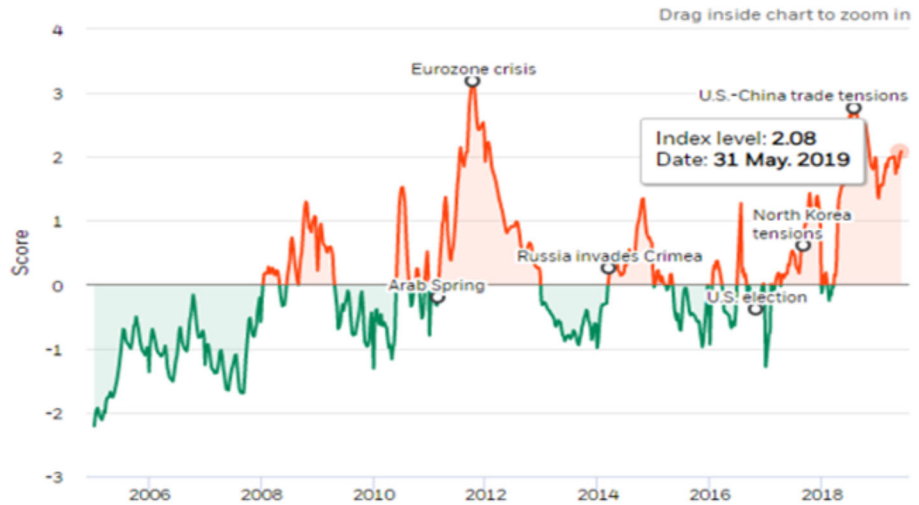
BlackRock geopolitical risk global index

If you haven't been keeping score, here is a summary of our investment pillars:

- I. Economy is growing slowly. Recession risks have risen, but still unlikely.
- II. Earnings growth is positive.
- III. Interest rate pressures have subsided. Fed is now on hold.
- IV. Valuation is average.
- V. Geo-political risks are high.
- VI. Sentiment is swaying back and forth quickly.

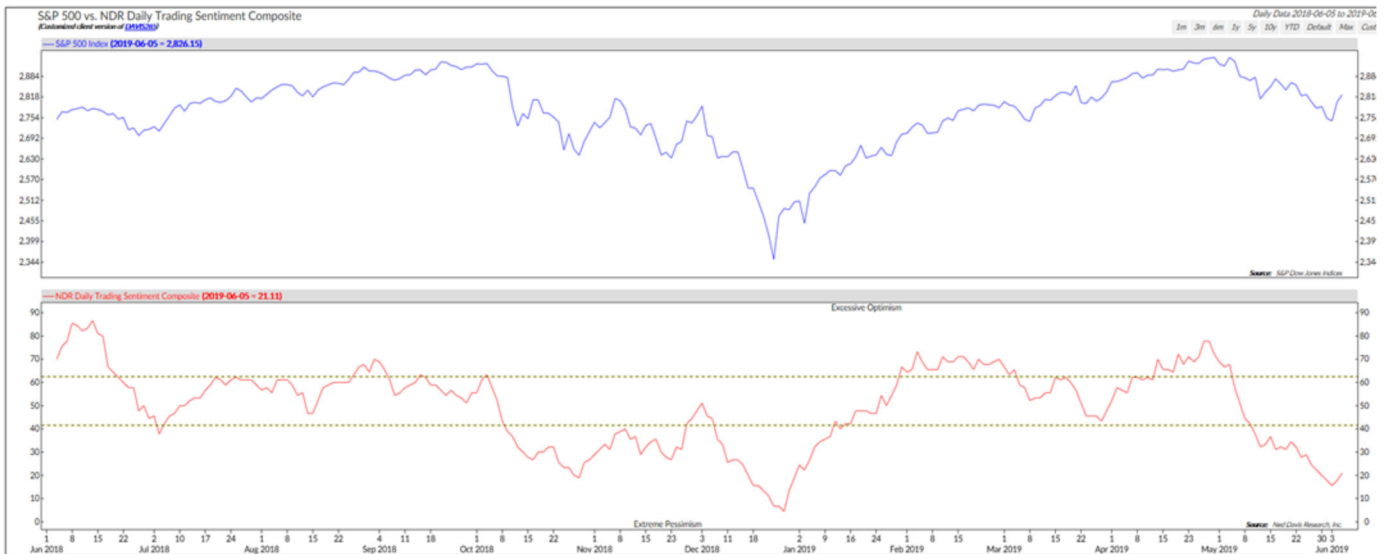
Note, sentiment is a contra-indicator. When everyone is bullish it's best to be bearish (and vice-versa). It is very difficult to time market swings in general, but especially when sentiment rather than fundamentals are driving markets.

Global index



Strategy

Late last year we moved to a defensive position in both our Strategic and Tactical Portfolio Models. Remember our Strategic Models are only adjusted if we believe the economy or markets are changing for longer term and fundamental reasons. Tactical Models will be adjusted on shorter term factors. In some respects, becoming more defensive has been correct. Equity markets are virtually unchanged from where they were in January 2018. On the other hand, the timing of making changes over the last 18 months has been treacherous. Stocks were down 20% in the 4th quarter and rose 10% - 15% in the 1st quarter, and then fell 7% in May.



Based on improved fundamentals (primarily the absence of Fed tightening), we are returning to a normal equity weighting in our Strategic Models. We anticipate making changes in the next few weeks. The Tactical Models will continue to closely follow the recommendations of Ned Davis

Research (NDR), which remains defensive with equities targeted at about 75% of normal. If you have any questions, don't hesitate to call your Advisor.

Happy returns,



Brad Bickham, CFA, CFP®
Partner | Chief Investment Officer

Index Definitions & Disclosures:

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.

Performance Calculation Disclosures: a) Time weighted returns are used; b) Cash and equivalents are included in the balanced composite, but not in the equity or fixed income composite; c) Gross figures do not reflect the deduction of investment advisory fees for all clients. Therefore the return would be reduced by the advisory fees in some cases. d) Returns are not GIPS compliant; e) Total return includes the reinvestment of dividends and capital gains.

Past performance is not to be construed as a guarantee of future performance. Returns are presented for the period shown and may differ for future time periods. Composite is a broad reflection of performance. Prospective clients should recognize that each client's account is customized and performance can vary widely.

References to specific investments should not be construed as a recommendation by Colorado Financial Management to buy or sell securities.

Past performance is not an indication of future results, and as is the case with all investment advisors that concentrate on equity investments, future performance may result in a loss. Portfolio holdings and weightings are subject to change at any time due to ongoing portfolio management. Portfolio returns given are after trading costs but not after fees. Returns do not reflect the holding of cash in the account, if any. This report is for informational purposes only.

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COLORADO
FINANCIAL
MANAGEMENT®

303-443-2433

www.colofinancial.com

Boulder

Denver

Loveland

4840 Pearl East Circle, Suite 300E

3033 E First Ave, Suite 408

4848 Thompson Pkwy, Suite 320

Boulder, CO 80301

Denver, CO 80206

Johnstown, CO 80534