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Celebrating 31 Years
1988-2019




Summertime Economic & Market Perspectives

Mid-Year 2019

Summertime is synonymous with swimming pools, family vacations, camping, baseball games, soccer matches, hiking, parties and just being outdoors enjoying camaraderie with friends and family. I trust you are taking pleasure in this beautiful summer with your favorite pastimes, activities and love ones. At Leshnak Wealth, we are busy reviewing our investment models and preparing to see you for our fall financial reviews.

As the summer has heated up so has the U.S. stock market, recently hitting all-time highs fueled by growth and technology stocks, as well as, the Federal Reserve's reversal to a dovish monetary stance.[i] This has prompted many to wonder if this market could be somewhat like 1999 and the dot.com bubble bust. To recap the dot.com bubble era; the NASDAQ was up nearly 400% in a few short years with stocks being driven up by speculative day traders, buying companies with no earnings, and to make matters worse, initial public offerings of these dot.com companies were rapidly coming to market with almost 900 in 1999 and 2000 (by comparison 2018 had 190 IPO offerings).[ii] Gerry Mihalick of Berkshire Asset Management believes there are some notable similarities between 1999 and 2019 such as low unemployment, low inflation, solid earnings for blue-chip companies, investors buying technology and growth stocks, a flat to inverted yield curve and less investor interest in buying value stocks.[iii] However, he states "investors seem more sober about the risks vs. the pure nothing can go wrong euphoria of 1999" and notes that price to earnings multiples are trading far below 1999 levels and are in line with long-term averages in a low interest rate environment. Additionally, the established growth and technology stocks of 2019 on average have cash flow and earnings from their applications as consumers and businesses become more technologically driven.[iv]

The Fed, Inflation & Interest Rates

Federal Reserve Chair Jerome H. Powell provided his Semiannual Monetary Policy Report to the Congress on July 10th, first to the Committee on Financial Services, in the U.S. House of Representatives, and then on July 11th to the Committee on Banking, Housing, and Urban Affairs, in the U.S. Senate.[v] The Fed changed its U.S. outlook for growth from solid to moderate, emphasized slower growth in China and Europe, the possible risks from uncertainty with trade policy negotiations[vi] and noted lower than expected inflation.[vii] Although Chairman Powell had been consistent in the recent past with his stance that the Fed would remain data dependent and not persuaded by political noise, the Fed nonetheless signaled with its statement, testimony and subsequent press conference a dovish stance without actually cutting rates and telegraphed a rate decrease of 0.25% at its next meeting in late July.[viii] This seemed a bit premature since a great deal of data will come in the six weeks between the Fed meetings. Since the Fed meeting personal income and spending have come in strong for May, the jobs created in June were 224,000 and unemployment claims at near historic lows.[ix] U.S. manufacturing has trended down from last year, but manufacturing was only 11% of the U.S. economy in 2018.[x] However, orders for durable manufactured goods increased in June 2% after declines the past two months powered by orders for aircraft, autos and business investment.[xi]

The Fed's stated mandate is to keep prices steady by staving off inflation and to keep America as fully employed as possible. Currently, we have inflation at or below the Fed's target of 2% inflation and unemployment stands at 3.7% which is the lowest since 1969.[xii] U.S. consumers make up roughly 70% of the our economy and the Commerce Department reported that consumer spending jumped by 4.3% in the 2nd quarter of 2019. Furthermore, the Federal Reserve Bank of Atlanta estimates wages have risen 3.9% in the last twelve months.[xiii] The Fed, despite seeing little signs of recession, appear to be giving greater emphasis to developments in overseas economies and the potential they might have on U.S. growth.[xiv] Former Federal Reserve Chairman, Alan Greenspan commented in an interview recently that he endorses an interest rate cut by the Fed at the their July meeting as insurance against further slowing of the economy.[xv]

The European Central Bank, the Bank of Japan and Australia's Central bank have indicated, or are in the process of, reducing rates or employing quantitative easing to aid slowing growth within their economies.[xvi] However, as the Wall Street Journal points out, unemployment in developed countries on average is low, albeit with growth slowing, but not near a recessionary level and inflation in most developed economies is below the 2% mark most central banks consider optimal.[xvii] European Central Bank President Mario Draghi commented recently about the signs of strength in the European economy while acknowledging the uncertainties present with ongoing trade negotiations.[xviii] Europe is being hurt by the trade dispute between the U.S. and China as exports to China have decelerated affecting the global economy.[xix] China has increased stimulus in an effort to boost its economy[xx] including fiscal policies such as infrastructure projects, an accommodative monetary policy and measures to shore up business and consumer confidence.[xxi]

China & Trade Negotiations

After months of what seemed to be productive negotiations with China over a new trade deal, discussions abruptly ceased on May 29th without a new deal. The deal breaker seemed to be the U.S. insisting on addressing the forced transfer of technology and intellectual property protections for U.S. companies, specifically, the arbitration and enforcement of such terms.[xxii] Fortunately the two countries agreed to recommit to trade talks at the G20 summit in Osaka, Japan on June 28-29th that are ongoing and encouraging.

The World Trade Organization (WTO) was created to encourage global trade between private enterprises within participating countries through multi-lateral agreements. China was admitted into the WTO in 2001 after assurances they would open their markets and relax restrictions on foreign investment. Initially, China appeared to comply with the WTO requirements but has since reverted to a state-controlled economy with state-sponsored entities that has resulted in trade conflicts with other WTO members.[xxiii] The Trump Administration believes the current trade agreement is a major cause of the $419 billion trade deficit with China, and the forced transfer of technology for companies doing business in China and the lack of intellectual property protections within China need to be addressed.[xxiv] China would like to see a roll-back of Trump era tariffs as continued import/export taxes harm both consumers and businesses in the U.S. and Chinese economies.[xxv] There are strong incentives for President Trump and Chinese President Xi politically and economically to reach a happy medium and get a deal done. The countries are interdependent, given they are the world's two largest economies and trading partners. China may have more at stake economically, but the U.S. has 2020 elections right around the corner.[xxvi]

The U.S. Economy, Jobs & Recession Fears

Economic expansion in the U.S. is now in record territory with more than 10 years of growth, based on data provided by the National Bureau of Economic Research, with the economy remaining reasonably strong.[xxvii] The dovish shift in monetary policy by the Fed may help set the stage for an extended economic cycle in the U.S.[xxviii] However, the U.S. economy has slowed from 2018 due in part to diminishing fiscal stimulus, a slowing global economy, tight labor market and trade disputes but is certainly not recessionary.[xxix] As technology continues to advance in the U.S., productivity gains may improve growth beyond expectations.[xxx]

The economy grew at 3.1% in the first quarter of 2019 but came in lower in the second quarter at 2.1% due mainly to less inventory accumulation after the excess inventory build-up in late 2018 and early 2019.[xxxi] However, core GDP comprising personal consumption, business investment and home building was the strongest rate in a year.[xxxii] The personal consumption component of GDP came in very strong at 4.3% in the second quarter.[xxxiii] Existing home sales declined in June but the overall trend in 2019 is positive with two quarters of growth after four quarters of decline in 2018.[xxxiv] New single-family home sales increased 7.0% in June and are up 4.5% from a year ago.[xxxv]

The U.S. consumer remains a driving force in our economy representing nearly 70% of our gross domestic product (GDP) plus U.S. consumers represent the single largest force in the global economy as well representing 17% of global GDP.[xxxvi] This share of global GDP by U.S. consumers is larger than the total global GDP share of China or the total share of global GDP of Japan, Germany & the United Kingdom combined.[xxxvii] The University of Michigan's Consumer Sentiment Index is at 98, above the five year average of 94 and near a ten year high mark.[xxxviii] Low unemployment and rising wages, especially at lower income levels could be a formula for continued strength in consumer spending.[xxxix] However, the Fed's most recent discretionary debt information reveals consumer revolving and credit card debt has grown at an 8% annualized rate year over year and non-revolving debt including student loans and auto loans has grown at a 4.25% year over year.[xl] This discretionary debt information reveals two things in my opinion; first, the consumer is confident with spending, but secondly, both categories are growing faster than wages which could be troubling over the long-term. Consumer deleveraging after the housing crisis in 2008 had boosted household balance sheets.[xli]

Rising wages and a tight labor market could put pressure on corporate profit growth going forward[xlii], but as corporate profits for the second quarter are announced, so far with a third of the S&P 500 companies reporting, profits on average are roughly 4% above the strong Q2 2018 earnings exhibited last year[xliii] with 78% of companies surpassing their projections.[xliv] Another worry sign could be that since 2013, dividends, stock-buybacks and mergers have exceeded free cash flows in U.S. companies with the shortfall covered by low interest debt, thus artificially inflating stock prices.[xlv] In fact, as a percentage of gross domestic product U.S. non-financial debt is now at a peak not experienced since the tech bubble in the 1990s and the housing bubble of the 2000s.[xlvi] In a low interest environment, this might continue for a while but if interest rates rise unexpectedly or in a slower growth environment the result may be more volatility.[xlvii] Companies that have a history of sustained dividend increases, are innovative and have manageable debt loads have the likelihood to insulate investors against severe volatility.[xlviii]

As Brian Wesbury, Chief Economist at First Trust, likes to point out "there are five threats to prosperity and economic growth: tight monetary policy (rising interest rates), increased taxation, increased regulation, increased government spending, and trade disruptions". In my opinion the U.S. economy currently has a green light, free from three of five threats. the Fed has begun easing monetary policy, personal and business income taxes have been reduced, and regulation has lessened for companies. However, a yellow caution light is flashing for government spending that seems to have no limits. Likewise, a yellow caution light is blinking as disruption remains with U.S. attempts to renegotiate trade deals and the utilization of tariffs with many global trade partners.

Woody Allen is quoted saying "confidence is what you have before you understand the problem". This newsletter is not meant to scare or create euphoria among readers, but rather provide a balanced landscape of what we are seeing in the economy and markets.

Brexit and Geopolitical Wildcards

Former Federal Reserve Chairman, Ben Bernanke, once said "recessions are very hard to predict and forecast, and usually happen because of some unanticipated series of events…" which we refer to as wildcards, and here are three.

Boris Johnson has taken the helm as the successor to Prime Minister Theresa May in Great Britain.[xlix] He vowed to get Great Britain out of the European Union (EU) by the October 31st deadline either by renegotiating a more favorable Brexit deal than the one his predecessor could not get through Parliament, or by leaving without a deal.[l] The EU has stated they will not renegotiate a new deal.[li] Trade disruptions with a no-deal Brexit could be troublesome for both the U.K., the EU and other global economies.

Tensions between Iran and the U.S. have heated up since President Trump withdrew the U.S. from a 2015 Obama era international accord designed to restrain Iran's nuclear weapons program and subsequently re-imposed economic sanctions against Iran that have hurt their economy.[lii] Iran retaliated by shooting-down a U.S. drone, as well as, seizing oil tankers from the Strait of Hormuz, including a ship from Great Britain.[liii] At present, the U.S. response has been tepid, but the U.S. has purportedly shot down two of Iran's drones[liv] as they approached U.S. naval assets.[lv] Twenty percent of the world's traded oil annually flows through the Strait of Hormuz, according to the U.S. Energy Information Administration, which if encumbered, could drive oil prices up throughout the global economy.

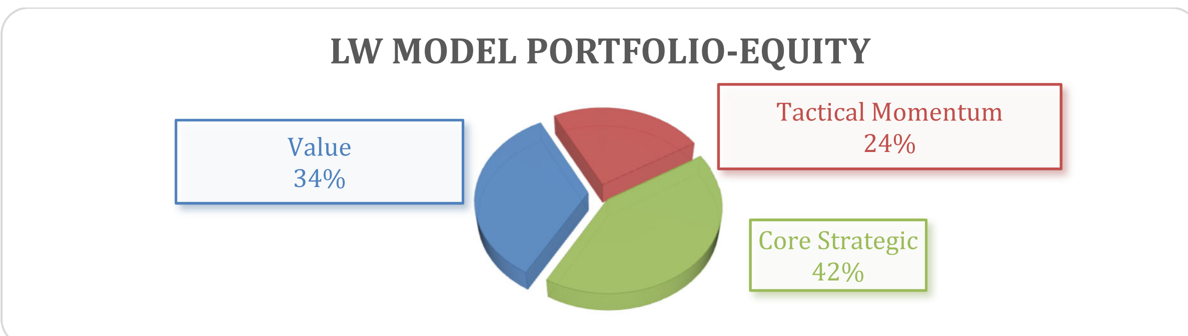
Thousands of citizens in Hong Kong have protested a bill that would allow for the extradition of Hong Kong citizens to mainland China.[lvi] Hong Kong's autonomy is feared in jeopardy as mainland China encroaches on freedoms enjoyed the past 30 years as a special administrative region of the People's Republic of China.[lvii] Hong Kong was a former British Colony and is a global financial center but prospers from its relationship with China.[lviii] As China's military and economic power continue to grow it is important to note that the U.S. and China are not only in a trade dispute at present, but more importantly, in a battle for security and influence in the Pacific.[lix] The battle centers on China's Belt and Road Initiative which is designed to fund infrastructure in the pacific region as a means to gain influence; countries in that region rely on China for trade, tourism and investment.[lx] However, many countries in that region rely on the U.S. for security.[lxi] The U.S.'s Indo-Pacific Strategy is designed to gain regional influence by creating alliances with democracies in the Pacific such as Japan, Australia, South Korea, India, Indonesia and Singapore to curb China's economic and military rise.[lxii] The U.S. and China are economically interdependent but as each contends for global influence and security that picture may change.[lxiii]

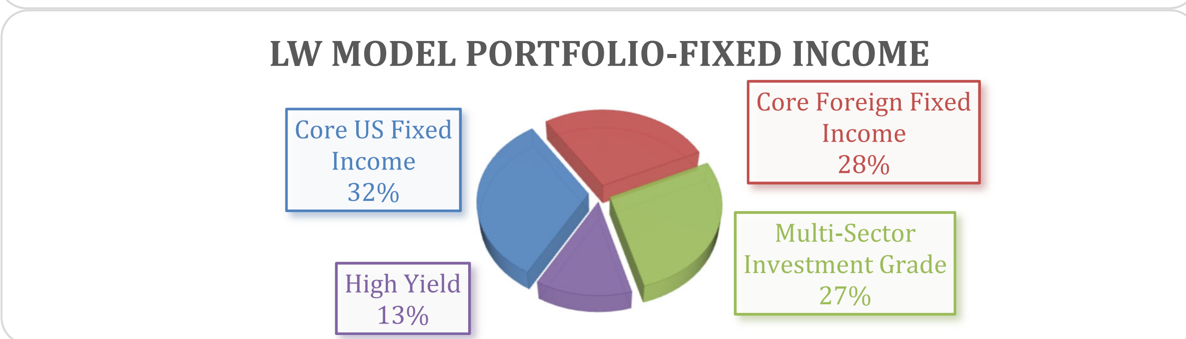
Our GamePlan

Our **Leshnak Wealth Portfolio Models** are not immune to declines in global markets as we do not have a crystal ball nor do any of the market analysts and forecasters. Our belief is that our LW Portfolio Model construction is diversified for potential resilience in any environment and may put us in a position to take advantage of market mispricing during such market gyrations. We do not modify overall asset class allocation due to market corrections unless a fundamental change in the underlying outlook for the domestic or global economy has diminished or brightened verses our expectations. As the ancient Buddhist proverb states "If we are facing in the right direction, all we have to do is keep on walking". Pullbacks can be expected to last relatively shorter periods on average compared to the bull markets they take reprieve from, as the greed present turns to fear and shakes out those investors who are not fundamentally based in their convictions.

Our **Leshnak Wealth Portfolio Models** are globally diversified and strategically constructed, with core equity positions, coupled with a tactical component utilizing a momentum-based investment discipline. This allows the manager to move assets into the sector(s) that best fit current market conditions based on their investment methodology. Additionally, we complement our core equity positions with a value overweight. We believe adding value puts us in the position of the "turtle", in the proverbial tortoise verses the hare scenario, over the long-term with equities. Lastly, we prescribe dividend yield from our equity investment positions so that no matter what markets are doing day to day, we still have dividends coming into the portfolio. Our fixed income blueprint for the portfolio consists of allocations to core domestic bonds, foreign core bonds, strategic investment grade bonds and high yield global fixed income.

Overall, we evaluate investment positions in eight asset classes including domestic equities, foreign developed stocks, foreign emerging market equities, domestic bonds, foreign bonds, cash equivalents, commodities, and real estate for inclusion within our overall asset allocation. How much of each asset class (if any) we hold in these asset classes is based on your unique risk tolerance, financial resources and personal goals and objectives.





As your financial fiduciary, the Leshnak Wealth Team cares deeply about your financial well-being and will monitor for rebalancing opportunities that may add value to your portfolio, or to be defensive as conditions might warrant. We know that as your advisor, the trust you bestow upon us is built and maintained on three pillars; doing what we say we will do, assisting with planning for and achieving your financial independence, and providing unbiased advice with your best interest at the forefront. As always, please call with questions or if you wish to discuss your specific portfolio in greater detail.[lxiv]

–Bob Leshnak, July 26, 2019

The investment decisions are those of Robert M. Leshnak, Jr., CLU, ChFC, CFP®, MS, EA as of 7/26/2019 and are subject to change. The information contained herein is only intended for Leshnak Wealth clients invested in the Leshnak Wealth Portfolio Models. No forecasts or recommendations are guaranteed. The technical data utilized as part of the investment decisions does not guarantee future positive results. Performance, especially for short periods of time, should not be the sole factor in making investment decisions. The information contained herein does not constitute client specific investment advice or consider a specific client's particular investment objectives, strategies, tax status, resources, or investment time horizon. No investment strategy such as asset allocation, diversification, tactically overweighting sectors, or utilizing fundamental and technical analysis can always assure a profit, nor always protect against a loss. The information presented is not intended to be a substitute for specific individualized tax, legal, or financial planning advice. The payment of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time. Investing involves risks regarding all of the investment products mentioned in this commentary, including the potential loss of principal. International investing involves additional risks including risks associated to foreign currency, limited liquidity, government regulation, and the possibility of substantial volatility due to adverse political, economic, and other developments. The two main risks associated with fixed income investing are interest rate and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the insurer of the bond will not be able to make principal and interest payments. Investments in commodities may entail significant risks and can be significantly affected by events such as variations in the commodities markets, weather, disease, embargoes, international, political, and economic developments, the success of exploration projects, tax and other government regulations, as well as other factors. Indexes are unmanaged and investors are not able to invest directly into any index. Past performance is no guarantee of future results. Please note that individual situations can vary. Therefore, the information presented here should only be relied upon when coordinated with individual professional advice.

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