McQueen, Ball & Associates
Private Wealth Management

Quarterly Insights

July 2018

Crosscurrents

The second quarter saw continued strength in the global economy with robust US Corporate earnings. At the same time, investors are content with the prospect of higher interest rates, rising inflation, and the unpredictable political environment all of which could hinder growth. The confluence of these factors will likely continue to feed volatility for the near term.

The slow and steady economic recovery that began in 2009 and passed a milestone in the second quarter is now tied for the second longest economic expansion in American history. First quarter GDP was reported at a 2.2% annual rate, down from the 2.9% rate in the fourth quarter. The slowdown was attributed to lower inventory investments and consumer spending,. However, the fiscal stimulus provided by the tax cuts will likely boost growth for the remainder of the year.

Enduring economic strength and a low unemployment rate (3.8% at the time of this writing) is emboldening the Federal Reserve to advance a tighter monetary policy. At the June meeting they cited that the economy was, "rising at a solid rate." With two 25 basis point hikes thus far, the Federal Funds Target Rate is now 1.75%-2.00%. Given the underlying economic strength the Fed is telegraphing two additional hikes by year end and it anticipates we will have three more in 2019.

One reason for the Fed's actions is that inflation is starting to move higher. Inflation is generally a lagging indicator so higher interest rates are needed now to quell inflation later if economic growth kicks into high gear. May core CPI was 2.2% year-over-year, but low unemployment coupled with fiscal stimulus will likely keep inflation gradually moving higher.

The effect of higher interest rates on stocks is a wild card. It will ultimately depend on how high rates rise and the ability for corporations to continue growing profits. Equity valuations on the S&P 500 are roughly at a Price/Earnings ratio of 16.5x on 2018 estimates which seem reasonable given the backdrop of a 3.00% US 10 Year Treasury rate.

Aside from the economic fundamentals, the ongoing trade disputes that began in 2017 continue to dominate headlines. As markets attempt to decipher the impact, volatility has noticeably increased. The major dispute remains between the US (23.3% of Global GDP) and China (16.1% of Global GDP). By comparison, the next largest country on a Global GDP basis is Japan at 5.90%.

In the past 3 months we have witnessed a dizzying array of tit-for-tat trade moves. In order, they have been: (1) the US imposes steel (25%) and aluminum tariffs (10%) – China responds with tariffs on $3 billion on US imports (2) US and China each threaten targeting an additional $50 billion of imports with tariffs (3) The US threatens tariffs on $100 billion and banning one of China's largest tech companies -ZTE (4) Negotiations commence and appear successful with conciliatory statements from each side (5) US revives $50 billion tariff threat and a limit to Chinese tech companies, with the threat of an additional $200 billion should China retaliate.

The size of the $200 billion threat makes it impossible for Beijing to respond with a tariff targeting an equal amount as it exceeds the total value of US imports to China. Beyond tariffs, China could employ other tactics such as creating costly bottlenecks for US imports, boycotting US products, or allowing the Yuan to move lower thereby making US goods more expensive and Chinese exports cheaper.

Given the benefit of trade to both sides, it seems unlikely that a true and ongoing trade war will develop. At Berkshire Hathaway's annual meeting Warren Buffett addressed this issue by stating, "There will be some back and forth, but in the end I don't think we'll come out with a terrible answer on it … [Trade] benefits are huge and the world's dependent on it in a major way for its progress that two intelligent countries [won't] do something extremely foolish."

Short-term volatility can be unsettling, but it often masks perspective of the longer term progress the country has made and continues to make. Virtually all of the modern amenities that we rely on to make our lives easier and more fulfilling were developed over the last 100 years. Imagine life in 1918 with a lack of air-conditioning, travel that would take days or weeks, painful less effective medical care, limited food choices, and no computers or internet are just a few. It's encouraging to think that a middle class American in 2018 lives a lifestyle of conveniences that the richest man of the period, John D. Rockefeller, could not have dreamt of.

With the advent of new technologies such as Artificial Intelligence (AI), automation, and robotics the pace of innovation seems to only be accelerating. One tangible example is that of Google X, a division of Alphabet (Google's parent company) which focuses on inventing "moonshot" projects that hope to be breakthrough technologies. Amongst many, X encompasses projects like Waymo – a self-driving car unit, Loon – a project to bring internet access to everyone in the world via a network of solar powered flying balloons, and Wing – a project to rapidly deliver packages by using flying vehicles.

The world's ceaseless, underlying innovation and the delivery of modern technology (from agriculture to computers) to an underserved world is a prime, long term driver of economic growth. Yes, it is often detoured by self-serving governments and individuals but it persists nonetheless.

While the future seems promising there will always be unknowns. At this time the fundamentals of the global economy appear to be healthy while the risks are always most apparent with the benefit of hindsight. The juxtaposition of strong economic growth with rising interest rates and geopolitical tensions could keep volatility elevated. We will maintain our discipline by remaining balanced and diversified.

-Jerry McQueen & Todd Fungard

Bond Funds when Interest Rates Rise

When interest rates rise bond prices fall. Bond funds follow this same rule, however because the funds hold a basket of individual bonds they do not have a single stated maturity date. Some investors believe that due to this it is superior to hold only individual bonds because they will receive their principal back at maturity. The benefit of holding to maturity is more of an emotional benefit than an economic one.

Given that bonds are issued at a fixed coupon rate the only factor that can be adjusted to compensate for higher prevailing current interest rates is price. For example, if a 10 year bond is issued at a 3% coupon rate and the 10 year market rate immediately moves higher to 4% the price of the 3% coupon bond needs to adjust down to offer the same return or yield to maturity as the new bonds being issued at 4%. All else equal the price will drop to a point where both bonds from that point forward offer the investor a comparable yield to maturity. See the chart directly below.

Hypothetical 10 Year Bond Comparison

Coupon Rate at Issuance	6%	5%	**4%**	3%	2%
Yield to Maturity - Current Market Rates	4%	4%	**4%**	4%	4%
Market Price of $10,000 bond	$11,635	$10,817	**$10,000**	$9,182	$8,364

When a bond's price falls an investor has two options: 1) hold the bond to maturity and receive the scheduled coupons and original principal or 2) sell at a loss and reinvest the proceeds into a bond with the same maturity but now higher coupon. It is correct that an investor who does not sell will indeed receive their original $10,000 back at maturity. In the above example though they will have foregone earning an additional 1% for 10 years as the cost. Both options from the point the bond falls in price should offer the same rate of return. Therefore there isn't any economic benefit to having a specific maturity date to receive principal back.

The same is true in a falling interest rate environment. An investor could theoretically "lock" in a principal gain as interest rates fall by selling their bond at a premium and reinvest the proceeds into a lower coupon bond. However, if they decided to hold that same bond to maturity they would only receive back their original investment and forego their principal gain. In either instance the yield to maturity would again be the same.

One way of thinking about this is that a bond fund is simply a collection of individual bonds and can't be worth less than the sum of its parts. Holding a portfolio of individual bonds is in essence similar to a bond mutual fund.

The primary benefit of holding individual bonds is that of control and taxes. Bond funds cannot pass realized losses through to individuals where an investor could make the decision to sell a specific bond at a specific time to capture a loss. Bond funds however do use realized losses to offset realized gains that would need to be passed to investors. Investors also have the option to sell mutual fund shares where applicable to realize losses.

Holding individual bonds can allow a portfolio to be tailored to an individual investor's needs. For example a portfolio of municipal bonds can be bought to be exempt from state income taxes. It also provides investors the ability to control credit quality and interest rate sensitivity of the portfolio (duration).

For more information about McQueen, Ball & Associates and our products and services please contact us at 610-954-0400 or by email at info@mcqueenball.com

McQueen, Ball & Associates, Inc.

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