Yanni & Associates
Investment Advisors, LLC

FOURTH QUARTER – 2018 CLIENT NEWSLETTER
REVIEW OF THE MARKETS:

Index:	4Q18	2018
S&P 500	-13.52%	-4.38%
S&P Mid-Cap	-17.28%	-11.08%
S&P Small Cap	-20.10%	-8.48%
Morgan Stanley's EAFE (International Stocks)	-12.54%	-13.79%
Barclay's US Aggregate (Bonds)	1.64%	0.01%

ECONOMY & MARKETS:

The stock market significantly retreated in the fourth quarter and it's December month alone was the worst since The Great Depression. While we have experienced a few corrections starting in December, 2015 with the Fed's first interest rate hike, this past quarter was much more extreme. For the next few years, we will likely not see a year similar to 2017 which went more than a full year without a 3% correction. We believe 2019 will be somewhere in-between. While the stock market was positive through September, the bond market was negative virtually all year before a surprise turn in the last few weeks enabled it to squeak out a 0.01% annual gain. As we continued through the fourth quarter, this left very few hiding places. Earnings growth is projected to slow from approximately 20% to 6-7% in 2019, but the risk may be to the downside. The forward P/E on the S&P 500 is now 14.3 times earnings; the lower end of its historical average. Overall, the major threats to the markets continue to be pressure from further interest rate hikes, a possible yield curve inversion, and the ongoing potential trade war with China.

The economy continued to grow in 2018 with the latest measure of GDP being 3.4%. This July, the expansion will enter its 11th year, making this the longest U.S. expansion in over 150 years of recorded economic history. General inflation measures continue to rise modestly, but still remain tame with little threat of a significant spike in the upcoming years. The latest measure of the unemployment rate was reported still at a low level of 3.9%.

While we were hoping for a pause in interest rate hikes, the Federal Reserve (The Fed) did raise them again this past December. However, the Fed did lower their interest rate forecast for 2019 from three to two more rate hikes (we do believe they will "pause" at least at their next quarterly meeting). **Arguably, there is a disconnect between the markets and where the domestic economy is at this point (*more on page 2!*).** The Fed's most recent economic growth projections for the next three years continue to show growth (2.3%, 2.0%, and 1.8%, respectively); meanwhile, the markets are behaving as if a recession will occur well sooner. We also do not believe a recession "should" occur in 2019, but the underlying risks causing the market volatility could inadvertently push the economy towards one. In addition, the next Presidential election is about 18 months away raising the probability that another stimulus package could get passed. With unemployment remaining historically low and wages continuing to rise slowly, this gives the Fed more ammunition to raise rates. We believe that Committee is not properly discounting the structural change that accounts for Baby Boomers leaving the workforce. Yields reversed late in the quarter; the yield curve then unexpectedly flattened. By November, the 10-year government bond crept to 3.263% then unexpectedly dropped to 2.550%. The threat of the Fed causing an inverted yield curve still persists today (short-term rates higher than long-term rates), which again has been a high predictor of an upcoming recession. In recent weeks, we experienced an inversion in the "belly" of the yield curve; for example, the one-year Treasury Bond is higher than the three-year Treasury bond, but still less than the 10-year.

2018 mutual fund "pass-through" capital gains:

Two years ago, 2017 was phenomenal for stock market returns. As a result, many mutual funds distributed abnormally high capital gains in late 2018, making that a high tax year in a down market. As discussed in prior newsletters, once a year mutual funds must distribute their trading gains to shareholders, typically done in the fourth quarter (we term this "pass-through gains"). As YAIA utilizes many ETFs in place of actively managed mutual funds, this high level disbursement of pass-through gains normally does not affect our clients as much.

On a related note, we were active with December trading attempting to move into investments that should buffer expected volatility and also realized losses, where appropriate. Realized losses can be used to offset other capital gains, potentially an offset to ordinary income, with the excess being carried forward perpetually on one's federal tax return. In times of negative stock returns, we believe the proactive approach of realizing losses is often a way to still help clients save money.

In a recent example, we worked with a new client whose former Broker invested her inheritance at the beginning of 2018. The Broker chose many Class A & Class C funds (Class C has an exit fee if sold within the first year). We discovered the Broker not only failed to actively take losses, but in some instances was restricted to do so because the Class C funds would have triggered an additional exit fee. Rather than taking losses in some Class A funds and communicating the Class C fund sale restrictions, the Broker instead chose to do nothing.

How to spot a Recession:

Forecasting a recession is an extremely precarious task and this section will attempt to outline why that is the case. By definition, an official recession is when the economy experiences two consecutive quarters of negative GDP growth. GDP is reported quarterly, but in arrears. For example, the fourth quarter 2018 GDP report will be released on January 30th, which is then revised twice. The last and final GDP report comes on March 28th. Thus, we will not officially know if the economy had negative GDP growth for the fourth quarter until three months after the quarter ends. Other key points to consider are:

1. Early indicators of trouble, such as stock-market selloffs and surveys of sentiment, are imperfect forecasters of a recession. These early indicators have a lot more credibility when many of them flash a warning sign, which arguably is what is happening now.
   - ✓ Examples of early indicators of a recession happening today are stock market sell-offs, (near) inversion of the yield curve, bond spreads (corporate yields over safe Treasury yields) widening, business sentiment waning, and the housing market weakening. Traditionally, the stock market tends to be a leading indicator of a recession by approximately 6-9 months, and consequently often rallies from its trough well before the economic recession has officially ended (*my college Senior Thesis was on a related topic!*). Also, it's very possible one or more of these lead indicators could indicate a false-positive.

2. Hard economic numbers that more accurately predict a slowdown are lagging, so they often confirm what everyone already knows.
   - ✓ Many of the "close-to-real-time" lagging indicators including initial jobless claims and other unemployment figures, industrial production, and others are currently still growing steadily. It is also important to note that recessions can start fast. While the most real-time lagging indicators can show steady growth one month, they can also quickly turn the next.

So, which is it? ➔ It's probably still a bit premature to make a definitive decision. To make matters more complicated, corporate earnings growth is still expected to be positive this year, which could drastically change through increased Geopolitical issues or ancillary pressures from the Federal Reserve's interest rate increases.

We must also point out that academically speaking, the stock market is supposed to follow the path of corporate earnings growth. However, we have clearly witnessed the stock market's influence from both the Fed and President Trump's comments. Earnings growth is very related, but not 100% correlated to GDP growth though. In comparison to how S&P 500 earnings growth is calculated, GDP growth does not include international sales, but does include government spending. Also its accounting method is different and it has a disproportionally higher amount allocated towards consumer spending.

Future withdrawal expectations to be tested:

Our often discussed "5% rule-of-thumb" for potentially, sustainable retirement withdrawals will be tested. We often guide clients to develop a budget and attempt to keep their withdrawals to be less than 5% of the portfolio value (including taxes) as to not run the risk of depleting principal over time. Some Advisors actually use 4% as a guideline. With the high probability of the markets entering a period where below-average returns should be expected, this guideline may be challenged. We also do note that unexpected changes to health care costs and/or emergency spending is generally, not a part of this calculation.

Pertinent tax, Social Security, and other changes for 2019:

A. IRA contributions will increase from $5,500 to $6,000 (catch-ups will remain at $1,000).

B. Employer sponsored plan contributions will rise from $18,500 to $19,000 (catch-ups will remain at $6,000).

C. Alimony will no longer be tax deductible by the payee nor taxable by the recipient.

D. Social Security Restricted Claim is officially going away if you did not turn 65 by 01/02/2019. Restricted Claim is the term used to describe when a person files to receive ½ of either their spouse or ex-spouse's benefits while letting their own benefit continue to grow in the background. Adding to the story of the new client on the first page, she is divorced and her birthday falls closely still within the eligibility range for Restricted Claim. Her former Broker never mentioned to her she would still be eligible to file a Restricted Claim application upon turning 66 on her ex-husband's behalf.