HFG WEALTH MANAGEMENT

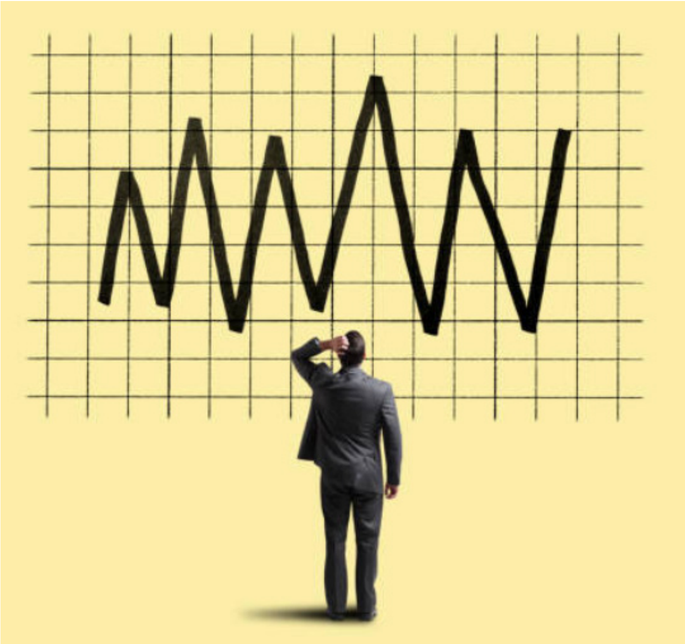
INSIGHT

PERSPECTIVES FOR THE GOAL-FOCUSED INVESTOR

WINTER 2019

A Rough Ending to 2018

Last quarter was a rough end to a rocky year. Unlike 2017, 2018 was volatile. It even had the worst December performance since the Great Depression. Volatility fought back in a big way, as if to remind investors that stocks don't always go up.



As American economist Milton Friedman would put it "There is no such thing as a free lunch." This rings true, especially today, when it seemed many investors were jumping into stocks because they kept moving up.

The stock market does not create a free lunch. Stock investors get paid their returns by taking risk. The risk is always that a stock goes down. However, over the long-term, investors are usually paid for taking this risk. Stocks generally have stronger returns, compared to bonds or certificate of deposits (CDs), because they are a riskier investment. Investors are paid over the long-term for volatility in the short-term.

Here are some tips to manage the emotions that short-term losses may invoke:

- Talk to your advisor about your risk tolerance.
- Don't look at your account too often.
- Focus on long-term goals.
- Call your advisor with any questions you may have about the markets or your investments.

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>
> - Milton Friedman

Politics is Affecting the Economy

There are two main uncertainties revolving around the political spectrum. The first is the trade war with China. The other uncertainty comes from the government shutdown. While the trade war with China has a lot more investment implications, the government shutdown can also affect the U.S. economy.

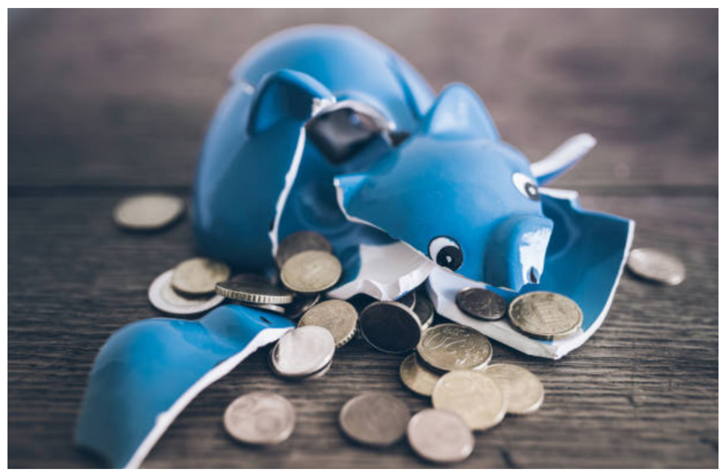
The trade war is a big deal for both countries. The Trump administration has levied tariffs on $250 billion worth of Chinese imports. China retaliated by imposing tariffs on $110 billion worth of American goods. As most economists will tell you, nobody wins in a trade war, and these tariffs are wreaking havoc across many industries and sectors of both economies. Many U.S. farmers are feeling the pain as China looks to other countries for their soy bean and pork needs, and China's economy as a whole is struggling to absorb the higher costs and weaker trade.

However, the trade war has taken some promising steps forward by both sides. The two sides agreed to a 90-day moratorium, so negotiations could restart. This came while President Trump and President Xi met in Argentina for Dinner. Hopefully the two sides can come to a quick resolution. Although, where the trade talks stand, depend on who you ask. Some analysts believe there is a quick resolution, while some think it could take years. Unfortunately for the U.S., time is on China's side. They only need to wait until 2020 or 2024 when a new President takes over, and they can hopefully gain better favor.

In other political news, Trump's government shutdown shows no end in sight. He really wants his wall, and Democratic leaders do not want to give it to him. The president believes the wall is a necessary tool that will help stop illegal border crossings, human trafficking, and drug trafficking. Meanwhile, democratic leaders want to use the money to provide new technology and tools to stop and prevent the illegal activity. More specifically, they do not want to spend the money on a wall.

This is only a partial government shutdown, so only 800,000 workers are not working or being paid. Most of the workers are people that work for the National Parks, TSA, and Homeland Security, so they are not necessarily an integral part of the government or the investment world. However, the SEC is affected, and investment regulators and activity are taking a hit. The biggest examples come from two IPO (initial public offerings) by Lyft and Uber. These have been delayed due to the shutdown.

However, the biggest problem investor's face doesn't come from the shutdown directly; it comes from the after affects. Non-essential workers are not working, and not being paid. Essential workers are working, and still not being paid. The latest news headlines such as "Rent Isn't Furloughed" paint pictures of struggling government workers that need their paychecks.



The U.S. economy relies on consumption. When a federal worker gets paid, they redistribute that wealth throughout the economy to buy food, pay rent, and acquire anything else they need/want. When the government doesn't pay its workers, it is also taking money away from the people that provide services to the worker. While a quick shut down will not likely affect the overall economy, a prolonged one may.

Market Rotation: Growth into Value

Last quarter we discussed the Value vs. Growth paradigm. Over the last 10 years growth has outperformed by over 4%, as the Russell 3000 Growth Index has returned 15.2% compared to 11.1% for the Russell 3000 Value Index on an annualized basis. Jim Cramer of CNBC coined the term FANG back on February 5, 2013 and the acronym has morphed into the ubiquitous FAANG which represents Facebook, Apple, Amazon, Netflix, and Google parent Alphabet. Last summer, at their peak, the collective capitalization of these stocks was approximately $4 trillion or about 12% of the entire US stock market surpassing all other global stock markets with the exception of Japan, China and Euronext. However, these stocks along with their technology and growth brethren took a nosedive as the NASDAQ composite index fell over 17% in the fourth quarter and dropped nearly 10% in December alone. However, value stocks led their growth counterparts in the fourth quarter by over 4%. As a result of the recent declines the market has become less expensive as the S&P 500's forward price to earnings ratio stands at 14.5% compared to over 17% in early 2018.

The source of the fourth quarter market volatility was multi-pronged. As the Federal Reserve continued to raise the Federal funds rate and reduce their balance sheet, investors became skittish about the prospect that the Fed may increase short term rates by another 0.75% to 1% in 2019. However, as there are continued signs that the US economy is slowing, albeit slightly, there are indications that the Federal Reserve is no longer on "autopilot" and will be cautious regarding any further rate increases this year. Additionally, global investors remain concerned about trade tensions between the US and China. As a result of these trade concerns, as well as tightening global liquidity, emerging markets were weak as the MSCI

Emerging Markets Index declined by 14% in 2018. Additionally, the Chinese market fell by nearly 20%.

Regarding trade issues with China, it is reasonable to assume that there will be a resolution sooner rather than later. President Trump has shown no sign of backing down and the fact of the matter is that he is in a strong position as China exports far more to the US than we export to China. It is no coincidence that Chinese market declines accelerated as US tariffs were put in place last summer. The open question is how much pain will the Chinese government allow their economy to endure? It is important to remember that emerging and foreign markets in general, experienced a strong year in 2017. No one can predict what 2019 holds for foreign economies but as I write this the combined foreign market index is up over 4% during the first two weeks of 2019. Allocation "drift" will occur with any portfolio and it is important to remain disciplined to address this issue. As asset classes either outperform or underperform, they should be periodically rebalanced as short-term movement in any direction for a given asset will tend to revert to the mean over the long term.

It is important to remember that fixed income investments are a key component to a diversified portfolio. Whether they comprise 10% or 50%, high quality fixed income investments tend to have an inverse correlation to stocks. As a result, while stocks were declining in December, the Barclays Global Aggregate Bond Index gained 2% for the month. As the Federal Reserve has been raising short-term rates it has resulted in a flattened yield curve. As a result, 90-day Treasury bills are yielding 2.4%, only slightly lower than the 2.7% yield for the 10-year Treasury note. Under current market conditions, investors are simply not adequately compensated for taking on the risk of holding longer term fixed income securities.

In conclusion, it is reasonable to assume that we are in the midst of a market rotation from growth into value. Investors should focus on owning high quality, value-oriented stocks. These companies typically have high barriers to entry, have enjoyed long periods of profitability and often pay above-average dividends. Indeed, historical returns have shown that these types of stocks have experienced long-term outperformance with lower volatility. As a result, they tend to fare better during slowing economic conditions relative to those whose valuations are built on future growth prospects and less by profitability and earnings. While the recent daily volatility may be difficult to endure, it is important to remain disciplined and focus on your long term financial goals.