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TILIA NEWS

INVESTMENT MANAGEMENT | FIDUCIARY ADVICE | RETIREMENT PLANNING

Don't Sweat the Bond Decline

As interest rates have risen since the lows of 2016, investors are feeling the effect in their portfolios, in the form of loss in value of bond holdings. This value shows what an investor could expect to receive if they decided to sell that bond prior to its stated maturity date.

This is not something to fear as investor. At Tilia, our primary focus with the fixed-income portion of investor portfolios, is to buy individual bonds and hold them to maturity. In order to meet potential funding needs, and protect the overall bond portfolio from the effect of rising rates, we "ladder" our bond holdings in a way that provides a steady stream of maturing bonds. The proceeds from the maturing bonds can then be reinvested to earn higher rates, used to fund spending needs, or to adjust your overall allocation.

Simply put, when you buy an individual bond with a set maturity date, you are locking in your annual return. Rising rates may cause your returns to be lower for a year or two, but you make that up in the form of higher returns as the maturity date approaches.

It doesn't feel good, but this is what you want to see if you are a bond investor. When bonds mature, you want to be able to earn a higher return with the proceeds, which is exactly the situation investors are in now.

Assessing the Health of Stocks & the Economy

It's been said many times that "the stock market is not the economy", but over time, stock prices are heavily tied to corporate earnings. For most companies, earnings are dependent on a stable & growing economy that gives consumers the optimism to spend money & businesses the conviction to make investments for future growth & hire new employees.

Notice I used the the words "over time" - two words that our clients hear from us repeatedly. In the short run it is certainly true that the market is not the economy. As we've seen several times during 2018, the market will look downright sick, while the economic data continues to indicate that the economy is moving along nicely.

In the short run, markets are heavily tied to investor behavior & sentiment. Investors attempt to be forward-looking, assessing whether earnings next quarter and next year will be stronger than they were last quarter and last year. Predicting the future is a tough business though, so investors more often than not, get it wrong. That's likely the case with the ugliness in the U.S. market as of late. Investors are starting to worry about the effect of rising interest rates and trade disputes, among other things. As a result, skittish investors are selling out of higher growth stocks & cyclicals, in favor of defensive companies (think consumer staples & utilities) or cash.

In light of the recent market duldrums, this is a good opportunity to take a step back and look at the bigger picture, including both the positive and negative forces at play.

The Positives

1)Unemployment is low & continues to fall. There have been more job openings for the last six months in a row than the number of unemployed job-seekers.

2)Post tax-reform, U.S. corporations are retaining considerably more (in most cases) of every dollar earned, which is strengthening corporate balance sheets, adding fuel to corporate expenditures & increasing the amount of cash being returned to shareholders via dividends and stock buybacks.

3)Heavy truck sales are booming, +18% year-over-year in October. Major declines in heavy truck sales have preceded several of the recent recessions, including in the years 1979, 2000 & 2007.

4)ISM Manufacturing & Non-manufacturing indexes remain firmly in growth territory, though the pace of growth slowed in October.

Happenings at Tilia

We recently celebrated Ryan Casey's one year anniversary as an Investment Advisor with our firm. Ryan's has made a very successful transition from the Marine Corps, and we're thrilled to have his talent at the firm. Ryan was recently accepted into the *Leadership Wilmington* program orchaestrated by the Wilmington Chamber of Commerce. He's also working diligently towards the CFP® designation, which requires countless hours of studying & test-taking beyond the normal work day. On top of that, Ryan was recently promoted to the rank of Major in the Marine Corps Reserves. If that isn't enough, he and his wife, Kristi are expecting their second child in February of 2019. Congrats Ryan!

Ryan has not been alone with his educational pursuits. Tilia Managing Director, Walker Abney, is several classes into the Masters in Finance & Investment Management online program at UNCW. Walker is also wrapping up his 7th year serving on the Board of Trustees for Historic Wilmington Foundation, having served the last two years as the President of the Board. Walker is hoping to complete the UNCW program at the end of the summer of 2019, and very much looks forward to having some free time again.

We're big believers in continuing education at Tilia, but we also realize that what got us all individually to where we are today was our "PSD" degree. Being Poor, Smart & Determined. That is what we value highly when looking for new hires & we will never turn down potential clients with minimal assets if they possess those traits.

5)National inventory of loans in active foreclosure just recently fell to 12 year lows, falling below pre-financial crisis levels.

6)Light vehicle sales are in-line with 2017, on pace to have the 5th best year ever.

7)Port traffic remains strong. This October was the busiest October ever for the Port of Long Beach, which is the largest west coast port.

8)Overall construction spending was +7.2% year-over-year in September.

9)Gross Domestic Product is forecasted to expand between 2.6 - 2.9% in Q4 2018.

10)Corporate revenue & earnings reports for the 3rd quarter have showed steady, impressive growth across most sectors.

The Negatives

1)Interest rates are rising, and the Federal Reserve's pace for the last 12 months has been 1 full percentage point per year. This of course makes borrowing of all sorts more expensive, which dampens growth. We are now at a 7-year high for 30 year mortgage rates, though still low by historic standards.

2)On top of interest rate increases, the Federal Reserve is unwinding its balance sheet, which has a tightening effect on the economy, helping to push up rates. Following the financial crisis, the Fed made regular purchases of U.S. Treasury bonds & mortgage-backed securities, and that extra demand drove long-term rates lower. Now the opposite is happening - the Fed is selling off these bonds, so the extra supply drives rates higher.

3)Housing is showing signs of slowing & price declines in some major markets, including New York & San Francisco. This seems to be isolated for now, as many markets with lower taxes or cost of living are thriving.

4)Global stock markets have experienced a widespread downturn in 2018, led by emerging markets. The large economies of Japan and Germany actually shrank in the 3rd quarter, contracting at annualized rates of - 1.2% & -0.8% respectively.

5)Though port traffic is strong, evidence of the effects of the U.S. - China trade war are showing up in the data, with exports to China slowing, while U.S. importers are rushing to bring in Chinese goods ahead of pending tariffs.

In summary, we make these lists from time to time, and the positive & negative forces are the most balanced they've been in a long time. There is no doubt that the U.S. economy is currently in good shape. The momentum of the economy, and the tailwinds behind it could keep stock prices trending higher for a few years to come. On the other hand, the odds of a near-term recession are rising, and bond yields are becoming more attractive. This is not the time to take undue risk. Long-term investors should continue to own high-quality stocks, but consider making incremental adjustments to lower portfolio risk, and ensure that they have a cash/cash equivalent safety net in place.

Sources: Calculated Risk Blog calculatedrisk.com

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