

# INVESTMENT REPORT



LYNCH FINANCIAL GROUP LLC  
— Retirement Wealth Management —

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[www.LynchFinancialGroup.com](http://www.LynchFinancialGroup.com)

## Investment Review and Outlook

### Benchmark and Mutual Fund Performance

The box below contains benchmark (capital market and investment style) performance results. This quarter, both equity markets and interest rates have been on an up-and-down roller-coaster ride. Amidst this backdrop, stocks rose in July, fell in August, then rallied in September. Foreign stocks outperformed in the September rebound, but it wasn't enough to see them keep pace with U.S. stocks for the quarter. Due to declining interest rates, core investment-grade bond returns have been strong.

### Third Quarter 2019 Key Takeaways

The third quarter of 2019 was another choppy one for financial markets as investors continued to weigh the overall health of the global economy against a host of uncertain macro factors. Uncertainties included the ongoing trade war with China, a drone attack on Saudi Arabia's oil fields, the seemingly never-ending Brexit negotiations, and—as September wrapped—an official presidential impeachment investigation in Washington, D.C.

On the economic front, the Federal Reserve followed its 25-basis-point interest rate cut in late July with another 25-basis-point cut in mid-September. These actions were in response to the weak global economic (continue on page 2)

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**Equity markets rose in July, fell in August, then rallied in September.**

**Despite a rebound in September, foreign stocks posted negative returns for the quarter.**

**Bond yields around the world continued to move lower in the third quarter as deflation concerns took hold.**

**Corporate bonds gained for the quarter.**

*We welcome questions or comments regarding this newsletter at [jlynch@lynchfinancialgroup.com](mailto:jlynch@lynchfinancialgroup.com). Lynch Financial Group provides Retirement Wealth Management Services to individuals within 15 years of retirement, retirees, and surviving spouses. We also provide specialized assistance to professionals, fiduciaries and heirs in wealth transfer situations.*

### U.S. Stocks are Priced as if History is Irrelevant

At a time when U.S. stocks have continued to outperform, clients sometimes ask why we don't have more in U.S. stocks.

(Interestingly, we rarely get asked why we don't have less.) The most important point we relay in those discussions is that a portfolio needs to maintain a balance because each asset in it has a defined role and no one knows how to time market tops or bottoms.

*Continued on Page 4*

### Benchmark Returns (Periods Ended 9/30/2019)

	Quarter	12 Months
<b>Large-Cap Benchmarks</b>		
Vanguard 500 Index	1.7%	4.1%
Russell 1000 Growth iShares	1.4%	3.5%
Russell 1000 Value iShares	1.3%	3.9%
<b>Mid-Cap Benchmarks</b>		
Russell Midcap iShares	0.4%	3.1%
Russell Midcap Growth iShares	-0.8%	5.0%
Russell Midcap Value iShares	1.2%	1.5%
<b>Small-Cap Benchmarks</b>		
Russell 2000 iShares	-2.4%	-9.0%
Russell 2000 Growth iShares	-4.2%	-9.7%
Russell 2000 Value iShares	-0.6%	-8.4%
<b>Other Benchmarks</b>		
Vanguard Developed Mkts Idx	-1.0%	-2.1%
Vanguard Emerging Markets	-3.7%	1.1%
Vanguard REIT Index	7.4%	19.7%
Vanguard Total Bond Mkt Index	2.4%	10.3%
Credit Suisse High Yield Index	1.0%	5.8%

## Investment Review and Outlook (Cont.)

environment and the impact of trade policy on U.S. business sentiment and capital expenditure. The European Central Bank also cut its policy rate and announced it would launch a new open-ended asset purchase plan (i.e., quantitative easing) starting in November.

Amidst this backdrop, equity markets rose in July, fell in August, then rallied in September. Larger-cap U.S. stocks gained 2% for the quarter and have netted over 20% year to date. Smaller-cap U.S. stocks suffered more acutely during the market drops and ended the quarter down 2.3%. For the year to date, they are still up a healthy 14.1%.

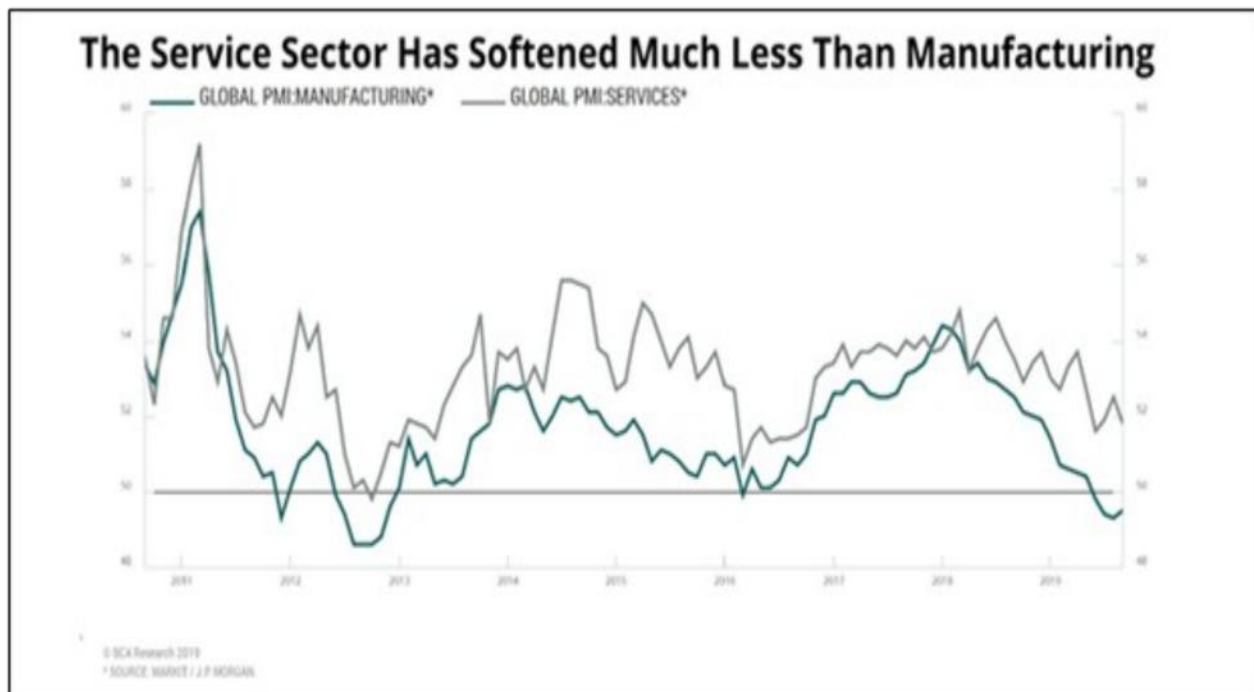
Foreign stocks likewise rode a roller-coaster quarter; however, their rebound in September wasn't quite enough to see them keep pace with U.S. stocks. In the third quarter, developed international stocks fell 0.9%, European stocks fell about 1.8%, and EM stocks fell 4.1%. Returns are still robust for the year so far, with developed international and European markets posting double-digit gains (13.2% and 13.6%, respectively) and EM stocks rising close to 8%.

Bond yields around the world continued to move lower in the third quarter as deflation concerns took hold. The benchmark 10-year Treasury yield ended the quarter at 1.68%, down from a 2% yield at the end of the second quarter. Core investment-grade bonds gained 2.4%, while floating-rate loans returned 1.0% and high-yield bonds gained 1.2%.

The global tilt of our balanced portfolios was a damper on our overall performance for the quarter. However, our portfolio positioning added value in September when interest rates moved higher, catalyzed by an apparent détente (at least for the time being) in the U.S.-China trade war. Rising interest rates brought losses to core bonds, while our flexible fixed-income and floating-rate loan funds had gains. September's more optimistic news on the trade front also boosted more cyclically sensitive international and EM stock markets as well as U.S. value stocks, all of which have lagged the S&P 500 market index the past several years.

### Market and Portfolio Outlook

The financial environment continues to feel like a game of tug of war. On one side, we have a still-solid U.S.



## *Investment Review and Outlook (Cont.)*

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economy that has grown for a record number of consecutive years. While measures of manufacturing activity are slowing, global services activity, which represents upward of 70%-plus of the global economy (and more than 80% of U.S. GDP) still looks solid. (See the prior page chart from BCA Research; note, PMIs above 50 denote expansion and PMIs below 50 denote contraction). Household balance sheets and consumer spending also remain healthy, supported by low unemployment and solid wage growth.

On the other side, global economic growth remains weak and consensus expectations are for further slowing. In particular, the longer a China-U.S. trade agreement remains elusive, the weaker the economy will get as corporations further delay capital expenditures and hiring decisions, not to mention the direct impact already felt by the manufacturing sector.

The expansive monetary policies of central banks around the world continue to present an unknown risk factor. The total value of negative-yielding bonds is over \$14 trillion, globally. Central banks in Europe and Japan have resorted to these experimental policies because simply lowering interest rates, even to zero, has not helped them meet their growth and inflation targets. While no one really knows what the long-term ramifications will be, we can identify some clear short-term dangers, including investors seeking out riskier assets than they normally would, driving up the prices of these investments to unprecedented levels and exposing their portfolios to greater loss.

Much has also been made in the financial press of the “inversion” of the yield curve: an uncommon, inverse yield-time relationship where longer-maturity bonds carry lower interest rates than shorter-term bonds. A yield curve inversion is historically significant in financial markets, given an inversion has preceded the last seven recessions. One interpretation is that bond markets are telling us: “Good times are here ... but bad times are coming.”

### **Looking Further Ahead**

While we think it’s prudent to be a little more defensive in our bond positioning, we also recognize that the current tug of war may continue. U.S. stocks may be priced at historically high levels, but the opportunity cost of selling our U.S. stock position is too great, given they may continue to go up over the short term as they have for several years.

Following a comprehensive review of our global equity assumptions, we also remain firmly convinced that foreign stocks are relatively attractive, particularly versus U.S. stocks. Despite the risks, we continue to see country-level reforms and company-level restructuring that we think are significant positives. If and when global growth returns to healthy levels, as it started to in 2017 before trade war tensions contributed to a growth slowdown, we think European and EM stocks are poised to do very well.

The current investing environment and its range of conflicting outcomes only highlights why we believe it is important to incorporate a wide range of scenarios in our portfolio management process. The most effective way to do this is through diversification across multiple asset classes and investment strategies that have different risk exposures and different sources of return. Of course, this also means that not every position will perform well in every scenario or macroeconomic environment. That’s the definition of portfolio

diversification and the essence of risk management under uncertainty.

We appreciate your trust in us and welcome any questions you may have.

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### ***Special report - U.S. Stocks are Priced as if History is Irrelevant (continued from Page 1)***

Markets typically don't stop rising when they reach fair value. History has shown they overshoot both when they go up and when they go down because of investors' greed (or fear of missing out) and fear (of losses). To justify a higher weighting to U.S. stocks at present, we'd have to assume history is largely irrelevant. We will explain how we arrive at this conclusion.

First, we want to touch upon the basic components that make up U.S. stock returns. By analyzing each component, we can assess potential returns and the likelihood of achieving them. We rely on history as a guide because we believe economies and markets move in broadly repeating cycles of different durations. But we also know history does not repeat exactly, so we pay close attention to forces that can lead to different scenarios or outcomes than observed historically.

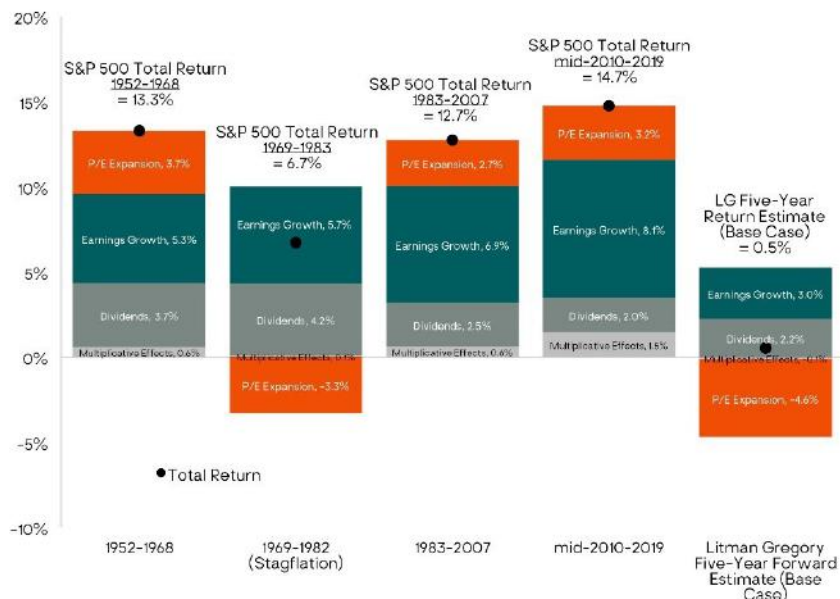
### **Breaking Down Equity Return Components**

There are only three drivers of equity returns:

1. Dividend Yield—the portion of earnings distributed to stockholders as a percentage of the stock price
2. Earnings Growth—determined by sales growth and by changes in profit margins
3. Valuations—how much investors are willing to pay for each \$1 of earnings (P/E ratio)

For some historical context, the chart below shows how these return components break out across different periods or regimes.

Historical S&P 500 Total Returns and Our Five-Year Base Case



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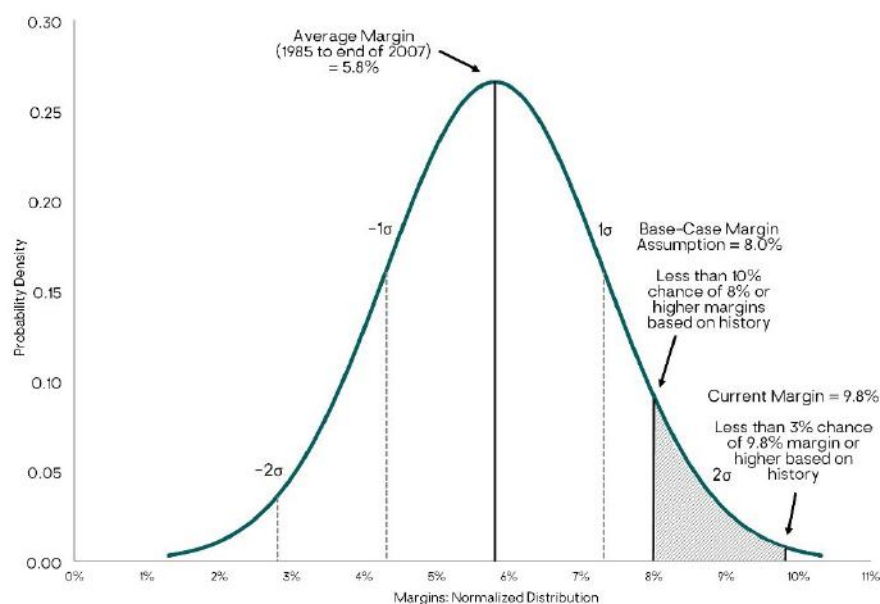
## The Situation Today

Dividend yields (currently around 2.2%) tend to be stable over time and don't lead to a lot of variance in return outcomes. But earnings growth and valuations do. So, let's dig into these two components.

### Earnings Growth

Since 2008, sales growth has been roughly 3%. This is in line with overall U.S. economic growth this cycle, but much slower than the 5% to 6% sales growth observed post-1980s. However, slow top-line growth has been more than offset by a sustained rise in profit margins—from a historical average of 6% to 10% in this cycle. This is an outcome an investor in 2009 would have given a less than 3% chance of occurring (see chart on this page). But this is what transpired, thanks to the confluence of two main forces: globalization and free trade, and corporations gaining a larger share of the economic pie than labor.

Prior to 2008, There Was Only a 3% Chance of 10%+ Profit Margins



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However, these two forces now seem to be turning negative, and we believe there's a good chance their impact will be long-lasting, depressing both margins and investor sentiment. The latter will also impact valuations—what investors are willing to pay for a dollar of earnings.

As we analyze and model expected returns for U.S. stocks, in our central or base case we give credence to the optimistic view that corporate margin structures have permanently shifted up; we assume margins of 8%, much higher than the historical average. With this assumption, we are essentially ignoring nearly 90% of historical outcomes (see same chart on this page).

We also need to make an assumption about sales growth over our five-year estimation period. We assume 6% growth, almost twice the level achieved this cycle—and this is despite U.S. monetary and fiscal stimulus unseen outside wars and recessions.

One could argue we are being generous with these base-case assumptions. That's partly our point. Even with margin and sales-growth assumptions that seem optimistic relative to what history and current and future economic fundamentals suggest, our model yields just 3% annual earnings growth in our base case.

## Valuations

We consider a lot of factors when determining a reasonable valuation multiple to pay for a dollar of what we'd consider a normal level of earnings. We want to be compensated in absolute terms for the downside risk of owning equities. Since the end of World War II, we have seen market declines on the order of 20% to 50%, and we expect a decline of similar magnitude in the next bear market. We seek at least a high single-digit five-year expected return to fully compensate us for equity risk. Said another way, we don't consider stocks attractive based simply on whether they will do better than core bonds (a much lower-risk asset), especially when bonds arguably are the most overvalued asset class in the world today, offering extremely low yield and expected return.

We want to learn from history. We study different valuation regimes across time: the unique fundamentals, optimism, and fears that existed and underpinned valuations in those regimes. We factor risks that can't be quantified or that we may not have historically observed. For example, back in 2014, we were concerned how the unwinding of unprecedented monetary policy (QE) would impact the risk assets that it was meant to inflate (which it did). We got a taste of this risk in the fourth quarter of 2018 when the Fed was forced to make a U-turn in its monetary policy after the S&P 500 dropped around 20% in a very short period.

In today's valuation regime, the key unique risk factors we believe we should factor in our analyses are the following:

- **Higher regulation and political risk:** Income and wealth inequality has widened this cycle to a point where historically high corporate profit margins are inviting greater regulatory and political scrutiny and actions against corporations and investors.
- **Protectionism risk:** While trade tensions may resolve in the shorter term, we think there is a good chance we will remain in a heightened environment of global trade friction for an extended period. This will weigh on business and investor sentiment and increase the cost of doing business for companies.
- **Inflation risk:** This risk may be higher for investors than in the past three decades. We believe we don't even need to make the case for inflation because "stagnation" or "disinflation" appears to be fully priced into markets wherever we look—stocks, bonds, commodities, real estate, etc. Ultimately that's what matters to an investor—what's likely priced in and over what duration.

So, given these risks, instead of assuming an 18x to 19x P/E multiple for earnings, the post-1985 average, our base-case assumption is 17x, which is higher than the post-1920s average of 16x and in line with the post-1950s average. As of June 30, 2019, investors were paying 22x earnings for the S&P 500. An investor in a U.S. stock market index fund or ETF is paying an even higher premium: the weighted P/E ratio for the S&P 500 is close to 30x, according to Fiduciary Investment Management.

Many investors incorrectly assume that low interest rates justify today's higher valuations. It is true that permanently lower rates mean future cash flows are discounted at a lower rate as well. This should raise stock prices, all else equal, but all else is not equal. Interest rates are low because the Fed is concerned future growth will be low. If future cash flows grow at a slower rate, this offsets any lower discount rate, and higher valuations are therefore not justified. For current high valuation levels to be fair, rates must stay this low forever and growth cannot continue to disappoint as it has this cycle.

Finally, it's worth remembering low rates do not shield investors from an overvalued equity market. Case in point, the Fed was significantly cutting interest rates in the bear markets of 2000–2002 and 2008–2009 but could not prevent the nearly 50% declines in the stock market.

When we assume valuations revert from the current level to 17x P/E over a five-year period, it implies an annualized loss of –4.6% from contracting P/E multiples.

## Putting it Together: What Our Analysis of U.S. Stock Market Return Components Tells Us

When we aggregate the three return components (dividend yield of 2.2%, earnings growth of 3%, valuations or P/E compression of negative 4.6%), future five-year expected U.S. stock returns are less than one percent, annualized, and this is despite our relatively generous margin and sales-growth assumptions. If we were to stretch on valuation multiples and assume 19x or 20x P/E, expected returns are a bit above 3%, which is still poor and well below what we require to be fully invested in U.S. stocks. In our bear-case scenario, where we give history more weight and assume 6% margins and 4% sales growth (the two determinants of earnings growth), returns are quite negative over our five-year time horizon.

So, to ask the question we get rarely: Why don't we have even less in U.S. stocks? Because there are scenarios where we can see U.S. stocks generate 8% to 10% annual returns over the next five years. For such an outcome, investors would have to assume profit margins stay at all-time highs, sales grow at more than twice the rate they have since 2008, and investors continue to accept the relatively high valuations of today, possibly paying even more during what remains an uninspiring real economic environment with heightened geopolitical and trade tensions. In our view, this outcome has little chance of playing out over an extended period. But it's a possibility we can't exclude from our thinking entirely, especially if the promise of technology (artificial intelligence, robotics, etc.) allows companies to continue to lower their operational costs in the next cycle and beyond. (We think it would be hard to achieve though given the social and political pushback we are already seeing in America and other developed nations in this cycle.) So, we have continued to hold a reduced allocation to U.S. stocks across our clients' portfolios in favor of more attractive asset classes: non-U.S. stocks, income investments, and alternative strategy investments.

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