Perspectives

Quarterly Newsletter I September 30, 2019

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Inside This Issue

Markets in Recap

In our April issue of "Perspectives", we reported on the best first quarter for the S&P 500[1] in nearly 10 years. In our July issue of Perspectives, we reported on the best first half of a year since 1997. And, now, in this issue of Perspectives, we can report on the best first three quarters of a year since 1997. Yes, we are having a very good year for stocks, with the S&P 500 just 1.6% off of its all-time high at the end of the quarter.

The 3rd quarter (Q3) wasn't easy, though. July started off well - maybe too well - with growth stocks getting ahead of themselves a bit. The stock market surged on expectations (fulfilled) of a Fed Funds rate cut for the first time in over 10 years. However, at the end of July, we had a sudden 5.6% drop in just over 4 days – our second 5% plus drop of the year. That is not at all unusual (three 5%+ drops in a year is about average), but disconcerting nonetheless. The continuing trade wars caused the angst.

In August, the stock market stabilized over the first few weeks and then rose to its July highs again by the middle of September. In fact, September was an unusually calm month, with only one 1% or more down day, and only two 1% or more up days.

However, the market looked a bit like ducks on a pond to us – relatively calm on top but frantically churning under the surface! The August to September run-up in the stock market coincided with the largest shift from growth stocks to value stocks in the last 40 or so years.[2] It was a truly dramatic shift. Growth stocks fell significantly in value, while heretofore moribund value stocks surged. Fortunately, our portfolios include both styles of stocks, therefore our portfolios held up relatively well. That is why we diversify.

Bonds had a very wild quarter with demand (much of it foreign) creating a bubble of sorts and driving the interest rate on the 10-yr. Treasury down to 1.43% (an all-time low) from 2.00% at the beginning of the quarter. By the end of Q3, it had recovered to 1.68%.

Oil prices, which have been terrible for quite a while, experienced their largest one day rise ever, after a drone attack on a Saudi Arabian refinery. Those gains have been paired back since then. Gold rose and the U.S. dollar generally strengthened during the quarter.

Forecast

In the interest of fairness, it is important to note that we were kind of in the same position exactly a year ago (enjoying a great first three quarters), only to have one of the worst 4th quarters (Q4) in stock market history, which resulted in a loss for the year. In fact, given that loss, the S&P 500 is only up 2.2% over the past 12 months, in spite of being up 20% this year to date! So what is in store for this year's Q4?

Brent Schulte, Chief Investment Strategist at Northwestern Mutual, was quoted in the Wall Street Journal recently as saying, "Never in my 25 years of doing this has so much seemingly revolved around what will happen from a political perspective each and every day." We could not agree more. Markets react quickly to tweets and television interviews – sometimes creating significant moves - both up and down - in the same day!

The two big issues in Q4 will be a focus on impeachment and the trade war with China. The impeachment process will create noise, but it should not have too much of an effect on the financial markets, as the process will not likely affect earnings in any significant way. Conviction in the Senate is very unlikely at this time unless more damning information comes to light and Republican senators break ranks.

We expect that news from negotiations between the U.S. and China in October will be mostly positive. Both sides seem to be motivated to largely end this - or at least agree on something so that each can take a victory lap - even if only some of the disagreements are resolved. The stock market would welcome such news. The failure to agree on anything of substance in these upcoming talks would be a real negative for stocks.

The good news is that Q4 has averaged 3.8% gains since WWII and has been up 78% of the time.[3] Analysts expected negative earnings growth in Q2, but we had 3.2% growth instead. They expect negative earnings growth in Q3, but we think earnings will surprise to the upside again. And, they expect positive earnings growth of 4.1% in Q4![4]

With respect to interest rates, there is a 72% probability of a quarter-point cut in the Feds Funds rate in October and another cut in December is possible. We'll see.[5]

Portfolio Management

The biggest change we made in portfolios during Q3 was to reduce our exposure to short-term bond funds in favor of lengthening our duration (basically the average time to maturity).[6] The Federal Reserve cut the Fed Funds rate in late July marked the end of the rate-raising cycle for the time being. Rising rates hurt longer-dated bond yields, and lower rates help. Therefore, until the next rate-raising cycle begins (who knows when), we will bring our average duration closer to benchmark neutral.

We also made a decision to reduce our exposure to small and mid-sized U.S. equity mutual funds in favor of adding exposure to individual common stocks in portfolios that include those. Our individual stock picks are watched very closely by our team, and we like them because we have a bit more control over them than mutual funds, and can react quickly when market conditions dictate doing so.

We also want to keep current our plans to reduce exposure to the markets if and when we believe we are beginning a sustained and significant downturn in the markets. Fortunately, we rarely have to activate this plan, but when we need it, we

need it. We want to make decisions on what to sell first, second and third, etc, in the cool and calm; not in the heat of the battle. We certainly don't activate our plan when we have a 5-10% pullback in the market, and may not do so for even larger corrections, depending on what is causing them (a temporary problem or something more serious). But, if it is something more serious, then we need to be ready.

News Flash

Schwab Cuts Stock and ETF Commissions to Zero You read that correctly! Effective October 7, Schwab commissions on stock trades and ETF's (usually stock or bond indexes) will be cut from $4.95 per trade on most accounts, to zero.

Paul Horn, CFP®, CPWA®, joined us in June as a Senior Financial Planner and Wealth Manager. As such, he is in charge of financial planning for our Irvine office. Paul takes an active role in educating clients to help them grow, manage, and protect their wealth. Paul assists clients in various aspects of wealth management including clients in transition, retirement planning, succession planning for business owners, and planning for executives. Paul is also a member of our investment committee.

Michael Allbee, CFP® After two years of rigorous study at UCI, Mike took and passed the CFP exam in July and given his many years of experience already accumulated, the Certified Financial Planner Board of Standards, Inc. certified him as a Certified Financial Planner™.

Arash Navi, CPA, CFP® Arash came on board with the acquisition of Steven's First Principles in July. Arash sat for the CFP exam in March and passed. Given his experience as a CPA, he also qualified for the CFP designation recently and is now a Certified Financial Planner™.

Please join us in congratulating both Mike and Arash and welcoming Paul and Arash to the BFSG team.

The Score Board

	9/30/2019	YTD Change
Dow Jones Industrial Average	26,916.83	15.4%
S&P 500*	2,976.74	18.7%
NASDAQ Composite*	7,999.34	20.6%
MSCI EAFE (USD)*	1,889.36	9.9%
Bloomberg Commodity Index	77.78	1.4%
Barclays Aggregate Bond Index	2,120.95	8.5%
10 Yr U.S. Treasury Bond Yield	1.68%	-100 bps
30 Yr Fixed Mortgage Rate	3.89%	-71 bps
Prime Rate	5.00%	-50 bps
Crude Oil ($ / Barrel)	$54.07	19.1%
Gold ($ / Oz.)	$1,465.70	14.7%
U.S. $ / Euro €	$1.09	5.2%
Core Inflation (excluding food / energy)		2.40%**
Inflation (including food / energy)		1.70%**

**Without Dividends*

***Unadjusted 12-Months ended August 2019*

bps (1 Basis Point = 1/100%)

UNCH (Unchanged)

Sources for Score Board and quoted statistics:

WSJ, US Dept. of Labor, Federal Reserve

Sources:

1. The S&P 500 is designed to be a leading indicator of US equities and is commonly used as a proxy for the U.S. stock market. Price return quoted.
2. The S&P 500 Growth index comprises S&P 500 stocks with above-average combinations of the ratio of earnings growth to price, sales growth, and momentum. The S&P 500 Value index comprises S&P 500 stocks with above-average combinations of book value-to-price, earnings-to-price, and sales-to-price. The weightings of both indices are by capitalization, although the weight of some stocks is divided between the Value and Growth indices.
3. Source: CFRA. S&P 500 best and worst quarters since 1945.
4. Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management. EPS levels are based on operating earnings per share. Earnings estimates are Standard & Poor's consensus analyst expectations.
5. Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management. Market expectations are the federal funds' rates priced into the fed futures market as of the following date of the September 2019 FOMC meeting and are through August 2022.
6. Duration measures the sensitivity of the price of a bond to a change in interest rates. The higher the duration the greater the sensitivity of the bond is to movements in the interest rate.

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