SNOWBALL™
WEALTH MANAGEMENT

303.666.6292 www.snowballwm.com Second Quarter 2018

Fed Shatters Conventional Economic Wisdom

Conventional economic wisdom holds that the record-low unemployment rate will cause employers to bid up wages, which then will be passed through to consumers in the form of higher prices, triggering rising inflation. However, conventional wisdom is being shattered.

Just as civilization came to understand that the world is not flat, the world just recently realized that the framework for understanding the relationship between inflation and employment, The Phillips Curve, was wrong.

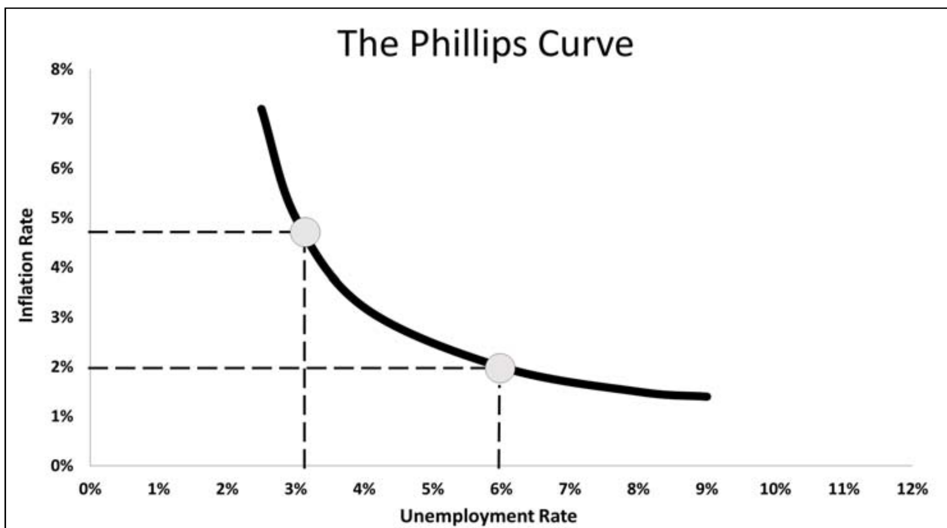
While civilization generally progresses at glacial speed, this is a breakthrough in the world's understanding of economics and it has modern-world consequences.

William Phillips, a professor of economics at the London School of Economics in the 1950s, explained the inverse relationship between unemployment and wages in 1958. When the economy grows the unemployment rate declines, driving wages and spurring higher inflation.

By the late 1960s, the Phillips Curve was the primary framework for forecasting inflation among central banks across the world. Now, however, in a departure from conventional economic wisdom, the Phillips Curve is being rethought by the U.S. Federal Reserve.

Jerome Powell, the chairman of the U.S. central bank, does not expect a sharp rise in inflation, even though unemployment has hit a record-low and wages are on the rise. He believes the inverse correlation between employment and wage inflation isn't as strong as it used to be, and he sets U.S. interest-rate policy.

If the Fed relied on the Phillips Curve, Mr. Powell would likely be trying to head off inflation right now by raising rates more aggressively to slow down the economy.



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Interest Rates 101

We went a bit interest rate wonky in this newsletter with two articles. Both articles infer that the bond investment returns of the next 40 years are not likely to look like the past 40 years. I couldn't agree more.

It's Econ 101 that as interest rates rise, bond prices fall. Interest rates are rising, so bond prices must retreat. Bonds had a great run over the past four decades, but those days are over. As the articles in this newsletter highlight, we're likely headed for a period of very low returns in the bond market. In fact, if history repeats itself and we see a 30+ year period of rising rates, bond returns are likely to be 3-4% on average. That's not bad until you compare it to the inflation rate, which averaged 4.3% during the last rising rate environment from 1948 to 1981. Suddenly your real return (the return after inflation) is negative, or flat at best.

One of my most feared phrases in investing is, "It's different this time." Nope, never, not true. History always repeats itself, it's just the length of a cycle that changes. Higher interest rates are coming. The only question that remains is will the Fed break out of its statistically significant habit of raising rates right up to the next recession, or will newly appointed Chairman Powell successfully guide us to a soft landing with measured and gradual rate increases? Regardless of the answer, higher interest rates will lower bond returns.

So, how do we navigate lower bond returns? First, we shorten up the maturity in fixed income. Second, we look for alternative sources of properly risk-adjusted, quality income. Third, we reduce exposure to fixed income. And fourth, we reduce expectations. Don't expect the returns from the fixed income portion of your portfolio to look like the recent past. Bonds are part of your portfolio to provide stability and safety, not inflation beating returns.

This Is Not Your Parents' Interest Rate Cycle

If you're a pre-retiree, your returns on fixed income investments may be much lower than your parents' portfolio.

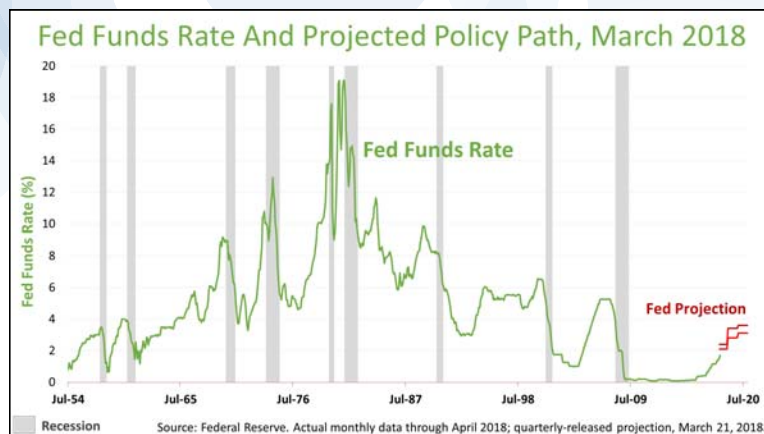
If you're over 70, you were invested during four decades marked by strong fixed income returns. From the astronomical highs of the late 1980s, rates climbed down before finally bottoming in 2017, and two generations of retirement investors enjoyed bull market returns in bonds annually for years. The next generation of retirees face an entirely different fixed income investing environment.

The last 50 years were an aberration when viewed from the perspective of the past 171 years. The rise in rates of the 1970s and 80s and the unwinding of that anomaly is behind us now, and history indicates the next decades could be characterized by 10-year U.S. Treasury bond rates of about 4%. That may be the new normal.

Past performance is not a guarantee of your future results, but we are nonetheless grateful to Robert Shiller, an economics professor at Yale University and Nobel Laurate in Economics, for sharing this historical data online. It shows that, over in the long arc of U.S. financial history, nothing like the last 50 years ever happened before the 1970s. If interest rates revert to their long-term mean, a 4% 10-year U.S. Treasury bond is a likely path in the decades ahead.

The yield on a 10-year U.S. Treasury bond, in the grand sweep of history, averaged about 4% annually. That's normal. Mortgage rates of the 70s, 80s, or 90s were abnormal. The new normal may be a 2% inflation rate and a 10-year bond yield of 4%. That's what the Federal Reserve Board of Governors expected in the second quarter of 2018.

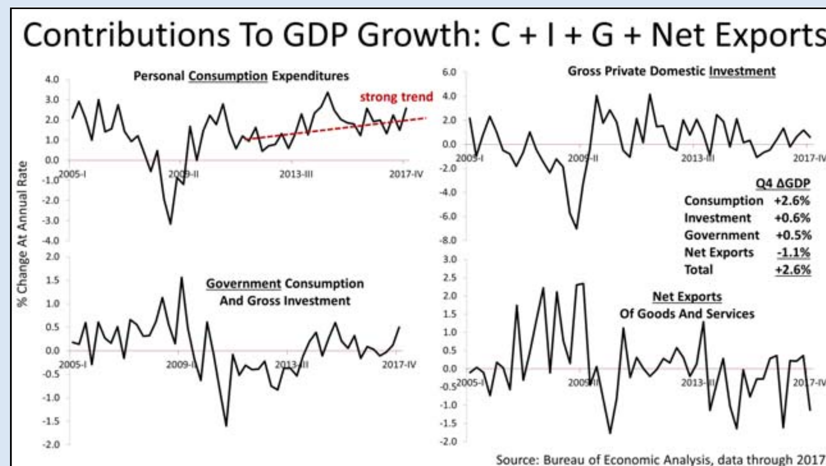
The point is, this is not your parents' retirement savings environment. Economic fundamentals are different. If you learned about investing from your parents or invest based on what's worked in the past, the future may not be much like the recent past but instead like the distant past. This is the kind of fundamental analysis you get from a real financial professional. This is the kind of analysis you can expect from us. ●



A Bright Outlook For Consumer Spending

Investing prudently requires understanding economic fundamentals. Here's some insight into current economic conditions and the kind of ongoing analysis required to manage wealth prudently for the long term over up and down economic cycles.

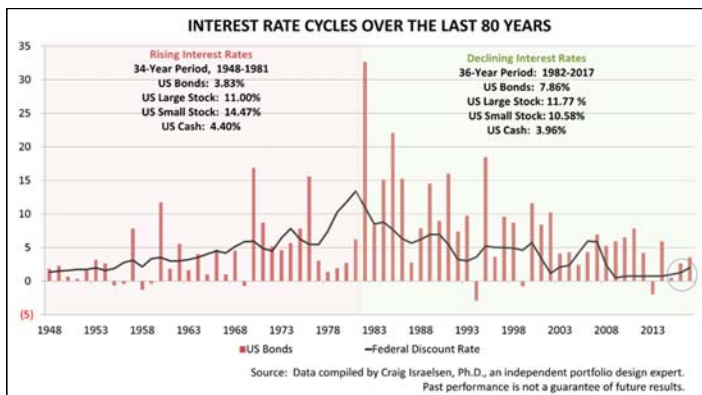
The economy is measured quarterly in terms of gross domestic product (GDP), which is the sum of four factors: consumption, investment, government and net exports. Consumer spending is by far most important, accounting for 69% of U.S. economic activity. The key to strong economic growth, then, is a strong American consumer.



In the final quarter of 2017, net exports were a drag on GDP growth. However, net exports are volatile month-to-month and its dips have been followed repeatedly by surges over the past two cycles of the economic expansion and recession that occurred since

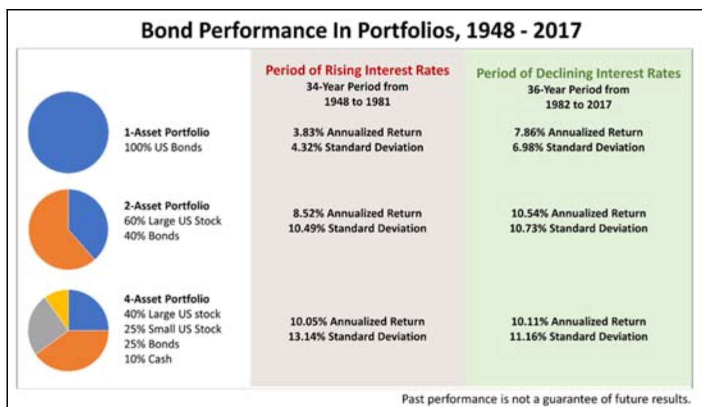
The Interest Rate Inflection Point And Your Portfolio

Interest rates are on the rise, and that means bond prices will decline. Here's a summary of financial history since World War II demonstrating how long interest rate cycles last and how it is likely to affect you.



From the end of World War II to 1981, interest rates rose, as is shown in the black line in the chart. Of course, when interest rates rise, bonds prices fall because bonds paying less than the new, higher rate are less desirable and their prices adjust downward. Thus, from 1948 to 1981, the average annual return on bonds was just 3.83% annually.

Now look at what happened since the declining rate cycle began in 1982 through the end of 2017. As interest rates moved lower, the prices of bonds climbed. Bonds returned an annual average of 7.86%, for this 36-year period. Which brings us to where we are today.



Bond Performance In Portfolios, 1948 - 2017

	Period of Rising Interest Rates 34-Year Period from 1948 to 1981	Period of Declining Interest Rates 36-Year Period from 1982 to 2017
1-Asset Portfolio 100% US Bonds	3.83% Annualized Return 4.32% Standard Deviation	7.86% Annualized Return 6.98% Standard Deviation
2-Asset Portfolio 60% Large US Stock 40% Bonds	8.52% Annualized Return 10.49% Standard Deviation	10.54% Annualized Return 10.73% Standard Deviation
4-Asset Portfolio 40% Large US stock 25% Small US Stock 25% Bonds 10% Cash	10.05% Annualized Return 13.14% Standard Deviation	10.11% Annualized Return 11.16% Standard Deviation

Past performance is not a guarantee of future results.

Interest rates started moving up about two years ago, which means bond holdings declined in value. The Federal Reserve, which controls short-term rates — the black line — will continue to push rates higher for many years, if history is a guide. In fact, amid the strengthening economy, the Fed says it expects to ratchet rates higher again and again in 2018.

For investors who, over three decades, have grown accustomed to bonds appreciating at a rate rivalling stocks, the future seems likely to be very different, which especially affects the demographic bubble of baby-boomer retirees, who have long favored bonds for producing reliable income.

To understand the effect the new rising rate cycle might have on your portfolio in the years ahead, this table gives you the key facts.

The 11% annual return on stocks and the return of about 4% on Treasury Bills stayed approximately the same through both the rising and falling interest rate cycles. However, the 3.8% average annual return bonds in the rising rate cycle from 1948 to 1981 was less than half the 7.86% annually averaged on bonds during the 1982 to 2017 period. This poses a new kind of risk that many investors have never experienced before.

During the rising rate cycle, when the average annual return on bonds was a measly 3.83%, stocks and 90-day Treasury Bills averaged about the same annual return as they did in the falling rate cycle. The performance of stocks, bonds, and cash over this period demonstrates why diversification and a strategic approach are so important to long-term investing.

Shorter maturity bonds — due in three- to seven-years, as opposed to 10, 20, or 30 — are less susceptible to interest rate risk than longer maturity bonds with more years to run paying your interest before returning your principal.

These illustrations do not reflect the impact of inflation, which adds another dimension and requires a separate discussion. The takeaway here is that rates may be at the start in a new long-term cycle and clients can rely on our advice on the best way to manage this risk. Please do not hesitate to contact us with questions. ●

Large-cap US equity represented by the S&P 500 Index. Small-cap US equity represented by the Ibbotson Small Companies Index from 1970-1978, and the Russell 2000 Index starting in 1979. Non-US equity represented by the MSCI EAFE Index. Real estate represented by the NAREIT Index from 1970-1977 and the Dow Jones US Select REIT Index starting in 1978. Commodities represented by the Goldman Sachs Commodities Index (GSCI). As of February 6, 2007, the GSCI became the S&P GSCI Commodity Index. U.S. Aggregate Bonds represented by the Ibbotson Intermediate Term Bond Index from 1970-75 and the Barclays Capital Aggregate Bond index starting in 1976. Cash represented by 3-month Treasury Bills.

January 2002.

Government spending, which includes state and municipal expenditures, has been on the rebound after suffering years of cutbacks in The Great Recession and its aftermath. With real incomes rising since the financial crisis, tax receipts have risen and state and local government spending grew, which has been a positive factor in GDP growth in recent years.

However, business investment and government spending are together not even half as important a factor in growth of the U.S. economy as consumers. If consumers keep spending, the good times for the U.S. could keep on rolling, and there is some reason for optimism on that score.

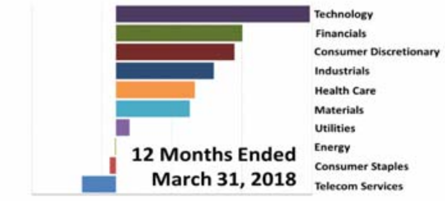
Consumer strength rose in closing out the year, according to the most recent data, extending the strong growth trend line (in red) experienced in recent years. In addition, in February, a lower rate of withholding federal taxes on employee paychecks kicked in, and that is putting more money in consumers' pockets to spend. That could show up in GDP growth figures to be released in early April 2018.

Economic growth shows up in profits of companies and is the key determinant in the value of stocks. Profit expectations at the Standard & Poor's 500 companies grew sharply in the opening quarter of 2018, according to independent economist Fritz Meyer, and the outlook for consumer strength was bright despite an 11.8% correction. ●

Market Data Bank: 1st Quarter 2018 Ψ

CORRECTION, RECOVERY, FRACTIONAL LOSS
The S&P 500 suffered a 10.2% correction in early February before recovering to post a 0.8% loss in the first quarter of 2018. The fractional loss followed a 6.6% gain in the fourth quarter of 2017, 4.5% in the third quarter, 3.1% in the second quarter and 6.1% in the first quarter of 2017. Volatility reappeared after a two-year lull.

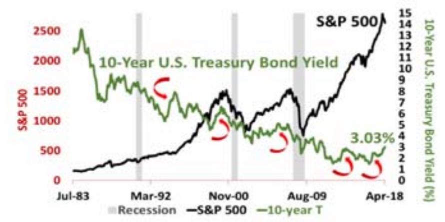
STOCKS NEARLY DOUBLED IN FIVE YEARS
Over the 10 years shown, $1 invested in the S&P 500 grew to $2.48. From the low on March 9, 2009, $1 in stocks grew to $4.72 — a 372% return! What makes America exceptional among all nations has been unfolding in plain sight for 10 years, but it is always difficult to recognize it the moment it is happening.



SECTORS SHOW GROWING APPETITE FOR RISK
The technology sector was again the standout in the 12 months ended March 31, 2018. The laggards — telecom, consumer staples, energy, and utilities — are considered more defensive. This is a sign of a gradual shift in sentiment toward riskier assets.

INDEXES TRACKING 13 ASSET CLASSES
The S&P 500 index's total return of 87% in the five years through March 31, 2018, was more than double the 40% return on the S&P global stock index excluding U.S. stocks. For the first time in years, global growth accompanied the long U.S. expansion, boosting returns of a portfolio broadly diversified across the globe.

APPROACHING THE LONGEST BOOM
At 107-months old, this is the second-longest expansion in modern U.S. history, surpassing the 106-month long expansion of the 1960s, and just 13 months shy of the 120-month boom of the 1990s — the longest ever. With fundamentals strong, this is likely to become the longest in post-War America.



FED PLANS INTEREST RATE HIKES
After hiking rates in March, the Fed said three more quarter-point hikes would follow in 2018. Interest rate cycles are slow. The most recent 24 years were marked by falling rates, while rates fell the previous 24 years. A new rising recently began. Rising bond yields often coincided with bull markets in stocks in the past.

Past results may not indicate future performance. Indices and ETFs representing asset classes are unmanaged and not recommendations. Foreign investing involves currency and political risk and foreign-country instability. Bonds offer a fixed rate of return while stocks fluctuate. Leading economic indicators from the Conference Board. S&P 500 bottom-up operating earnings per share as of April 3. 2018: for 2017(e), $131.98; for 2018(e), $157.99; for 2019(e), $173.97. Sources: Yardeni Research, Inc. and Thomson Reuters I/B/E/S for actual and estimated operating earnings from 2015; Standard and Poor's for actual operating earnings data through 2014. NBER, Federal Reserve, Standard & Poor's, and Fritz Meyer, independent economist. Data through April 25, 2018.

Fed Shatters Economic Wisdom

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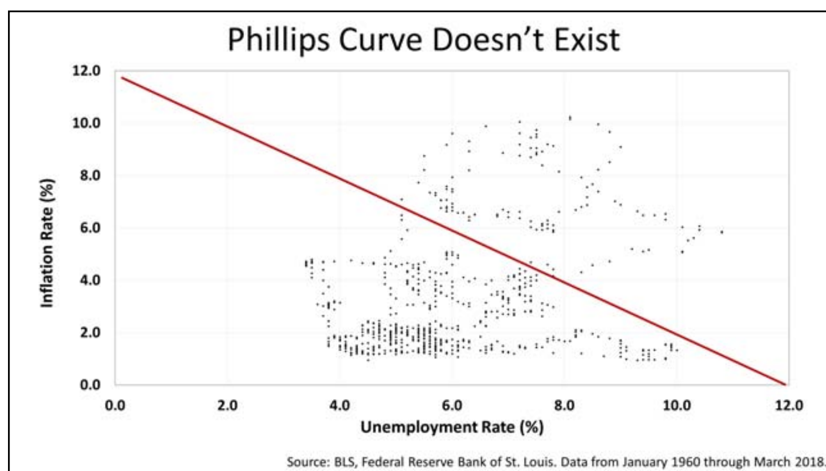
Inflation recently surged to the Fed's target rate of 2% and the unemployment rate dropped to a record low of 3.9%. In addition, the Index of Leading Economic Indicators, a forward looking composite measuring growth literally 10 ways monthly, rose again in April continuing an uptrend and suggesting solid growth continuing through the second half of 2018.

Mr. Powell, who became Fed chair in February 2018, has moved decisively in defiance of conventional wisdom, highlighting humanity's improved understanding of financial economics.

This chart from independent economist Fritz Meyer, whose research we license to share with you regularly, shows the inverse relationship of inflation and unemployment since 1960.



If the Phillips Curve were an accurate forecasting tool, each of the black dots would line up on top of the red line. When Professor Phillips came up with his theory in 1958 it was prophetic, but a half-century later we know so much more.

We're here to help you plan your future based on facts, analysis, and humanity's growing understanding of financial economics. ●

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