viewpointe

A Horizon Trust & Investment Management Publication

HORIZON

ISSUE NO. 67, FIRST QUARTER 2020

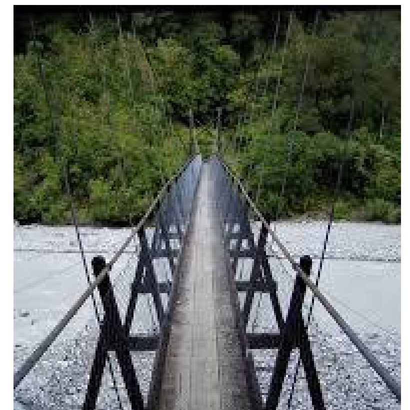
“All things are difficult before they are easy.” *- Thomas Fuller*

While there is continued evidence of an economic slowdown here in the U.S., you would never know based upon investment returns. Portfolio performance in 2019 definitely will go down in the history books as providing a remarkable upside surprise. In this edition of Viewpointe, we reflect upon some of the key events of 2019 and provide our outlook for 2020. We also provide an update on our model portfolios. We conclude with a brief discussion regarding Social Security, which is a topic of interest for many of our clients that are approaching retirement.

Economic Review - A Manageable Slowdown

While the U.S. economy is still in the midst of a slowing trend, a soft landing looks manageable. With third quarter gross domestic product (GDP) revised slightly higher to 2.1% and the Atlanta Fed's GDPNow fourth quarter estimate at 2%, U.S. economic growth is on track to fall close to our 2% annual forecast. While economic indicators are not terrible, they are softening. We expect this softening to continue into 2020. While we do not anticipate a recession in 2020, a slow growth environment is always vulnerable to an unexpected negative shock. Absent such a shock, we anticipate 2020 economic growth to fall somewhere around 1.5%. We anticipate this low growth and low inflation environment to continue for some time to come.

The key to continued economic growth in the U.S. rests on the shoulders of the U.S consumer. Consumer spending has remained resilient throughout 2019. While consumer spending is slowing, it is not contracting. We have been surprised by this given a myriad of negative events such as the inversion of the U.S. Treasury yield curve in August, presidential impeachment proceedings, general political dysfunction, heated trade rhetoric, etc. To a large degree consumers remain optimistic as the result of strong equity market returns. Simply put, when one's investment portfolio is doing well, they have a tendency to feel better about their general financial condition. A strong labor market as well as favorable lending rates are undoubtedly also contributing to resilient consumer spending. Regardless, it is vital for consumer spending to hold near current levels or expand in 2020 to avoid a recession.



Due to the vital role consumer spending will play, we are monitoring data on this front carefully.

Something that we have not yet built into our 2020 economic projections is a material increase in business spending. Businesses were reluctant to spend in 2019 as a result of trade uncertainty. Recent developments on the trade front, however, increase the likelihood that business spending may improve in 2020. The reason we choose to not factor in a boost on this front is due to the fact the situation can shift from a deal to no deal quickly. We watched U.S./China trade deals announced in May 2018, December 2018, June 2019 and October 2019. None of those announcements materialized into an actual written agreement. As a result, we are reluctant to incorporate the recent announcement of a deal into our forecasts until it is put in writing and signed. Previous false alarms indicate that deals can fall apart quickly once the two sides sit down to iron out the details.

As it stands now, a phase one or “skinny” trade deal appears in the works. The details of the deal remain sketchy. They, however, seem to include an increase in purchases of U.S. agricultural goods, better access for U.S. financial firms conducting business in China and greater restrictions on Chinese currency manipulation.

Continued on Page 2

IN THIS ISSUE:

Economic Review - A Manageable Slowdown

Fixed Income Commentary - A Volatile Year

Equity Commentary - A Welcome Surprise

Asset Allocation - Just a Few Adjustments

Financial Planning - Social Security: What Should You Do at Age 62?

In exchange, China will receive tariff reductions. Despite not covering many of the key issues, this deal at least would avoid the drag of increased tariffs that appeared imminent just a few weeks back. This, at least for the time being, reduces some of the tariff drag that many business owners incorporated into their 2020 forecasts.

With that said, we are not out of the woods yet. The current deal is not expected to address the key sticking points. Tensions are likely to escalate when the two sides sit down for phase two and discuss more controversial items such as intellectual property theft, the direction of 5G technology, human rights violations, Taiwan, navigation in the South China Sea, etc. All of these items present potential obstacles that will be difficult to reach an agreement on. That is why some are questioning whether a watered down phase one deal will be followed shortly thereafter by a re-escalation in tension. We anticipate this to be the case and therefore expect the trade issue to remain a key economic driver in 2020. It is also important to point out that election uncertainty will also negatively impact business spending. In conclusion, we do not think it is prudent to build increased business spending into our forecasts at the present time.

Fixed Income Commentary -

A Volatile Year

Four Federal Reserve (Fed) rate hikes in 2018 were followed by three rate cuts in 2019. You talk about an abrupt shift in direction. It seems like it was only yesterday that we were criticizing the Fed's decision to hike in December of 2018. We viewed the Fed's decision as a mistake given the deteriorating economic conditions present at the time. Ultimately, fixed income investors agreed with our assessment based upon the steady decline in long and intermediate interest rates that transpired during the first half of 2019. The Fed's overly hawkish policy, combined with the fixed income markets reaction, led to the widely publicized Treasury yield inversion that took place in August. Fortunately, the Fed eventually got the picture and eased three times throughout the year. This shift in policy eventually led to a steeper yield curve.

For the time being, it appears the Fed is content with their current policy strategy. This became evident at their December meeting, where they chose to make no further adjustments to the Fed Funds rate. At this meeting Fed officials presented a stable economic back drop, citing factors such as a healthy labor market and lack of persistent inflation. Chairman Powell noted that in order to move rates up he would like to see inflation that is "persistent and significant." Currently, there appears to be little threat of inflation with headline and core CPI (Consumer Price Index) inflation remaining moderate throughout the year.

From a historical perspective, going back to 1982, the average length of time between the last Fed cut and the first Fed rate hike has been 571 days. Simply put, the Fed is reluctant to make such a drastic shift in a short period of time since it indicates a policy error. This too suggests that the Fed will be motivated to remain on the sidelines.

To a large degree, whether the Fed gets its wish or not, will be dependent upon developments on the trade front. For example, if either the U.S. or China were to walk away from a phase one trade deal the negative economic impact could require more accommodation. On the contrary, if we proceed to a phase two deal the positive economic impact would likely be inflationary and thus tighter policy may be required. For now, yield uncertainty and trade uncertainty are closely correlated. We believe the Fed is determined to hold here until they are forced to move.

Our base case calls for the adoption of a phase one trade deal with an escalation of trade tensions during the negotiations of a phase two deal. We believe such a scenario will leave interest rates trading within a relatively narrow trading range in coming months. Upward drift will largely be driven by positive developments on the trade front. Downward drift in contrast will be driven largely by negative developments on the trade front.

Equity Commentary -

A Welcome Surprise

It is hard to believe, but the current bull market for U.S. stocks started over ten and a half years ago. Despite the extended duration of this bull market, it may go down in history as one of the least loved of all time. Even though we experienced significant positive flows into equity exchange traded funds (ETFs), these positive flows have been more than offset by outflows from domestic equity mutual funds. Many retail investors chose to sit on the sidelines after facing the ravages of two 50% declines in the first decade of the century. The more stocks rose, the more reluctant many felt regarding getting in at the elevated levels.

Some saw the weakness that occurred during the fourth quarter of 2018 as the beginning of a bear market. Nevertheless, U.S. stocks moved higher with the S&P 500 reaching its 28th record high of 2019 at the beginning of December. Currently, the S&P 500's calendar year return sits near 28%, far exceeding the index's average return of 9.8% per year over the last 50 years.

We have to admit we were surprised by the strength of the U.S. equity markets in 2019. We did not anticipate such strong returns in a slowing economic environment where corporate earnings were lackluster at best and investor outlooks were typically gloomy. To a large degree we believe the Federal Reserve can be credited with boosting stock prices in 2019. The Fed's three rate cuts in 2019 directly increased the supply of money in the United States. An increase in money impacts the banking sector by increasing the bank's ability to lend under more favorable terms. Increased access to credit in turn boosts liquidity by freeing up other capital to be invested in other assets such as stocks.

This is not the type of equity environment that we take comfort in. In fact, our anxiety level has grown throughout the year. We prefer to see stocks rise based upon fundamentals, not Fed policy. After all, what the Fed gives, the Fed can take away. Calendar year earnings growth in 2019 is projected to be only up 1.1%. This definitely does not justify a 20% plus equity return. Current sell-side estimates anticipate calendar year 2020 S&P 500 operating earnings at about $178.20, or up about 9.9%. While those estimates are not bad, it is hard to get excited when the index is trading at 17.9x earnings and estimates are likely to be cut further. Fortunately, low interest rates have resulted in higher valuations in the fixed income space making current equity valuations more palatable on a comparative basis.

In summary, we are anxious as we enter 2020. As long as money supply continues to grow, we expect the increased liquidity to provide a floor for equity prices. In the event the money supply begins to decelerate, we believe stocks will sell-off absent an alternative upside driver. We would like to see improving economic conditions and increased corporate earnings slip into this role. Unfortunately, it is too early to tell if this will be the case.

Asset Allocation - Just a Few Adjustments

We did not rebalance our Lakepointe Classic model portfolios during the fourth quarter. While we wanted to trim our equity weightings back to target, we decided it was more efficient to simply wait for our equity funds to make their year-end capital gains distributions. We try to avoid rebalancing toward the end of the year. No sense in adding to a fund just before it makes a capital distribution. In addition, distributions result in excess cash, which must be reinvested. We would just as soon wait for this cash and put it to work in January.

Perhaps the most noteworthy event on the Classic front was the acquisition of the PNC Small-Cap fund by Federated. This resulted in our PNC position getting merged into the Federated MDT Small-Cap Growth fund. The new fund manager has an average track record and it is our intention to replace this fund sometime in January. We are also exploring the possibility of slightly increasing our international stock exposure sometime in 2020. Lastly, we plan on introducing a new actively managed intermediate bond fund to our fixed income line-up. This fund is intended to complement our current position in the DoubleLine Core Fixed Income fund.

We did rebalance our Lakepointe Premier equity models during the fourth quarter. It had been awhile since we conducted a comprehensive rebalance in our Premier models. We took this opportunity to replace a few individual stock names and bring our 50 stock portfolio closer to their 2% target weightings. All in all this resulted in a reduction of our equity position. We let several names run throughout much of the year and we determined it was a good time to harvest some of those gains.

Financial Planning - Social Security: What Should You Do at Age 62?

Is 62 your lucky number? If you are eligible, that is the earliest age you can start receiving Social Security retirement benefits.

Although collecting early retirement benefits makes sense for some people, there is a major drawback to consider: If you start collecting benefits early, your monthly retirement benefit will be permanently reduced. So, before you put down the tools of your trade and pick up your first Social Security check, there are some factors you will need to weigh before deciding whether to start collecting benefits early.

How much will your retirement benefit be?

Your Social Security retirement benefit is based on the number of years you have been working and the amount you have earned. Your benefit is calculated using a formula that takes into account your 35 highest earnings years. If you earned little or nothing in several of those years, it may be to your advantage to work as long as possible, because you will have the opportunity to replace a year of lower earnings with a higher one, potentially resulting in a higher retirement benefit.

If you begin collecting retirement benefits at age 62, each monthly benefit check will be 25% to 30% less than

Investment vehicles made available through Horizon Trust & Investment Management are: Not deposits or other obligations of, or guaranteed by Horizon Bank; Not insured by the FDIC; Subject to investment risks, including possible loss of principal.

HORIZON

it would be at full retirement age. The exact amount of the reduction will depend on the year you were born. (Conversely, you can get a higher payout by delaying retirement past your full retirement age, because the government increases your payout every month that you delay retirement, up to age 70.)

However, even though your monthly benefit will be 25% to 30% less if you begin collecting retirement benefits at age 62, you might receive the same or more total lifetime Social Security benefits as you would have had you waited until full retirement age to start collecting benefits. That's because even though you will receive less money per month, you might receive more benefit checks.

If you want to estimate the amount of Social Security benefits you will be eligible to receive in the future under current law (based on your earnings record) you can use the SSA's Retirement Estimator. It is available on the SSA website at ssa.gov. You can also sign up for a "my Social Security" account to view your online Social Security Statement at the SSA website.

Have you thought about your longevity?

Is it better to take reduced benefits at age 62, or take full benefits later? The answer depends, in part, on how long you live. If you live longer than your "break-even age," the overall value of your retirement benefits taken at full retirement age will begin to outweigh the value of reduced benefits taken at age 62.

You will generally reach your break-even age about 12 years from your full retirement age. For example, if your full retirement age is 66, you should reach your break-even age at 78. If you live past this age, you will end up with higher total lifetime benefits by waiting until full retirement age to start collecting.

Of course, no one can predict exactly how long they will live. However, by taking into account your current health, diet, exercise level, access to quality medical care, and family health history, you might be able to make a reasonable assumption.

How much income will you need?

Another important piece of the puzzle is to look at how much retirement income you will need, based partly on an estimate of your retirement expenses. If there is a large gap between your projected expenses and your anticipated income, waiting a few years to retire and start collecting Social Security benefits may improve your financial outlook.

Will your spouse be affected?

When to begin receiving Social Security is more complicated when you are married. The age at which you begin receiving benefits may significantly affect the amount of lifetime income you and your spouse receive. It will also impact the benefit the surviving spouse will be entitled to. As a result, you will need to consider how your decision will affect your joint retirement plan.

Other considerations

In addition to the factors discussed here, other financial considerations may influence whether you start collecting Social Security benefits at age 62. How do other sources of retirement income factor in? Have you considered how your income taxes will be affected?

For more information

Social Security rules can be complex. For more information about Social Security benefits, visit the SSA website at ssa.gov, or call (800) 772-1213 to speak with a representative.