Fee Only Financial Planning & Investment Management

Sept.
2019

We put your interests first.®

Resolute Connections

In this month's newsletter, *Boring Bonds Come Alive* reviews the change in your bond portfolio's return as investors have reaped significant returns over the past year compared to the norm. *Negative Yields in Our Future?* - concerns the current situation across the developed world; governments paying investors a negative interest rate for the privilege of lending it money, or, to put it another way, investors are paying their government for the privilege of loaning them money.

Whenever you hear pundits talking about a recession it's important not to be an alarmist as it is exceedingly difficult to time a recession, as outlined in *Recession Talk*. And *The Risks of a Tax-Saving Opportunity* reviews an investment opportunity created by the tax reform law passed in 2017 called Qualified Opportunity Funds. These funds invest in projects that spur growth in economically disadvantaged part of the U.S. offering investors advantageous tax rates on capital gains along with unknown risks.

If you have any questions about anything we have covered in the articles, or a specific situation please feel free to give us a call, or visit our website, www.ResoluteFinancial.com.

Boring Bonds Come Alive

Bonds are boring, right? Stocks jump up and down and all over the place, and over several years they might even jump 100% in value. Meanwhile, the bonds in your portfolio crank out predictable coupon yields quarter after quarter after quarter.

If you're bored by the bond market today, then you may not be paying attention. Year to date, while stocks are bouncing around at prices roughly where they were in early 2018, a sharp fall in bond yields has caused bond investors to reap some significant capital gains.

How significant? Since the beginning of 2019, investors in the 30-year Treasury bond have seen gains (interest plus price appreciation) of 26.4%—which would be a great full year's return for stocks. Long-term bonds overall have generated a 23.5% return, as represented by the Bloomberg Barclay's U.S. Aggregate Bond Index. Investment grade corporates have returned a not-too-shabby 14.1%, while the 10-year Treasury note has gained 12.6%.

The yield drop that caused these returns is actually jaw-dropping for market observers, who have been predicting for roughly a decade that bond rates have nowhere to go but up. The yield on the 10-year Treasury note is now just under 1.47%; it was more than 3% at the end of 2018.

Will we see more of the same? It's very hard to imagine that same 10-year Treasury falling another 1.5%—to zero yield. So the smart money says that most of the gains have already been taken, and anybody looking for 20+ percent returns in long bonds going forward is just chasing returns after the fact. Remember, any asset that can jump 20% in a little more than half a year can do exactly the same thing—or more—on the downside.

The lesson here is that if you think of bonds as the boring part of your portfolio, then understand that there are times when they can add a little more kick to your returns than you might have expected. And there is a significant chance that they'll give back those returns as rates stabilize and increase at some point in the future.

Negative Yields in Our Future?

Let's suppose somebody came to you with a proposal. You would lend this person $100 for a couple of months. Because this person was doing you the favor of keeping your $100 safe for a period of time, he proposes to only pay you back $95. In effect,

he has paid you a negative interest rate for the privilege of lending him money. Or, put another way, you've paid him for the privilege of loaning him money.

What kind of obvious scam is that? It might surprise you to know that some of the world's largest banks are lending their assets under similar circumstances, and these are institutions you may have heard of: the Bank of Japan, the European Central Bank, and the state banks of Sweden, Switzerland and Denmark. Basically, they were taking deposits with a promise that the lenders wouldn't get all their money back.

Negative interest rates came on the global financial scene in 2016, and at the peak, some $12.2 trillion were loaned at negative rates. The negative rate concept evolved as a policy that would punish lending institutions for simply parking their money and earning interest instead of making the loans that would stimulate the economy. In theory, negative rates also reduce borrowing costs for companies and households, driving up demand for loans. But what if banks start passing on the negative rates to their traditional depositors, in effect charging them a fee in return for holding their cash (and lending it out, and profiting on it)? Customers would respond by simply putting the money in their mattresses instead, and generate a higher return (0%) than they would get at the bank.

The longest-running experiment with negative rates is taking place in Denmark, where two large financial institutions—Jyske Bank and Syndbank—now "offer" -0.6% on retail deposits bigger than $1.1 million. Over the last seven years, these and other banks have declined to pass these negative rates on to their depositors. The result is predictable. In July, Danish bank deposits equaled roughly $140 billion, which are then deposited in a central bank account at -0.60% or invested in negative-yielding securities. The banks are reportedly under financial stress that gets worse every year. It turns out (surprise!) that locking in a negative return on your investments isn't a profitable business.

Could negative rates happen here? The U.S. Fed sets rates at the short end of the yield curve, and they are currently a rather robust 2.25%—which means banks can simply park their cash and earn more than they would if they invested in 30-year Treasuries (an astonishingly low yield of 1.97% currently). If the U.S. experiences a recession, that rate will go down; how far will depending on how alarmed Fed

economists become. In December 2008, at the bottom of the Great Recession, that rate came all the way down to 0.25%.

But it's worth noting that the Fed, this time around, would have to start its cuts from a lower initial rate, which means taking rates down to 0.25% won't have the same effect as they did in the last recession. If it were necessary to cut rates as aggressively in the next recession as the Fed did in the last one, that would certainly suggest negative rates in our future—and the U.S. would join a very big club around the world.

Recession Talk

Whenever you talk about recessions, it's important not to be alarmist. Because it is very hard to time a recession (that is, know precisely when it will begin and end), and because it is even harder to know when the stock market will decline and rise again in association with a recession, it is generally best to simply ride out these periodic downturns with a consistent asset allocation. After all, in every circumstance so far, the economy and the markets have eventually recovered to post new highs. Nobody is guaranteeing that, of course, but so far the track record has been good.

Nobody would be surprised to see the U.S. fall into an economic recession sometime in the next 18 months. A recent article in Forbes magazine laid out the clouds that economists are watching on the near horizon.

The biggest of these is an unusual slowdown in global trade these past two years. Indeed, trade growth has been essentially zero this year, and the Forbes article points directly to the trade wars between the U.S. and China, between the U.S. and Europe—and doesn't specifically mention another significant trade war brewing between South Korea and Japan. At the same time, the Trump Administration has been "interfering" [the magazine's term] with the global currency markets, changing the rules to make it easier to label a country a currency manipulator at the same time the President has been demanding that the U.S. Fed cut interest rates to weaken the dollar and make U.S. exports more competitive. Global companies are no longer sure who they can

invest in or where, and so they have held back on capital investments until the uncertainty passes—and when will that be?

At the same time, the article notes, periods of uncertainty tend to bring nervous capital rushing to the relative stability of the American currency, driving up the value of the dollar and making American exports less competitive on the world markets. U.S. corporate profits declined consecutively in the first two quarters of this year, including an alarming decline of 2.8% in the second quarter, according to statistics compiled by the Bloomberg organization. Small companies, which tend to carry more debt than large ones, appears to be faring worse.

And then there's the yield curve. There was a very brief inversion of the curve several months ago which triggered headlines, but you don't hear many people talking about the strange upside-down nature of the bond market today. At this moment, you can get paid more for investing in 3-month Treasuries (1.98% yield), than you can if you take more risk and go out six months (1.86%), and you get still less at 12 months (1.72%), 2-year (1.49%) and 5-year Treasury bonds (1.36%). That suggests that bond investors are trying to lock in very low rates for longer periods of time, a sign that they're unsettled about the future of the economy.

None of this means that a recession is inevitable, of course. According to the Journal of Accountancy, Americans' personal satisfaction levels are near their all-time highs (according to the AICPA's Personal Satisfaction Index), and the most recent Business & Industry Economic Outlook Survey shows that U.S. business leaders are more confident about the domestic economy than the global economy. But the fact that one of America's leading business magazines is uttering the dreaded "R" word to its readers suggests that it is never a bad idea to make sure you're comfortable with your current asset allocation, and willing to weather a market storm whenever it may come.

The Risks Of a Tax-Saving Opportunity

One of the more interesting—and least-discussed—investment opportunities on the financial landscape is also somewhat new. The Tax Cuts and Jobs Act of 2017 created

something called Qualified Opportunity Funds, which invest in projects at newly-created Qualified Opportunity Zones. The idea is to provide tax incentives for people to invest in projects that spur growth or affordable housing in economically-disadvantaged parts of the U.S. landscape.

How does it work? Let's say you own real estate or stocks that you purchased at a low price, and now they're worth a lot more. In accountant-speak, you have a low basis, and when you sell the real estate or stocks, you'll have a relatively high capital gains tax bill. Under the new tax law, you could sell your appreciated asset, and then reinvest the gains (not necessarily the entire proceeds) in a Qualified Opportunity Fund (QOF) within 180 days. If you do that, you can defer paying the capital gains tax on your sold investment, and if you hold the QOF as an investment for ten years, then the capital gains taxes are completely eliminated on the QOF investment.

The actual tax situation is more complicated than this; there are two step-ups in basis, at five and seven year holding periods, and since the law sunsets in 2026, there's some complication about the deferral lapsing at that point. But the larger issue is that already a number of companies are actively marketing projects in over 8,700 zones established by the IRS (you can download a spreadsheet on zone locations from the Department of the Treasury website: https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx). An Opportunity Zone Fund Directory (https://www.ncsha.org/resource/opportunity-zone-fund-directory/) has been created, which mostly seems to focus on affordable workforce housing projects. Sizes range from a few million dollars to $10 billion, and of course every promoter and developer touts their marvelous track records.

Investment concepts that are primarily driven by tax opportunities can be a dangerous proposition. The attractive tax benefits tend to distract from the much more important economic potential of the investment, including the nature of the properties being developed, their potential gains, the costs associated with building, acquiring and operating the properties, and most basically whether the promoter of the investment can be trusted or not with your hard-earned dollars. There is a good possibility that, despite the tax benefits, unscrupulous promoters will help you generate tax losses rather than gains, meanwhile lining their own pockets. In

retrospect, the whole QOF marketplace might turn out to be a great example of: "buyer beware."

Source:
Bob Veres Inside Edition Newsletter

For more information on these topics or for a free consultation, contact Resolute Financial, LLC at (978) 463-8771 ext. 1003.

Resolute Financial, LLC is an independent Fee-Only Financial Planning and Investment Management firm based in Newburyport, MA with offices in Chelmsford and Lynnfield, MA along with Portsmouth, New Hampshire. The principal financial advisors are all Certified Financial Planners (CFP®) and are members of the National Association of Personal Financial Advisors (NAPFA) an organization of fee only financial planners. As a fee-only advisors we are not paid commissions or fees of any kind by any product provider, mutual fund, or insurance company; we are paid solely by the client. This allows the firm to work for its clients in a fiduciary capacity; therefore, we will act in good faith and in the best interests of the client at all times as required by the NAPFA Fiduciary Oath we have signed. This newsletter contains general information, and is not intended as individual advice.