THIRD QUARTER,
SEPTEMBER 30, 2019

DEIGHAN WEALTH ADVISORS

Objective, unbiased *advice*

Celebrating Our 25th Year

1 MARKET COMMENTARY

3 PORTFOLIO CHANGES

3 CONGRATULATIONS TYLER D. HOXIE, CFA!

3 SOUNDBYTES

4 25 YEARS OF ADVICE

25 Years

Deighan Wealth Advisors
1994-2019

MARKET COMMENTARY

> 'Contrariwise,' continued Tweedledee, 'if it was so, it might be; and if it were so, it would be; but as it isn't, it ain't. That's logic.'
>
> – Lewis Carroll, *Through the Looking Glass, and What Alice Found There*

We live in a Lewis Carroll world, or at least it increasingly feels that way. Up is down, big is small, and the truth is getting harder to define, let alone believe or understand. Anyone who reads the morning news has likely experienced what it feels like to believe "…as many as six impossible things before breakfast."

Granted, much of this feeling can be attributed to political discord. However, while the political dysfunction certainly isn't helping, things feel upside down at least in part because of what's going on with the economy. Last quarter, we wrote:

"After raising rates rather methodically since 2015, the FOMC is considering a rate cut. This is rather remarkable, considering that rates are already low in a historical context…. policymakers don't seem to think the economy can handle today's modest rates, which would imply the economy isn't, in fact, all that healthy."

We wrote the above despite a strong stock market, decent retail numbers, modest wage gains, and historically low unemployment – things that persist today (though stock market volatility has increased). Each of these is associated with a healthy economy, and the Fed typically won't cut rates when the economic outlook is good. Most analysts expect that the U.S. economy grew at an annualized rate between 1.9% and 2.1% in the third quarter, and, for the full year, the Fed expects 2.2% GDP growth. By contrast, a recession is defined as two consecutive quarters of GDP contraction.

And yet, in July, the Federal Open Market Committee (FOMC) voted to cut rates by 0.25%. This was the first interest rate cut in a decade. In September, the FOMC cut rates by another 0.25%, further lowering the target range for the federal funds rate to between 1.75% and 2.00%. These moves have been both remarkable and unconventional. In his public comments, Fed Chairman Jerome Powell said, "It's an unusual situation. It's a challenging time, I admit it." This sounds a bit like a man peering through the looking glass and not liking what he sees.

Futures markets now predict a 65% likelihood the Fed will cut rates again in October. This would put the federal funds target rate between 1.50% and 1.75%. For context, the Fed cut rates to this level halfway into the Great Recession. It cut rates to this level at the tail end of the Dot-com Recession. Those were periods of great economic hardship. Those economies looked nothing like today's economy. Perhaps the next FOMC statement will read something akin to, "If it was so, it might be; and if it were so, it would be; but as it isn't, it ain't. That's logic."

So, if up is down and black is white and a relatively healthy economy needs interest rate cuts, then what, exactly, is the Fed's logic?

One might argue that, given the unprecedented nature of the Trump presidency, the administration has put undue pressure on the Federal Reserve to cut rates and bolster the stock market in advance of the 2020 election. Just recently, President Trump tweeted that Jerome Powell and the Federal Reserve "…don't have a clue." They are "pathetic," because they won't cut far enough or fast enough. The logic then would be that there is no logic, and the Fed is simply being strong-armed ("'I can't explain myself, I'm afraid, sir,' said Alice, 'Because I'm not myself you see.'").

However, we don't subscribe to this stance. We give the Fed credit where credit is due and assume instead that it has its reasons for cutting rates. For insight, we look to a different tweet, one that President Trump sent on September 11, 2019 (emphasis added in bold):

"The Federal Reserve should get our interest rates down to ZERO, or **less**…"

In this case, President Trump may very well be the tweeter in the coalmine. To be clear, we disagree that rates should be cut so drastically at the present time. However, Mr. Trump's comments have led us to peer through the looking glass, and, like the Fed, we don't like what we see: $17 trillion in negative-yielding debt worldwide, which accounts for 30% of all investment-grade securities.

This is truly astounding. It is astounding, because negative interest rates turn accepted financial theory on its head. So much of financial theory can be summarized as follows: A dollar today is worth more than a dollar tomorrow. This is the idea behind compound interest. I have no reason to lend money to you, unless you pay me what you owe PLUS compensation for time, risk, inflation, and so forth. If interest rates are negative, then the lender owes the borrower money:

$$\$100{,}000(1 - 0.02)^{10} = \$81{,}707.28$$

The above formula solves for the future value of a $100,000 lump-sum investment compounded annually at a rate of -2% for 10 years. In other words, if an investor (i.e. bondholder) were to lend $100,000 to another party (say the government) under the above scenario, the known future value of that investment (assuming no default) would be nearly 20% less than the amount lent!

You can see why President Trump might love such an idea, as the head of the world's largest debtor nation. You can also see why negative rates are disastrous for savers, who are, in essence, lenders. Pension plans, endowment funds, retirees and other bond investors have already weathered a decade of below-normal rates, robbing them of income they might have otherwise earned in prior decades. Should they now be expected to pay for the privilege of lending their money and putting it at risk? It's a perverse thought. Other perverse outcomes of negative rates include:

- Companies being incentivized to mortgage their assets, exchanging assets for debt.
- Depositors being charged interest on their savings deposits.
- Banks paying borrowers to take out home mortgages, car loans, etc.
- Investors having trouble pricing interest rate swaps using conventional models.

On its face, the premise behind negative rates makes little rational sense, inasmuch as no rational investor should be willing to forgo consumption and take on investment risk in exchange for a known loss. And yet 30% of all investment-grade securities globally are trading at negative yields. Can it be that lenders and central banks around the world have all gone mad as hatters?

Much of financial theory would say, no – investors are rational actors. There is a rational explanation, but it isn't pretty.

A central bank might employ a low or negative interest rate policy in order to jumpstart inflation and to spur economic activity. The European Central Bank (ECB), for example, further reduced its deposit facility interest rate to -0.50% in September as an incentive for banks to lend rather than hoard cash reserves. The ECB hopes this will help the region pull out of its economic malaise.

At the same time, an investor might be willing to purchase bonds at low or negative rates, because they're fearful of the economic outlook and they're looking for safety relative to riskier investments, like stocks. Investors in Switzerland, Germany, France, and Japan have been willing to buy government bonds at negative yields, because they view the price premium much like an insurance premium; it's a little bit of pain to insure against a great deal of pain.

In both cases, a poor economic outlook is the common thread behind the push for, and the acceptance of, lower interest rates. This is why $17 trillion in negatively-yielding bonds is such a big deal – it's a wake-up call saying the global economy isn't all that healthy. It's the tweet in the coalmine.

In August, Denmark's third-largest bank, Jyske Bank, launched the world's first negative interest rate mortgage (-0.50% for 10 years). Borrowers will make a monthly repayment as usual, but the amount outstanding will be reduced each month by more than the borrower has paid. Banks are in the business of making money, so why would a bank offer such a mortgage? An example can explain: Perhaps I lend you $100, and we agree that you'll pay me back $95 ten years from now. I might agree to this, so long as $95 will buy me more goods and services in the future than $100 buys me today.

The word for this is deflation. This is what the Fed sees deep within the looking glass, when it looks at negative interest rates. It sees a world upside down, where depositors and investors pay borrowers to put their money at risk. It sees a world stuck in a downward, deflationary spiral where prices, businesses, and jobs get sucked into the depths of a never-ending rabbit hole. Seeing this, the Fed has chosen to be proactive and cut rates before the suction can take hold. The hope is that, by cutting rates now and prolonging the economic expansion, we might yet escape the need for negative rates here at home. We might avoid Wonderland.

Despite the above, our economic outlook remains mostly unchanged, at least for now. The risk of recession is marginally higher than it was last quarter, but we still don't think a recession is likely in the immediate future. Rather, we think economic indicators will remain mixed for the next three to six months and continue to soften. Much has been written in recent days about the ISM manufacturing purchasing managers' index moving into contraction territory, but the ISM non-manufacturing index, despite slowing, remains above 50% (the cutoff between growth and contraction). Manufacturing has been particularly hard hit by the trade war, but a majority of businesses are still growing.

The past few days have been a bumpy ride for the stock market, a continuation of volatility witnessed throughout the third quarter. Going forward, we expect much of the same, as the market wrestles with conflicting economic data, tariffs, impeachment hearings, election cycle noise, and conflict in the middle east. Despite this expected volatility, we plan to keep equity portfolios fully allocated. In a low-interest-rate world, stocks are where returns will be had, if returns are to be had. The U.S. stock market has been perhaps the greatest beneficiary of low interest rates these past 10 years, and there's reason to believe that stocks might continue to benefit.

At the same time, as much as it frustrates us to purchase bonds at such low rates, we will continue to do so in order to counterbalance equity risk in client portfolios. As we described above, bonds have a role to play, and that role, today, is safety more so than income. That said, when purchasing bonds, we'll continue to pay careful attention to prices and seek the best yields we can, given each client's cash needs and risk tolerance.

It's no secret the Beatles were fans of Alice in Wonderland. On his final solo album, Brainwashed, which was released posthumously in 2002, the late George Harrison sings, "If you don't know where you're going, any road'll take you there." It is a quote often miscredited to Lewis Carroll, though it is, indeed, a reference to Alice's exchange with the Cheshire Cat. With this quote in mind, we'll agree with Jerome Powell – it's an unusual situation in which we find ourselves. We are in uncharted territory, and few, if any of us, truly know where the landscape will take us. With this recent round of interest rate cuts, at least we're on a road. That much is certain.

Until next time, best wishes for happy investing.

PORTFOLIO CHANGES

Schwab US REIT ETF (SCHH): SCHH seeks to track the underlying companies in the Dow Jones US Select REIT index, a market cap weighted index comprised of real estate investment trusts ("REITs"). With the Federal Reserve backing off on tight monetary policy, many investors are less excited about interest rates on CDs and other fixed income and have gravitated toward higher yielding investments such as REITs. Since REITs have a history of performing well in the late phase of an economic cycle, we've used a slight reduction in US Large Cap equity to add SCHH to help recession-proof client portfolios.

Emerging Markets: Our investment committee agreed to increase exposure to actively managed Invesco Oppenheimer Developing Markets Fund (ODMAX) using proceeds from reduction in the index-tracking Schwab Emerging Markets ETF (SCHE). We believe that active management will continue to add value in the emerging markets space, given that companies in such markets are often misunderstood by investors and inefficiencies exist. This provides opportunities for ODMAX manager, Justin Leverenz, and his resourceful team to perform in-depth research to capitalize on these inefficiencies. Additionally, emerging market indexes often include state-owned enterprises that may have incentives that conflict with the best interests of investors.

CONGRATULATIONS TO TYLER D. HOXIE, CFA!

We are pleased to announce that Tyler Hoxie has achieved what is considered one of the highest distinctions in the investment management profession – the CFA® designation. The CFA Program requires candidates to sequentially pass three levels of exams and four years of investment decision-making work experience prior to being granted the designation. The exams are known to be among the most rigorous in our industry and a typical candidate for the designation will spend an average of 1,000+ hours of self-study. Fewer than one in five candidates becomes a CFA charter holder. The curriculum is built from the CFA Institute Body of Knowledge, which covers ten key areas: Ethical and Professional Standards, Quantitative Methods, Economics, Financial Reporting and Analysis, Corporate Finance, Equity Investments, Fixed Income, Derivatives, Alternative Investments, and Portfolio Management and Wealth Planning.

Tyler was an intern here at Deighan before fully joining our team when he graduated from the University of Maine in 2014 with a Bachelor of Science in Business Administration with concentration in Finance. We appreciate Tyler's strong work ethic, his analytical skills, his willingness to help others, and his quiet but delightful sense of humor. He shares our company values of honesty, respect, responsibility, fairness and community. We are thrilled to promote him to Investment Analyst and congratulate him for achieving the CFA charter. Nice work, Tyler D. Hoxie, CFA!

SOUNDBYTES

This year's Seasons of Maine artist reception coincided with the celebration of Deighan Wealth Advisors' 25th Anniversary. Thank you to all who came to help us celebrate!!

Jean Deighan attended the opening of Good Shepard Food Bank's newly expanded distribution center in Hampden. This fine organization is a valuable resource for members of our community that suffer from food insecurity.

Lucie Estabrook, Jenifer Butler and Jennifer Eastman attended the 2019 Insider's Forum in Nashville. This three-day investment conference features presentations by some of the investment and financial planning industry's top thought leaders. We always come away with valuable ideas and information to help us better serve our clients.

25 YEARS OF ADVICE

The More Things Change, the More They Stay the Same

Twenty-five years ago, two young, intrepid investment professionals founded this firm with the vision that all people who want to better their lives deserve thoughtful, unbiased financial guidance from experienced professionals. In the beginning, there were only two of us sitting behind our desks fervently hoping that our vision had merit. We began 1995 as a modest firm representing a handful of wonderful families and institutions with $11M of assets under management. Today, our firm has blossomed into a full-fledged financial advisory firm of five investment professionals including Certified Financial Planners™, Chartered Financial Analysts, and a Certified Trust Financial Advisor, offering a robust menu of comprehensive financial planning and portfolio management. We now represent over two hundred families and institutions (including all of those "founding families") with over $175 Million of assets under management. We are so thankful to all of our wonderful clients, those who have been with us since the beginning, those who have joined us along the way, and those whom we are just welcoming now. What a privilege to serve you!

> "What hasn't changed is the unpredictability and uselessness of market timing and the predictability of human nature."

What's changed in twenty-five years? Everything, and yet nothing. The economic environment in 1994 certainly looked different from 2019. By 1994, market prosperity was evident in a thriving economy. Concerned that the economy was heating up too quickly, the Fed meted out some anti-inflation medicine by raising interest rates, a total of six times that year. Each rate hike felt like torture, for with each increase, the stock market fell off miserably, and bond values plummeted. What followed, then, was an about-face at the Fed that has largely remained pointed in the same direction since. The Fed started aggressively lowering rates, stimulating the economy to combat the tech selloff that infected the entire market, which, in turn, lead to a five year bull market, eventually to the housing bubble, and to the harrowing banking crisis of 2008, the so called "Great Recession." The Great Recession concluded over ten years ago, and while we have co-existed with the after-effects, perhaps we have never fully recovered from it. Yet as we look at the tumultuous periods of the last twenty-five years, we must also acknowledge that the Dow rose from 3834 points at year end 1994 to 26916 points on September 30, 2019.

With today's burgeoning stock market, slowing economy, and 30 and 10 year bond rates at 2.15% and 1.64% respectively, one might ask, "What hasn't changed?" What hasn't changed is the unpredictability and uselessness of market timing and the predictability of human nature.

"Tell me what's going to happen and when!" investors always ask. The response is this: After a recession, the markets start to rebound, usually when negativity and weariness has set in. Eventually, a straw emerges, breaks the camel's back, we tumble into recession, and the bloated market loses its fat. What will the straw be this cycle, and when will it set a bear market in motion? On October 1st of this year, the Institute for Supply Management Purchasing Managers Index came in at 47.8. Readings below 50 indicate contraction and this led to an immediate market drop. Is this the 2019 tipping point? Investors who try to time the market are often badly burned by opportunity cost. Logic suggests that those who choose to time the markets might want to consider just sitting in cash and avoiding all of the excitement. We agree. Finally, what is certainly true is that long-term investments, even after uncomfortably shedding excesses, are the only shown hedge against inflation. If investments do not exceed the ravages of inflation, investors are losing money.

Looking back over the past twenty-five years, this much we have seen, learned and believe is true. Investing is a long-term game, and it is best to stay in the game despite the market environment. It is also best to invest thoughtfully in quality investments, building a well-diversified portfolio that reflects one's educated risk appetite and one's ability to weather the ups and downs. Holding some cash is appropriate, but since cash does not provide a hedge against inflation, cash is never really "king." Market pull backs will happen, and must be considered normal, because they are. Be patient and wait, but don't be complacent. We'll be with you.

DEIGHAN
WEALTH ADVISORS

TELEPHONE 207-990-1117

www.deighan.com

DEIGHAN WEALTH ADVISORS
455 HARLOW STREET
BANGOR, ME 04401

LUCIE E. ESTABROOK, CTFA
CHIEF EXECUTIVE OFFICER
PRINCIPAL
lucieestabrook@deighan.com

JENIFER L. BUTLER, CFA, CFP®
CHIEF INVESTMENT OFFICER
PRINCIPAL
jeniferbutler@deighan.com

JENNIFER L. EASTMAN, JD
CHIEF OPERATIONS OFFICER
PRINCIPAL
jennifereastman@deighan.com

JEAN M. DEIGHAN, JD, CFP®
SENIOR ADVISOR
jeandeighan@deighan.com

TYLER D. HOXIE, CFA
INVESTMENT ANALYST
tylerhoxie@deighan.com

DONNA A. BUSHEY
OPERATIONS ASSISTANT AND
CLIENT RELATIONS SPECIALIST
donnabushey@deighan.com

KAREN S. MITCHELL, CAP
OFFICE MANAGER
karenmitchell@deighan.com