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The "Trade" of the Next Decade

I stole the gist of the title for this article from *The Bill Bonner Letter* that, at the beginning of each year, predicts the trade of the century. It's not that I don't consider myself a longer-term thinker or planner, but one hundred years is longer than any of us will be alive and a LOT can happen in ten decades.

> Think about one hundred years ago: World War 1 was ending, Woodrow Wilson was President, Paul Harvey was born and The U.S. Congress established time zones and approved Daylight Savings Time.
>
> Even over the next decade, a lot will happen that we simply can't envision at this point. Think about it. Ten years ago we were introduced to Smartphones as the first iPhone had just been released, computers used wires to connect to each other, the mortgage crisis plunged the economy into a recession and Senator Obama became President Obama. A lot can change in a decade, but ten years is at least a plannable timeframe.

Planning for the Next Decade

Have you worked on your 'next-ten-year' financial plan? Are you focusing on the things you can <u>control</u>?

- Wills up-to-date?
- Powers of Attorney up-to-date?
- Mortgage paid off?
- Beneficiary designations of insurance policies still valid?
- Plan to pay for kids/grandkids college?
- Plan to cover your long-term-care risk?

What about my money, you may ask? "What do you see for my investments over the next decade? I'd love to hear what you think?"

It's the beginning of a new year and the time when we all seem to look for predictions of the future. Of course, the predictions are mostly meaningless. But, we are human beings and most of us like to hear about what the future will be like. (It does sound a little silly when I actually write it down. We KNOW that predictions are pretty much meaningless, but we WANT to hear them anyway.) I guess you could say that we love to predict what we <u>cannot</u> control!

I did not seek assistance from the others in the office in writing this article, so I can't say if they agree with me or not. But, predictions, as meaningless as they are, can be a way to generate thinking on a topic and to consider what could happen and the ramifications of those events.

So here goes my view of the investment markets over the next decade:

The stock market is trading close to all-time highs. Many valuation metrics of the market are at elevated levels. That would lead me to believe in the coming years we should plan to expect rather modest returns from the overall stock market.

However, I could argue that if we adjust market valuations by the historically low interest rates, low level of inflation and the recent tax cuts, then the valuations look less elevated, but maybe still above middle-of-the road.

Interest rates have been hovering near historical lows; one can argue they should go up from here. Generally, a cycle of rising interest rates is not a good signal for stock and bond prices.

The exception to this may be if the interest rates and inflation increases are due to a booming domestic economy, then we may see a pattern where stock prices are good even in the wake of rising interest rates and inflation. This is not what I am expecting, however.

My view of the next decade in the investment world might be very modest overall stock returns and moderately rising interest rates created by the Federal Reserve actions and not by a booming economic environment.

You may read this and feel I see an economically struggling decade ahead of us. Not really…not at all.

But, I do think that new technologies, changing demographics, globalization and many other MAJOR forces will continue to create a lot of disruption to the patterns, activities and institutions that we find so comforting. This will be somewhat destabilizing to the populace, to say the least. And, the more mature one is, the more destabilizing it will feel.

So, maybe my prediction will turn out correct or maybe not, but we feel that assuming modest stock market growth and moderately rising interest rates is a good framework for making investment decisions.

We are not trying to guess when the next market down-turn occurs. We are not trying to guess what the inflation rate will be in two years. But, we are trying to follow a plan that will work even if the overall stock market returns are modest.

We believe that *income* will be very important. You have heard this from us before. But, if you are retired living on your savings, then you need income from those savings. In fact, the steady income is much more important, financially, than rising and falling market values.

If you are not retired and reinvesting your investment income, the income is again very important. It becomes even more important during times of falling market values. All the reinvested dividends are buying shares at lower and lower prices.

If you want to keep a "scorecard" of your investments in a very simple way, then don't plot the market value of your account each month from your account statement, plot the annualized income.

Most of us live on, or will live on, the income, not the market value of our accounts. (If you need to withdraw a lot more than the income, then you probably need to follow a different strategy.)

I grew up on a small farm. If the market value of farmland went down, it didn't matter. What was important was the harvest. Market values are temporary, focus on the income.

Income-Focused Investment Strategy

In the previous article we tried to direct your focus to the income your investments produce. That income is available to spend or to reinvest and compound to potentially give you higher future income.

"So how do you do this? Do you simply go to the internet and search for high income paying stocks or bonds?" You could, but that's not what we do.

High-Yielding Stocks- Today the interest rate on a Ten-Year U.S. Treasury bond, considered 'risk-free' and backed by the US Government, is about 2.75%.

We can find some high-yielding stocks that yield about double the 10-year US Treasury bond, or more than 5%. Actually, you can find over one hundred stocks that are paying a dividend that exceeds 5% annually. Some of these are solid companies but there are many of them you probably do NOT want to own.

Higher-Dividend Paying Stocks- These types of companies are usually more mature companies in more mature industries. Many of them have a long history of paying dividends and growing their dividends. But, since they are more mature companies, we would expect more modest dividend growth compared to their younger siblings. Here we are looking for a dividend yield likely in the 3-4% range with modest growth of dividend potential.

Faster-Growing Dividend Paying Stocks- Here we are looking for companies that have a history of paying a rapidly growing dividend each year. We would expect that dividend growth to be in the high-single digit to double-digit growth per year, but, of course there is no guarantee this will happen. For example, if your dividend does grow at 12% per year, you double your dividend in about six years. It can potentially grow even faster if you are reinvesting and buying more shares and creating what is called a *double-compounding* effect. We would expect the dividend yield for these stocks to be lower than the High-Dividend stocks, most likely in a range from 1.5% to 2.5%. In other words, assuming **IF** you could invest in a stock that was paying a 2.5% dividend and **IF** it doubled the dividend every six years, in twelve years the income would be about 10% on your original investment. (2.5% double to 5.0% in six years and double to 10.0% in another six years.)

Bonds- There are a lot of reasons to be skeptical of owning bonds in this market, and we probably agree with most of the skepticism. However, higher-quality bonds that mature within a few years can potentially offer a great deal of market value stabilization to an account. AND, they can provide an income, interest paid on the bonds, that could be in the range of what stocks pay. The big drawback is that the income is fixed, it does not grow.

Cash- We generally do not hold a lot of "cash" in our accounts. Actually, we should use the term *cash* equivalents (short-term bank accounts, money market funds and government bonds). Unless, of course, we know there will be a need for the funds over the next couple of years.

The real negative to holding a substantial part of an account in "cash" is that it literally earns nothing. Thus, if I have a bond that is only paying 2.5% per year, over five years we have earned 10%, assuming no compounding. This is almost 10% more than the safe "cash" would have earned. Granted there is some market volatility in the bond, but we accept that.

It is So Terrible Out There

The individual was telling us how bad things are everywhere. The weather, politics, world tensions, etc.

But, I was thinking, can't almost everyone who wants to buy a house, buy one? Can't almost everyone who wants a new car, buy one? Can't almost anyone who wants a job, find a job? Can't almost everyone who wants more education get funding for the schooling?

Interest rates on loans are historically low, making it less costly to borrow money. And, for the most part there seems to be a lot of money anxious to be loaned.

Now, I realize that there may come a time in the future when all this easy to obtain borrowed money comes back to haunt us, but right now the economic picture in this country looks anything but dismal, by almost any standards.

Granted, I would really like to see our governments get their financial affairs in order so the promises they have made can be honored. And, I would really like to see our governments get out-of-the-way and let the capitalistic system work. But, I'm not holding my breath waiting for either of those actions to happen.

Our system has a lot of problems and warts. We have made promises we will not honor and have regulations we do not need. But, this is not new. Like a family or like a business, we have struggles and we must adapt to those struggles. I think our system has done a pretty good job of adapting for many years and decades.

"HOW HIGH THE BULL?"

Here is the cover of the **February 6, 1984** ***FORTUNE*** magazine cover. Notice the main headline:

In case you don't follow it the Dow (Dow Jones Industrial Average) is currently hovering around 25,000. That's 12.5 times the level of 1984.

The Dow Jones Industrial Average is an unmanaged index that cannot be investing into directly.

We certainly have had many financial and political problems over the last thirty-four years, but most of us can't remember many of them anymore. As you listen tonight to the news headlines or listen to your friends lament the past, just remember that over the last thirty-four years the stock market has rewarded longer-term investors. I have no idea if in 2052 the Dow will be 312,500 that's 12.5 times today's level. What about 1950 to 1984? The Dow increased 6.0 times, that would put the Dow of 2052 at about 150,000. But, don't let today's headlines have too much impact on your longer-term investing decisions.

What Are the Really Big Risks Now?

Debt is a major long-term risk. Americans (individuals, governments and some corporations) have borrowed more money than they can ever dream of repaying. And, they just keep doing it.

We might be near the end of a cycle in which the Federal Reserve (and many of its equivalents around the world) finally acknowledge that they cannot "fix" what is wrong with the economy. For almost a decade we have not encouraged savings; no, we have encouraged spending to boost the economy. We punished savers by forcing interest rates to very low levels or even negative rates in some countries…to boost the economy. We did nothing to encourage capital formation. Instead, we encouraged borrowing to boost the economy.

We probably have way more government debt than can ever be repaid with honest currency. This is probably not a short-term risk, but debt is hanging over our economy, muting economic growth and encouraging citizens, individuals and corporations, to make bad long-term financial decisions.

"*Real people want real money. They don't want a depreciating currency, they want sound money. They want a currency they can save and accumulate for retirement that holds its purchasing power*." (Bonner & Partners June 28 2017)

The intervention of the Fed has made investing much more complex. The "signals" that the markets used to give off are now muted/distorted by Federal Reserve actions.

Debt has increased rapidly and continues to do so. However, debt cannot increase forever at a faster rate than income growth. At some point, probably when it's least expected, a crisis will happen, a debt crisis. Lenders will not get paid what they are owed. Many of the lenders, think pension plans, will be unable to honor promises. Think about the mortgage crisis of 2009. Thousands of homes went into foreclosure. It may not be homes next time, but it will probably be a crisis.

Passive Investments are the current *investment of choice* for billions of dollars annually. What are passive investments? They are investments that generally follow a market index. Maybe the index is the S&P 500, maybe it is the Dow Jones Industrial Average or any other of the hundreds of indexes.

The Dow Jones Industrial Average and the S&P 500 are unmanaged indexes that cannot be investing into directly.

What could be wrong with that you ask? Isn't this a cost-effective way to invest in the market?

The answer is…yes, it is lower cost than most alternatives. However, because of its nature, it becomes an investment that closely follows the <u>momentum</u> of the market.

The S&P 500 Index is the index that many passive investments follow. Since it's an index of 500 stocks, most people will say that it is well-diversified and closely mirrors the performance of all stocks. That is sort of true; however, if my math is correct, then an index of 500 stocks means each stock in the index represents 0.2%. However, it doesn't work quite that way. The S&P 500 is a "market-weighted" index, meaning the larger a company's "market valuation", the more it impacts the index. The five largest stocks in the index make up approximately 12.5% of the index.

Now, these five companies are considered some of the finest companies in the world. Four of the five are in some way technology companies. Who wouldn't want to own them? And, I'm not saying we don't want to own them, however, as people put more and more money into these index-following investments, they indirectly push up the share prices of these companies much more than the smallest five companies of the index, which in-total only equal about 0.5% of the index. So, as more and more money goes into these *passive* investments, the share prices of the largest companies go up. However, when the momentum changes, the opposite happens.

What is your strategy? To stay invested in the indexes until the last minute and then suddenly get out before the crash happens? Good luck with that.

You need a solid financial strategy to weather these financial times. We believe a solid strategy is to try to create a growing income in your investment accounts and focus on the income your investments produce rather than the always fluctuating market value.

INTEREST RATES seem to be moving upwards. As personal borrowers, we LOVE low interest rates. We can buy a bigger house, a nicer car, a second home, a 'play' car, etc. As governmental borrowers, we LOVE low interest rates. We can spend money on things that make voters happy without it actually costing much money. As corporations, we also LOVE low interest rates. We can borrow to buy back shares of our stock, thereby, making the remaining shares more valuable. We can borrow to pay dividends, thereby making our shareholders think we are doing better than we really are.

But, what happens when lenders sense risk…either that the borrower may not be able to repay the loan or the money he repays it with will purchase a lot less (inflation).

We haven't seen this yet in this country and in many other countries because the Central Banks (the Federal Reserve) have been buying so many bonds for their "house" account. (This used to be called *money printing.* Which, in normal economic scenarios, should lead to inflation.) But, for the last eight to ten years, it appears almost all the traditional rules of economics have been violated and nothing bad seems to have happened.

Have times changed?

Were the established "laws" of economics really just old-wives-tales?

Or is the *stuff* getting ready to hit the fan?

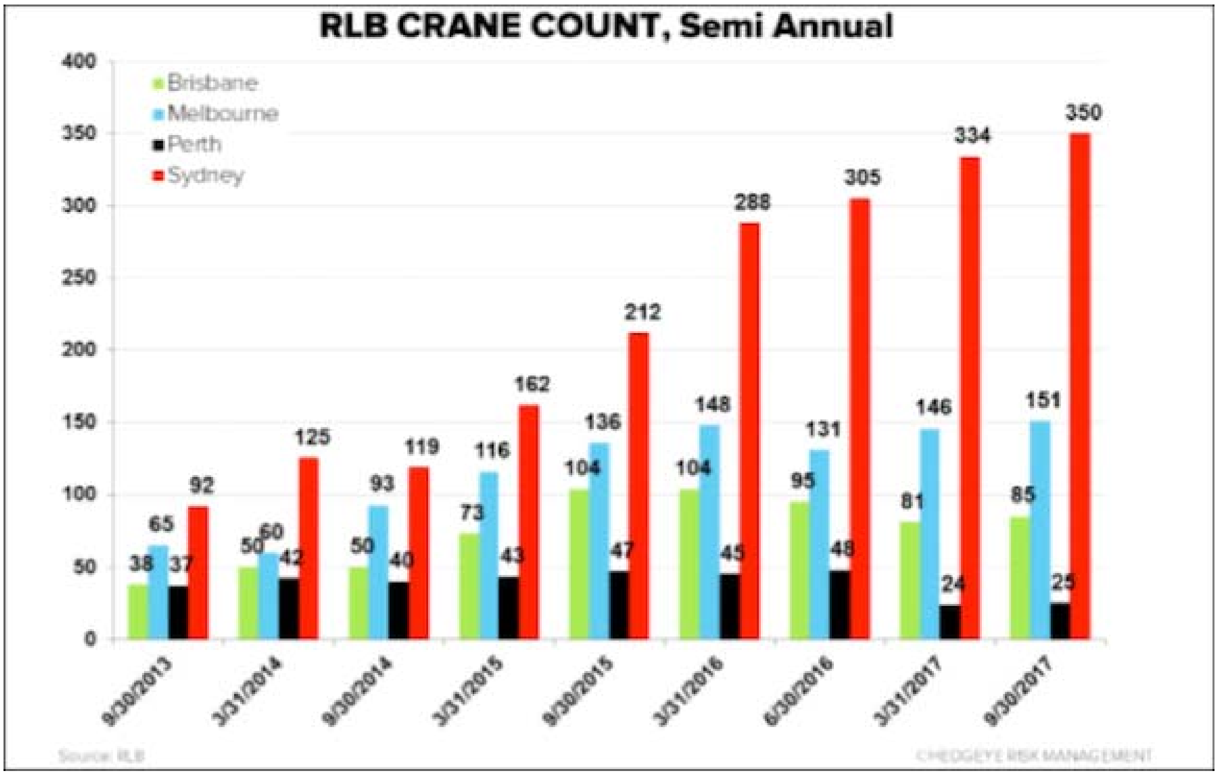
What's your prediction??

The Residential Building Boom in Australia

(We know this is rather random to throw in at the end of a Benedict Report, but we couldn't help it)

Do you know about the incredible residential building boom in Australia? Unless you travel or spend time there, or have friends or family there, you may not realize what's happening.

We subscribe to and frequently read John Mauldin's weekly newsletter, *Thoughts from the Frontline*. In his January 20th, 2018 newsletter, he presented a chart showing the crane count for Australia's four biggest cities (the data is through 3rd Qtr 2017).



Hedgeye

Focus on the red bars, which is Sydney, Australia. As you can see, Sydney alone had 350 cranes being used to build high-rise residential properties. For comparison, that's more cranes than are deployed in ***all*** North America's twelve (12) largest cities.

And, Australians are fueling this boom by engaging in 'Negative Gearing'; a practice of investing borrowed money in a way that intentionally produces losses. Investors are using interest-only loans to purchase these properties and are willing to rent them for less than the loan payments and absorb the difference. They believe they will make it up by selling for a profit.

Does this sound reasonable to anyone? Or, does this seem like a disaster in the making?

What's your prediction?

WHAT WE DO...

We prepare retirement income plans, which are essentially blueprints to help our clients pursue their long-term retirement goals.

We manage our clients' investment accounts on a fee basis with discretionary authority focusing on meeting their objectives rather than focusing on what the financial markets may be doing.

The primary author of The Benedict Report is Philip C Benedict, CFP®. Travis M James, CFP®, Mark A Beaver, CFP® and Ashley A Thompson, CFP® provide technical assistance. Fredda B Schwartz and Jackie Thompson handle the layout and editing of the newsletter.

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