



VIEWPOINTS

2ND QUARTER 2019

ADVISORY NEWSLETTER

MARKET COMMENTARY

FREDRIC W. WILLIAMS

Alternate Reality...

Distinctly different from the “altered reality” of the late 60s and early 70s that many of us can recall, we now seem to be navigating a global phenomenon of interpretive reality wherein fact and fiction are secondary concerns to the successful distribution of one’s point of view. In the auditory silence of social media, success is an acclamation “vote” measured by emojis rather than any vocal debate of the actual pros and cons of real facts...which oftentimes get lost in the forest of myopic, and self-serving, online posts. Truth, unfortunately, gets viewed as an inconvenience.

Our current tussle with alternate reality finds that our world is replete with examples of differing interpretations of, and conclusions from, the same data, events or information, depending what the “author” wants to promote. Traditional, online and social media have the uncanny ability to “spin” their perceptions to compete in the search for monetizable clicks and eyeballs – on again highlighting the prescience of one of England’s writers from the mid-1800’s.

“I’m not crazy! My reality is just different than yours.”

• *Lewis Carroll (Alice in Wonderland)*

To wit, the current debate surrounding that rationale, or need, for any reduction in interest rates by our Federal Reserve. Lurking behind the continuing cacophony of plaudits about how great our domestic economy is, we see the almost daily jawboning of the US Central Bank by the Executive Branch to cut rates – a request that would suggest all might not as trouble-free in River City as initially portrayed.

“The latest moves, by central banks in South Korea, Indonesia and South Africa, underscore the global nature of the brewing rate-cutting cycle, as policy makers attempt to ward off signs of weaker economic growth. With economies and financial markets interconnected, expectations of lower interest rates by the Federal Reserve and

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European Central Bank have given central banks in emerging markets scope to lower rates and prop up their economies.”

•WSJ; 7/18/2019

Although apparently not an allowable topic of polite conversation in our nation’s capital, concern about the condition, and direction, of the global economy is front and center elsewhere.

“A sharp deceleration of global trade driven by ongoing trade tensions is slowing the global economy more than earlier projections, according to the latest forecasts of the International Monetary Fund.

Real global economic growth will slow to 3.2% this year, 0.1 percentage point slower than forecast in April, and down from 3.6% last year and 3.8% in 2017, according to the quarterly update to the IMF’s flagship World Economic Outlook, released Tuesday.

The slowdown in growth and downgrade in the forecast reflect the ongoing fallout from trade tensions. Since the IMF’s last round of forecasts in April, three more months of data have confirmed weaker growth in much of the world, while tariffs escalated between the U.S. and China during a two-month breakdown in negotiations.”

•WSJ; 7/23/19

Disparities on more granular levels are appearing, given that, according to Bloomberg, most of the 2017 tax benefits that consumers realized have been offset by the costs of rising tariffs – a concern in light of the fact that about two-third of our GDP is driven by consumer spending, and absent the tax cash they might choose to be a tad more thrifty.

Within the equity markets themselves, the ratio of the gauge of small stocks (Russell 2000) to large stocks (S&P 500) is at its lowest level since March of 2009, and has dropped nearly 10% in the last year, something which is usually a precursor to a broader decline. And continuing the varying reality theme, this could be suggesting a buying opportunity on the small side and/or a canary in the mine on the large side.

Even within the large stock universe the climb from the December 26th lows to the S&P 500’s recent highs, the advance has been far from unequivocal, as 7 of the 11 sectors are not at new highs, with the overall index being pulled higher, not surprisingly, by the most crowded trades piling into the tech sector, driving the FAANG’s to even more stretched valuations.

The million-dollar question, of course, is which version of these various alternate realities is the market priced to – and which of the numerous variabilities are baked into the assumptions about the possible outcomes of the various geo-political issues we currently are dealing with?

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We're not suggesting that folks should go hide under investment-rocks, but do feel that common sense surrounding valuations and downside risk should focus attention on lagging sectors (and regions) with ample cash flows, rather than chasing momentum into overpriced sectors that could suffer a more Icarus-like fate should a "readjustment" occur.

"We continue to believe that navigating all the potential economic uncertainties, caused by our current spat of political gyrations, will be best served by maintaining prudent portfolio exposure to investment opportunities with (these) predictable cash flows."

CAPITAL MARKETS OVERVIEW

Index Returns			
Equities	Percentage Change for the 3 rd Quarter	Percentage Change for the Year	Annualized 10-Year Returns
S&P 500	7.71%	10.49%	12.06%
Bloomberg Commodity Index	-2.02%	-2.03%	-6.24%
MSCI EAFE*	1.35%	-1.43%	5.38%
MSCI Emerging Markets*	-1.09%	-7.68%	5.40%
FTSE NAREIT Equity REIT Index	0.79%	1.81%	7.44%
Fixed Income			
Bloomberg Barclays U.S. Aggregate Bond	0.02%	-1.60%	3.77%
Bloomberg Barclays U.S. Treasury Inflation-Linked Bond	-0.82%	-0.84%	3.32%
Source: BlackRock, Bloomberg, FTSE™, NAREIT®. *Returns are calculated with net dividends in USD Index returns are for illustrative purposes only and do not represent actual performance of any investment. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.			

Domestic and Global Market Recap

FRANCIS J. DAVIES, III

"It appears that uncertainties around trade tensions and concerns about the strength of the global economy continue to weigh on the U.S. economic outlook. Inflation pressures remain muted."

- Federal Reserve Chair Jerome Powell during his semi-annual testimony.

During the second quarter of 2019, US and global financial markets rose and fell based on predictions for the future direction of the Federal Reserve discount rate. Robust economic numbers dashed hopes of a rate cut and were met by market declines. Signs of global slowing buoyed hopes of a cut and markets rose. The tail was wagging the dog in Q2.

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Trade tensions with China increased concern of global slowing which drove performance of developed market government bonds, equities and gold while hampering emerging markets and industrial commodities. The S&P 500 rose 4.3% during the quarter and is now up 18.5% for 2019. The only sector that had a negative quarter was energy, which fell in tandem with crude prices.

International developed markets underperformed the US, despite weakness in the US dollar. The MSCI EAFE Index gained rose 3.7%, with 6 – 9% gains from Switzerland, Germany and France. The UK was down around 1% as they continue to fumble toward the unknown consequences of Brexit. Check the parachute before jumping next time.

China is facing the limits of unimpeded growth. It is also trying monetary policy to stimulate the economy. The Chinese GDP grew 6.2% in Q2, its weakest reading in 27 years. The last time China posted double digit, real growth was in 2010 when its economy grew 10.6% to \$6.1 trillion. The Chinese economy is now more than double that size, with GDP for 2018 at \$13.6 trillion. The larger it gets, the harder it becomes for outsized growth. China may have to experience a full business cycle, which includes a period of contraction.

The US bond market rose 3.1% as measured by the Barclays US Agg Index, on hopes of rate cuts. The longer maturity section outperformed, with the 10-Year Treasury yield dropping to 2%, a rate that was temporarily below that of 3-Month paper but has since corrected. This is closely followed as an inverted yield curve can be recessionary indicator.

The old saw is that the Fed takes away the punch bowl as the party gets going – or raises interest rates to keep the economy from over inflating and crashing. The Fed is meant to be the adult in the room. The Federal Reserve finds itself painted into a corner. In a disturbing turn of events, monetary policy has become the object of political fixation to an extent that fiscal policy has become an afterthought while strength in the stock market is confused with a strong economy.

Cutting rates in a slow growth period at the end of an economic expansion is needlessly spiking the punch. It will not create growth, particularly in the latter stage of a mature business cycle. At the end of the cycle is a growing divergence of the current economic state from forward expectations. For Q2 2019, earnings for the S&P 500 are expected to decline 2.6%. This would be the first time the index has reported two straight quarters of year-over-year declines in earnings since Q1 and Q2 of 2016. Q3 earnings should see a smaller fall. The Shiller P/E is 30.3 which is 78.2% higher than the historical mean of 17.

The years following Wall Street's destruction of the global economy in 2007 proved that even a zero-interest rate environment (ZIRP) does not compel business spending. Organic economic expansion like additional hiring or capital expenditure on expansion of production is not driven by monetary policy. Businesses focus on profit. Only demand exceeding supply can drive them to spend on capacity growth. ZIRP without demand equals zero economic growth.

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After the worst fourth quarter since the Financial Crisis and worst December since the Great Depression, stocks have come roaring back. In fact, the S&P 500 gained 18.5% in the first half of the year, it's best start to a year since 1997.

The Quarter's Best

Financials

Financials were up 8.0% during the 2nd quarter and 17.2% for the YTD. The financial sector continues to trade largely with changes in the slope of the yield curve. Financial institutions generally lend out at long-term rates and pay out interest at short-term rates. Corporate cash balances in many areas, such as technology, are high, but there are concerns that the increased trade tensions may negatively affect corporate confidence and result in delays in merger-and-acquisition activity, as well as perhaps depressing loan demand. The Financial services industry has a decent ability to reshape itself and adjust to the changing environment, as is evidenced by the modestly better performance seen recently.

Materials

Materials was the 2nd best performer during the most recent quarter, gaining 6.3%. Several factors for the recent improvements include increased demand from developing countries for more raw materials and the easing of some global fiscal restraint measures, which could help to stimulate growth. The Federal Reserve and European Central Bank both appear to be moving to an easier stance, which could also help to support commodities demand.

Information Technology

Technology continues to lead on a year to date basis, having risen 27.1% to date. The 2nd quarter was up 6.1%. The tech sector has given back some of its gains as the tariff dispute with China heats up. A modest pullback is healthy but the longer the tariff dispute lasts, the more potential for tech to struggle. The tech sector gets over half of its revenue from foreign sources, making it seem more vulnerable to trade disputes. Balance sheets in the information technology sector appear solid, with large cash balances and relatively low debt. This enables the group to pursue mergers and acquisitions that might help performance by removing competition and consolidating expenses but those may be delayed by uncertainty surrounding trade.

The Quarter's Worst

Energy

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Energy was down 2.8% during the 2nd quarter but is still up 13.1% for the year. Geopolitical tensions in the Persian Gulf have risen sharply in recent months. Historically, these tensions have tended to drive up oil prices but this year oil that hasn't happened, and oil-related stocks have lagged the broader market. Fears of a global downturn – which would hit oil demand – is one reason cited for the muted oil price reaction. The International Energy Agency (IEA) has trimmed the global oil demand outlook for two months straight, citing weakening economic sentiment, yet there are limited near-term risks of the usual catalysts that bring economic expansions to an end.

FIDUCIARY CORNER

STEPHEN L. EDDY

DOL Fiduciary Rule becomes SEC Best Interest Rule?

In early 2016, as the new presidential election machine was fully engaged, the Department of Labor under the Obama administration passed the “Fiduciary Rule”. The regulation was designed to protect retirement plan participants and investors, and force brokers to behave more like Registered Investment Advisors by holding them to a standard in which everything they do for clients needed to be in the client's best interest. The DOL rule was the culmination of six years of work post the 2008/09 “Great Recession”, when investor and government frustration with brokers had reached a crescendo.

Immediately following the recession, legislators attempted to improve the landscape for retirement plan participants and investors in general. First came fee disclosure requirements for retirement plans, then came the Fiduciary Rule which held brokers to the same standard of care as RIA's. The pushback from the industry was enormous, and predictable. Certain businesses with strong lobbying groups in Washington did not want to be required to disclose commissions and put in writing that the product they were selling was in the client's best interest.

One of Donald Trump's campaign promises was to rescind the DOL Fiduciary Rule. The rule was challenged in court a few times resulting in split decisions with one regional Superior court ruling in favor, and one against. In 2018 the Trump administration, while not entirely eliminating the rule, essentially told the DOL not to enforce it. This was very significant at the time because many firms had already changed their business models to be fee-only versus commission-based; some firms had even committed to being fiduciaries. The DOL's non-enforcement action created a path for the SEC to create its own rule regarding brokers and fiduciary behavior, which they had been researching behind the scenes while the Fiduciary rule was garnering all of the attention.

In many ways, it is more logical for the SEC versus the DOL to enforce a standard of behavior rule for brokers and investment advisors. The advisors are under their purview after all. So, in June of 2019, the SEC came out with their “Best Interest” Rule, designed to create more regulated behavior around a fiduciary/best interest standard of care for clients. The regulation changes are due to be in place by end of June of 2020. In the next few newsletters, I will review the new best interest rule (Regulation BI for short), and highlight the pertinent changes and modifications to existing advisor practices.

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Potential Risks of Universal Life Insurance

TRACY W. ROGERS

Historically low interest rates over the past decade have had a variety of impacts, from the beneficial - lower mortgage, home equity and credit card payments - to the detrimental - reduced income for retirees using fixed income and guaranteed products tied to the various interest rates. The low rates have also impacted more obscure products like Universal Life insurance.

When Universal Life policies were sold in the 80's and 90's, they were sold as much as a retirement investment as they were for the actual insurance need. In the 80's, IRA contribution limits were low, 401(k) plans were new and unproven, and the Roth IRA did not exist and so the tax deferred and tax-free nature of insurance was promoted. Credited interest rates for the decade ranged from 7% to almost 15% in 1982.

Universal Life Insurance Basics

Like other life insurance products, a Universal Life insurance policy has a death benefit and a premium cost. What made the Universal Life policy unique at the time was its flexibility. The policy holder had the flexibility to increase the death benefit and vary the premium amount based on current interest rates. Any excess premiums paid over the cost of insurance would earn interest, increasing the cash value of the policy. This behavior was encouraged as a savings vehicle and the cash value could be borrowed against, used to reduce or not pay premiums for a period, or as another form of retirement income.

The Risk

The potential risk for some is that the policy illustrations would have shown the premium cost at the current interest rate at the time (7-10% or so), not the minimum guaranteed rate (much lower). Any policy holder who funded their policy with the minimum premium needed to keep it in force, and was using let's say a 10% rate, may be in for a rude surprise. The policy's cost of insurance (the amount needed to provide a death benefit) is based on the spread between the cash value and the death benefit. Low interest rates and minimum funding will lead to minimal cash value, much lower than originally illustrated showing a higher rate, meaning that the cost of insurance is high.

The Result

Many people who were planning on the Universal Life policy to provide retirement income are now getting premium increase notices just to keep the policy in force as they do not have the cash value that was part of the original illustration. In some cases, the premium cost more than doubles just to keep a small amount of insurance in place.

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If you have one of these policies, then please review it with your agent or have us review with you. Many times, the cost of insurance is too prohibitive to keep the policy in retirement. If you are younger, it is always a good exercise to have your agent run an illustration with the minimum guaranteed rate to see what the policy looks like in a worst-case scenario.

OPA NEWS & COMMUNITY EVENTS

Save The Dates:

We're entering the time of year when a variety of non-profit organizations begin their annual fundraising efforts so they can continue to enhance the fabric of our community. Although by no means complete, the events below are but a sampling of the organizations that our firm, employees, colleagues and clients are involved with, should you want to consider supporting their missions.

30th Annual Betty Blakeman Memorial Tennis Tournament – Will be held July 19th to 21st in Yarmouth to benefit The Dempsey Center in Lewiston and South Portland. The tournament is sanctioned as a double major by the Maine Tennis Association and is held in conjunction with the Yarmouth Clam Festival. Additional information and registration can be found at:

<https://www.dempseycenter.org/blakeman-memorial-tennis-tournament/>

2nd Annual Portland Kids Duathlon – Presented by Benchmark Real Estate to benefit the Foundation for Portland Public Schools, these races are for young people between the ages of 3 and 12, and will be held July 28th in Payson Park. Details and registrations can be found at: <https://www.portlandkidsduathlon.com/>

Boys & Girls Clubs of Maine – Will hold their 29th annual “Steak & Burger Dinner on Wednesday August 14th from 5:00 to 7:30 PM in USM’s Sullivan Gym Complex. Join business and community leaders as they treat the members to steaks and the adults enjoy burgers. Additional information and registration can be found at www.bgcmaine.org/steak .

Institute for Family Owned Business – The finale of IFOB’s “Women in Business – Wine & Nine” golf series welcomes men as well and features a scramble and cookout, to be held on Tuesday September 3rd at Nonesuch River Golf Club starting at 3:00 PM. Additional information can be found at: <https://fambusiness.org/event-3182006>

Center For Grieving Children – Their annual “Swing Fore The Center” golf benefit will be held Tuesday September 10th at The Purpoodock Club in Cape Elizabeth. The Center for Grieving Children, based in Portland, serves more than 4,000 grieving children, teens, families, and young adults annually through peer support, outreach, and education. Since its founding in 1987, the Center for Grieving Children has served more than 66,000 children, teens, and their families. Additional information can be found at <http://www.cgcmaine.org/events/golf-tournament/>

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25th Anniversary of the Founding of the Firm

Old Port Advisors was founded 25 years ago this fall as Investment Management & Consulting Group (IMCG), with a vision to create a boutique independent investment management firm centered on the best interests of our clients.

Look for our save-the-date and celebration event later this year!

We're planning a client appreciation reception during the 4th quarter so we can provide a view of the next 25 years and thank the clients and colleagues who have been the reason for our success. We look forward to seeing you there!

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