BRIAN D. LOWDER, INC.

QUARTERLY NEWSLETTER

Volume 22, Issue 4 January 2020

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FINANCIAL MARKET OVERVIEW

U.S. stock indexes ended the 2019 year in a very different way than they began. Stocks dropped over 5% in calendar year 2018 on worries about slow global economic growth, expectations of more interest rate hikes in 2019, political media stories and trade wars with China and other countries.

Instead of interest rate hikes, the Federal Reserve actually lowered rates three times in 2019. Trade tensions still exist, but progress has been made and both the U.S. and China have said a "phase one" agreement is near. By year end, the U.S. stock market advanced about 30% and had its best performance since 2013. Once again, the annual financial market performance in 2017, 2018, and 2019 was completely different than the consensus opinion or forecast.

During the fourth quarter 2019, the overall stock market was up about 8% compared to less than 2% during the third quarter of 2019. Growth stocks handily outperformed value stocks during the fourth quarter and for the calendar year 2019.

Technology stocks have been leaders and are primarily responsible for the exceptional performance of stocks in 2019. The Dow Jones Industrial Average Index (30- stock average of primarily "value stocks" that have been around for many decades) was up 22% while the tech-heavy Nasdaq Composite Index was up 47% in 2019. Nearly one-half of that gain came from two stocks - Apple and Microsoft, which have surged 85% and 55% in 2019.

Small-company growth stocks outperformed both large and mid-size company stocks during the fourth quarter. Usually, large-company stocks lead the way during the initial stages of a stock-market advance and then as confidence grows, small-company stocks take the lead.

Fourth quarter real estate (REIT's) performance was just the opposite from the previous (third) quarter. Real estate investment trusts gained only ½% during the fourth quarter after advancing 7.5% during the third quarter of 2019. The 2019 calendar-year performance was up nearly 29%.

International stocks continue to trail U.S. stock market performance, but the gap has narrowed. International stocks were up about 7.7% during the fourth quarter and matched the 22% return of the Dow Jones Industrial Average for the entire 2019 calendar year.

Emerging market stocks (smaller-country international stock indexes) had the best return during the fourth quarter – up over 12%. However, that exceptional fourth quarter performance brought the year-to-date return for this category to only 18% - which wasn't enough to match the U.S stock averages.

Gold prices advanced nearly 3% during the fourth quarter and during calendar-year 2019, gold was up 17.8%. Gold is very near a 6-year high.

Fixed income or bond **prices** were relatively flat during the fourth quarter. Interest income continues to be very low and the 3% annual return for short-term Treasuries and the 8% return on intermediate-term U.S Treasuries in 2019 was primarily due to price

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appreciation – not income. As interest rates fell in 2019, the value (or price) of bonds increased – the appreciation represents the biggest portion of gain in 2019 – not income. Today, the 10-year U.S. Treasury Bond is only paying 1.8% interest! The 30-year U.S Treasury bond is only paying 2.3%. And, six-month certificates of deposit are paying only 1.65%. Clearly conservative investors can expect minimal returns from *top-quality* fixed income investments in 2020.

The following chart displays sample returns of various asset categories during the second quarter of 2019 and year-to-date:

Calendar Yr. 2019	**4th Qtr. 2019**	**Index Return (*includes dividends reinvested*)**
+ 22.34%	**+ 6.02%**	**Dow Jones Industrial Average (^DJI)**
+ 31.22%	**+ 8.99%**	**Standard & Poor's 500 Index (^GSPC)**
+ 30.67%	**+ 8.94%**	**DJ U.S. Total Stock Market (VTI)**
+ 35.87%	**+ 10.50%**	**Large-company stock – Growth (IWF)**
+ 26.13%	**+ 7.32%**	**Large-company stock – Value (IWD)**
+ 35.04%	**+ 8.14%**	**Mid-company stock – Growth (IWP)**
+ 26.73%	**+ 6.28%**	**Mid-company stock – Value (IWS)**
+ 28.48%	**+ 11.41%**	**Small-company stock – Growth (IWO)**
+ 22.00%	**+ 8.36%**	**Small-company stock –Value (IWN)**
+ 22.04%	**+ 7.69%**	**International (EFA)**
+ 18.23%	**+ 12.12%**	**Emerging Markets (EEM)**
+ 28.91%	**+ 0.57%**	**Real Estate Investment Trusts (VNQ)**
		Fixed Income (includes appreciation)
+ 3.38%	**+ 0.42%**	**Short-term U.S. Treasury (SHY)**
+ 8.03%	**- 1.42%**	**Intermediate U.S. Treasury (IEF)**
		Alternative Investment Category
+ 17.86%	**+ 2.90%**	**Gold (GLD)**

**All returns calculated using adjusted historical quotes from finance.yahoo.com*

FINANCIAL MARKET OUTLOOK

What a difference a year can make. After experiencing significant stock price declines in October and December 2018 and a negative 5% return on stocks in calendar year 2018, U.S. stocks roared back and delivered a 30% gain and with multiple record highs during 2019. Once again, too many investors can't seem to fight off an association between politics and investment decisions. The potential for negative political events to somehow translate into a market decline is a possibility never seems to go away.

There are old and new risks on the horizon and stock valuations are much higher today after a 30% gain in stocks than they were 1 year ago. Without even evaluating the true fundamentals that move the financial markets over years (not days or months), when you start a new year following a 30% gain in stocks last year, the natural tendency is to be cautious, reasonable, and with a more muted outlook for 2020. This caution is reflected in 2020 forecasts of "market strategists" or "experts" in both large and smaller firms. The consensus forecast is slower economic growth and single-digit returns on stocks in 2020. Naturally, most observers tend to be conservative with their expectations for stock market returns in 2020 after a 30% gain in 2019. We think that estimate is reasonable until the end of 2020 when actual economic growth is determined and after the Presidential election is over.

The Economy: the consensus outlook is for a "Slowing but Growing" economy. The average estimate for the growth in the U.S economy is 2% - that's down from the 2.3% estimate of growth in 2019, 2.9% in 2018 and 2.4% in 2017. Again, the 2020 projected 2% growth number is an estimate compared to actual growth rates in 2017 and 2018 and the 2.3% estimate for 2019.

When assessing stock market valuations, we often begin with reference points by comparing current ratios, such as price-earnings multiple, with past PE ratios. This beginning step is analogous to real estate buyers initially determining value by comparing price per square foot for recent home sales. It's a start. The overall price-earnings ratio for stocks was 15.4 at the end of 2018 and a PE ratio of about 15 is considered average. Today, the PE ratio for stocks is about 19.3 and the forward-looking (estimated earnings ahead) PE ratio is about 18.

Basically, the higher the ratio, the more expensive stocks are. The reason stock prices have risen to a higher PE multiple is because the majority of investors and managers EXPECT corporations to continue growing their earnings AND interest

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rates so low. With interest rates so low, safe returns on bank accounts and bonds are miserably low – stocks appear to offer a better opportunity for gain.

The same analogy and expectation for continued price appreciation coupled with low interest rates also occurs with real estate home prices. When interest rates are low, the monthly cost for real estate loans is cheaper. Qualifying for loans is easier, demand increases, prices rise, occasionally we experience bidding wars with offer prices above asking prices and the expectation is prices will continue to rise. With regard to real estate and stock prices, when something unexpected arises, perceptions change and prices adjust.

In conclusion, the economy is growing and the best measure for overall growth is gross domestic product or GDP. The U.S economy is growing solidly within the mid-range long-term average of 2%-3% growth. Mid-range economic growth and low interest rates certainly justify price earnings ratio to be above their long-term average of 15. If annual economic growth declines and or interest rates consistently rise, then the most probable near-term outcome is price earnings ratios will move down toward the long-term average of 15 and stock prices would adjust downward as well.

Consumer spending and confidence is still strong – another plus for stocks.

The potential shocks to anyone's forecast are:
Election and Trade

The two wild cards are U.S-China Trade relations and the Presidential Election in 11 months. Both are too hard to predict at this time and each has the potential to have a major influence on the markets in 2020. The world's two largest economies have been in a trade war for over a year with both sides raising certain tariffs and counter-tariffs that affect most of the goods traded. It appears that some sort of a beginning – referred to as Phase 1, may be imminent. That's positive. The financial markets have risen substantially in 2019 which implies anticipation of good news with trade relations.

Elections aren't what they used to be. Polls and pollsters can create, conduct and publish survey results to match just about anything you asked for or wanted. Look no further than the 2016 Election – the polls said the results were a slam dunk. It didn't turn out that way.

The Presidential election and the poll numbers indicating who is in the lead as November 2020 draws closer will likely have the biggest impact on stock market returns in 2020. A probability of a nearly 180-degree change in government policies of one party over the other, perhaps beginning on a certain date in the near future, almost guarantees volatile financial markets in 2020. Expect it.

If a change in government policies (meaning change of control of one party over to another) occurs in November 2020, the initial reaction in the financial markets will be negative. It's not that one party is deemed to be positive and another as negative for the financial markets. It's the type and magnitude of fundamental change that is drastically different that causes uncertainty. Whether a potential change (such as significant spending for universal healthcare, free college tuition, many changes contained in the New Green Deal) are for the better or worse down the road isn't the point. Initially, uncertainty will be as loud as an airport runway and financial markets HATE uncertainty.

INVESTMENT OUTLOOK AND RECOMMENDATIONS

Again, our outlook with regard to continued economic growth and its positive impact on the stock market have not changed. Our expectation is U.S. economic growth will be a bit slower than 2019 – perhaps around a 2% GDP growth initially, but solidly within the mid-range and long-term average of 2%-3%.

There will likely be no recession in 2020.

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Expect volatility and turbulence in the financial markets over short-term time periods in 2020. We do not plan to make any significant changes to client portfolios at this time. We will not make guesses disguised as forecasts to substantially change client portfolios until something unexpected or more probable than initially thought begins to develop.

As uncomfortable as it may seem and given that stock values are much higher since the beginning of 2019, stock prices are still reasonable and within our comfort zone. We expect the economic environment to remain positive in 2020.

The biggest dilemma continues: What to do with maturing certificate of deposit in client portfolios. Very few clients are invested 100% in stocks and real estate. The portion of client accounts NOT invested in stocks must stay in fixed income to maintain balance and not exceed clients' risk tolerance. For the near-term, as certificates of deposit mature, we will temporarily reinvest the funds into new short-term CDs or bonds. Expect top-quality fixed income investments to 2% or less until suitable alternatives are identified.

For clients with new investment accounts holding primarily cash, we expect to invest those funds into our recommended stock, bond, and real estate holdings ratably over the next 6 months. We will continue purchasing individual bonds (rather than bond mutual funds), money market funds and short-term certificates of deposits for the fixed income portion of client portfolios.

SECURE ACT 2019

The proposed changes we wrote about for "Stretch IRA's" in our last quarterly newsletter are official – the rules have changed for most IRA holders who must BEGIN taking required minimum distributions after 2019 and most beneficiaries of Inherited IRAs after 2019 must withdraw funds faster than in the past.

Prior to 2020, our tax laws allowed the **stretch period** (the time period for taking taxable required IRA distributions) **to be recalculated and continue** for a longer period of time when a younger person **inherits the IRA** and rolls over the deceased owners' IRA into his/her own Inherited IRA. Thus, the name "Stretch IRA". When inherited, a new (and younger) IRA owner calculates the required distribution using a longer life expectancy than the original IRA holder who died. The taxable annual Required Minimum Distribution is lower for younger persons (adult children or grandchildren) who inherit the IRA because their life expectancy is longer. Now, the life expectancy method has been replaced to 10 years for many beneficiaries (discussed in detail in the third paragraph below).

We will start with current (living) IRA account holders. First, if you attained age 70 ½ in 2019 or earlier, and have already started taking required minimum distributions from your IRA or other qualified retirement plans (401(k), profit sharing etc.) the new changes DO NOT apply to you. Also, if you have received an Inherited IRA in 2019 or earlier, the new rules do not apply to you either. Under the prior rules (before 2020) regarding required distributions for those 70 ½ or older and inherited IRA holders, the taxable required annual distributions could often be "stretched out" to provide income over the life expectancy of the account holders and once again over the life expectancies of the beneficiaries when they inherit the IRA. These prior rules stay in place.

Second, the new *Required Minimum Distribution AGE has been increased from age 70 ½ to age 72.* This is a positive change but will have a minor impact on IRA account holders as it will only push taxable required distributions up to two years longer.

Third, and the most radical change, is that the SECURE ACT requires NON-SPOUSE retirement account beneficiaries (those individuals who

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inherit a retirement plan account) to withdraw the entire retirement account value **within 10 years** after the original IRA account holder dies – not over the beneficiaries' life expectancy as the prior rules allowed. For *non-person* beneficiaries (e.g., trusts, estates, companies, non-profits) total required distributions must be completed over **5 years.**

This means taxable distributions must be taken out faster than before and taxable income must be claimed sooner (10 years verses life expectancy). Yes, this change will dramatically increase income tax revenue to our government and at the same time prevent wealthy retirement plan owners from "stretching out" taxable distributions over the life expectancy of BOTH the owner and again to heirs (beneficiaries).

In addition to retirement plan owners who have already attained age 70 ½ before 2020 and individuals who inherited a retirement plan before 2020; Below is a list of **eligible beneficiaries** who are EXCLUDED from the new required 10-year withdrawal period determined ***as of the date of death of the original retirement plan owner***:

- Heirs of retirement plan owners whose *original owners died before 2020*
- Surviving Spouses
- Heirs (beneficiaries) who are *less than 10 years younger* than the decedent
- Chronically ill individual beneficiaries
- Disabled individuals
- Minor children up to the age of majority in their state (18 - 21), or age 26 if the child is still in school. After they hit the age of majority in their state or age 26 if in school, the 10-year required payout begins.

In summary, the faster (shorter) withdrawal period for an INHERITED retirement plan beginning in 2020 does not apply to the most common beneficiaries – a surviving spouse or any person who is less than 10 years younger than the decedent. However, for adult children and grandchildren beneficiaries of a retirement plan owner, the shorter withdrawal period will result in reporting higher taxable distributions (10-year period verses over their life expectancy) over a shorter time period and could easily cause that beneficiary to fall into higher income tax brackets compared to the pre-2020 rules.

This change curtails an often-used and simple strategy that has been popular with many large IRA (and other retirement plan) owners who won't spend all the account assets during their lifetime. Simply take the minimum (taxable) required distribution over your lifetime and then leave the balance to a beneficiary who can do the same – take minimum required distributions over their lifetime. Now, only surviving spouses and the other eligible beneficiaries listed above can continue using this "*stretch IRA"* strategy.

These changes should encourage all IRA and other retirement plan account holders to review their beneficiary designations. Surviving spouses will continue to receive the favorable life expectancy payout period (as well as the other "eligible beneficiaries" noted above).

ROTH IRA CONVERSIONS

These changes should also encourage IRA account holders to review the strategy of converting Traditional or Regular IRAs to Roth IRAs. Roth IRA distributions are not taxable. So, some IRA account holders have elected to Convert a regular or traditional IRA account to a Roth IRA account as a tax strategy where you pay income taxes now on the entire IRA account value in exchange for never having to pay taxes on future distributions from the Roth IRA. Once the money is in a Roth IRA, the growth in the account value is never taxed in the future.

In addition, current (not inherited) **Roth IRA** account holders ***do NOT have to take any required minimum distributions*** over the new 10-year period or over their (prior rules) life expectancy. So, some taxpayers who are in low income tax bracket (due to

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job change, retirement etc.) may decide to pay the income tax all at once on the entire IRA account value and then let the Roth IRA account grow tax free for many years to come.

If taxpayers are already currently in a moderate to high income tax bracket, converting to a Roth IRA may result in the owner paying a third or more of the IRA account value in taxes when they convert to a Roth IRA and therefore may be less beneficial than before. Losing a third or more of the original IRA account value due to payment of income taxes now and then with the new law restricting the time period that many beneficiaries must withdraw the funds to ten years instead of their life expectancy, there may not be enough time for future tax-free growth to equal or exceed the lump sum payment of income taxes that are due at the time of conversion to a Roth IRA. You have to re-think the idea of converting to a Roth IRA if the strategy of the IRA account owner was to take minimum distributions over their lifetime and then leave the IRA account to younger heirs to make withdrawals over their much longer life expectancy. Those rules no longer apply to most beneficiaries.

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