W O O D S T O C K

QUARTERLY NEWSLETTER

Spring, 2019

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What should be the focus of an investment newsletter? We agree that imparting insights about what the next one to three-year period may bring is both interesting and useful. What if what an investor should be doing over the next 10 to 20 years is actually "set in stone"? Well, then, reinforce the 10 to 20-year strategy without being pedantic (page 1, we hope) and provide the one to three-year insights and tactical advice elsewhere in the newsletter.

Perhaps, we are entering a decade of below average returns for US stocks. From a strategic perspective, you already know that many other asset classes surrender return to equities and that the tax-free compounding of an equity-like return is the goal. If you follow the hedge fund or private equity markets you know that unless you are helping to run the fund, the managers expect you to receive and be happy with, an enhanced bond return. The upside of the investment beyond that ceiling tends to stay with the managers. Many developed markets and emerging markets tend to be burdened by excessive local government regulations and bad national tax policies and a dearth of good business operating numbers to crunch. We don't know what the US equity market will return over the next ten years, but we believe it has an excellent chance of being better or as good as the alternatives.

Besides what to invest in, there are some important choices to make regarding how to invest. Who owns what you're invested in? Is there a way to reduce the fees you pay? Once you determine the tactical opportunities available for the next one to three years, can you implement it and stay within your strategic objective? Most investment choices are pooled investment vehicles that may or may not owe a fiduciary duty to you, the investor. Within these structures, you are probably merely a creditor of the real owner. The real owners of stocks held in mutual funds are its trustees, of stocks held in another type of entity its stockholders, partners or managers. If things go badly for the fund management company, the US economy or the global economy you may wait in line for your assets. An individually managed account at Woodstock is in your name at a separate custodian. You own the stocks in your portfolio. Economic disaster may strike the companies you own, but you own them. And you own all the upside.

A recent article describing tax loss harvesting illustrates both the benefits and pitfalls of the practice. For taxable accounts it is the long term practice of taking investment losses to offset investment gains in any tax year.[1] The prohibition on repurchase of the sold asset for 30 days, a wash sale, is what the article described as tripping up robo advisers recently, but the successful implementation of the strategy may provide an after-tax benefit of 77 basis points ("bps"), according to Betterment, LLC.[2] It is easier to implement in an individually managed account with 30 to 40 equities in it and Woodstock managers are well versed in this technique. Of course, it is impossible in a mutual fund for the investor to implement and is not the goal of the performance oriented mutual fund managers, anyway.[3] Implementing tactical insights involves watching individual companies, industries and sectors. Vanguard has estimated that asset allocation decisions implemented while maintaining a measured and steady approach to investing can generate savings annually of 300 bps, not earned consistently but earned intermittently over the years and this does not include savings from tax loss harvesting.[4]

At Woodstock you own what's in your account, we owe a fiduciary duty to you to put your interests before ours and using tax loss harvesting and asset allocation decisions in concert with your investment manager can offset the investment management fee you pay. Strategically these "hows" ought to be "written in stone"! Now let's deal with the tactics.

We know that you are the most valuable business development tool that we have. Your referral of a friend, colleague or family member to us is the most important way that we grow.

We thank you for your support and want you to know that we are dedicated to serving your best interest.

William H. Darling, Chairman & President
Adrian G. Davies, Executive Vice President

[1] WSJ 4/16/19
[2] WSJ 4/16/19
[3] Vanguard claims to have patented a method of avoiding capital gains taxes by pairing mutual funds with ETFs. Bloomberg.com
[4] Vanguard research, September 2016

One and Twenty

Thomas C. Stakem

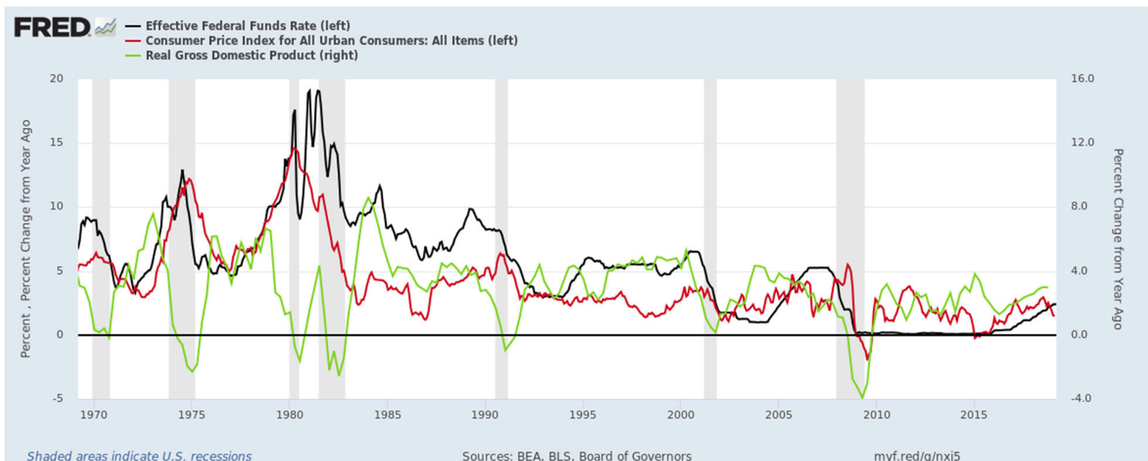
A long term investor usually has two time horizons in mind when thinking about investing – what will happen over the next twelve months (tactical) and what will happen over the next twenty years (strategic). Tactical thinking should take into account liquidity needs over the next year, current fundamental or valuation concerns and/or a buying reserve for expected opportunities. The strategic is normally the easier question to answer because of market history. But the investor's age has a profound impact as well. It is easier for a forty-five year old to think about the next twenty years than it is the sixty-five year old. For many investors their time horizons contract as they age. The importance of the tactical versus the strategic we leave to each reader to weigh and assess. And we will leave the easier, twenty year outlook, question for later.

The Next Year?

The two big economies – U.S. and China, the Federal Reserve and the 2020 elections hang over the short-term market outlook and could cast a shadow onto the twenty year outlook if there are dramatic fundamental changes. After raising the policy rate (federal funds) a quarter of a point at their December 18, 2018 meeting the Federal Reserve stood pat at their March 20, 2019 meeting. Lingering effects from the 35-day U.S. government shut-down, soft or weak economic data out of the U.S., China and Germany, and concerns about the outcome of the ongoing tariff negotiations undoubtedly encouraged policy makers to take out some recession insurance and stand pat on additional rate hikes. With the U.S. inflation rate well below 2% and looking docile there was no need for the Fed to be aggressive in the face of underwhelming data. Hopefully it turns out to be the pause that refreshes.

History would seem to be on the Fed's side. Note the following graph of the federal funds rate, the Consumer Price Index, and real GDP growth.

Continued on Page 3



Over the fifty year period it appears that a real (i.e. positive) federal funds rate always exists before the onset of a recession (i.e., the black line above the red line). With many observers on "recession watch" in the U.S. the emergence of a positive real fed funds rate in November 2018, the first time in over a decade (since Q4 2007), had to be noticed by the Federal Reserve governors. With U.S. inflation static or even falling, any further rate hikes would only push the real federal funds further into positive territory and increase the risk of a recession. So the Fed governors elected to "do no harm" and defer another rate increase (it would have been the tenth since 2015). In fact, the uncertainty of forward economic data must have been so palpable that the Federal Reserve hinted that there would be no hikes over the rest of 2019. On this score they will be very "data dependent". If the current uncertainty leads to more concern about the onset of recession as a result of subsequent economic reports the Fed will begin cutting rates to engineer a "soft landing" or, at worst, a mild recession. If stronger data emerges from the U.S., while Germany and China's stimulus policies kick-in triggering economic reacceleration, the Fed would be in position to resume their pattern of quarter-point hikes.

The much talked about yield curve, sloping downward for years as seen below, really picked up steam in the last two years as the spread between the 10-year Treasury yield and the 3-month T-Bill yield narrowed two percentage points to below zero in March 2019. At some point nine policy rate tightenings by the Fed will begin to restrain an economy that has absorbed the benefit of lower corporate taxes, de-regulation, and large budget deficits more than has already been felt. Perhaps it was time for the Fed to sit back and observe labor market conditions, the lack of inflation discomfort (i.e. sub 2% inflation), and the health of the other leading global economies for a quarter or two.

As can be seen in the graph below, three times in the last fifty years whenever the yield curve inverted (Q2 1989, Q4 2000, and Q1 2007), there was either a cessation of fed funds rate hikes or a decline had begun. No doubt the governors had access to this chart in March and it inspired respect for George Santayana's famous admonition about those who cannot remember the past being condemned to repeat it.

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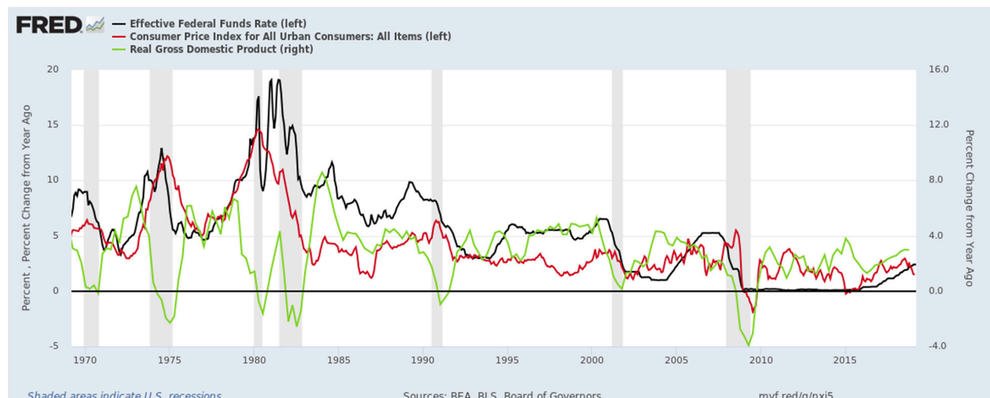

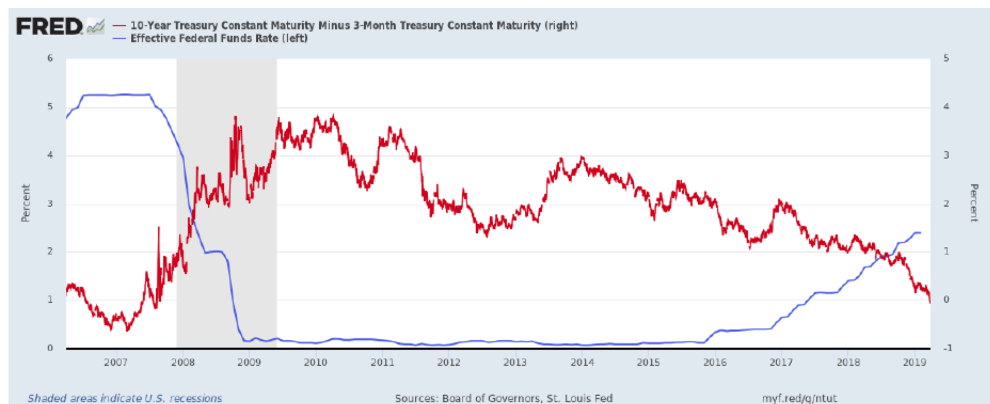

	--------------------------------Compound Annual Growth Rate--------------------------------						
	SPX	Operating EPS	Reported EPS	Operating P/E	Reported P/E	SPX Total Return	Yield
1 yr	-6%	22%	20%	-23%	-22%	-4%	2%
3 yr	7%	15%	15%	-7%	-7%	9%	2%
5 yr	6%	7%	6%	-1%	1%	8%	2%
10 yr	11%	12%	24%	-1%	-11%	13%	2%
20 yr	4%	6%	6%	-3%	-3%	6%	2%
25 yr	7%	7%	7%	0%	0%	9%	2%
30 yr	8%	6%	6%	1%	2%	9%	2%
50 yr	7%	7%	6%	0%	0%	10%	3%

source: *www.standardandpoors.com data, Woodstock calculations*

[1] *1968 operating EPS data assumed to be 1968 reported EPS data as operating EPS was not available.*

The Next Twenty Years?

Although the U.S. economy has grown so large that incremental growth has to slow, a look at history provides evidence and comfort that forward earnings growth of 5%-6%-7% should be in prospect. For long term growth investors, capital appreciation is primarily a function of earnings growth (P/E change is the other factor). On this point history is clear – equity prices follow earnings growth.

Two things stand out about the above table. Over long-term periods (20 to 50 years) the compound annual earnings growth rate has been 6%-7%. It is also obvious that in periods when stock price appreciation exceeded the earnings growth rate P/E expansion was the positive factor. Conversely, in instances where stock price appreciation lagged earnings growth, P/E contraction was the explaining negative factor. Over long periods of time (25 to 50 years) P/E change is minimal. This must have inspired the expression that stock prices follow earnings. But over shorter periods of time the P/E influence can be quite dominant. In 2018, for example, the S&P 500 fell 6% in price while earnings rose 22% on an operating basis and 20% on a reported basis. The P/E ratio fell 22%-23% in 2018, depending on the earnings series used (operating or reported). For the long-term horizon investor, the P/E influence is a minor factor, hovering near zero, highlighting the importance of earnings growth. Dividend yield was a factor adding a steady 2% to compound annual total return each period.

The law of large numbers applies to an economy's growth rate just as it does to a large individual company. The larger the company the harder it is to grow at high rates. At $20-$21 trillion the U.S. economy should logically have a harder time growing than any point in the past when it was a fraction of its size today. Similarly, the S&P 500 will have a harder time compounding earnings 6%-7% a year over the next twenty or more years. Haircutting the historical growth rate to a range of 5%-6% seems prudent particularly after the tax reform and share buyback era of recent years. Assuming no P/E change over the period results in S&P 500 appreciation potential of 5%-6% over the next twenty or thirty years. Conservative growth rates are also justified after reading the latest (January 2019) Congressional Budget Office (CBO) projections to 2029 that include higher individual and corporate taxes that are likely after the 2017 tax act expires at the end of 2025. Since the market P/E ratio is unlikely to be a material influence on capital appreciation over twenty and thirty year periods, an investor only needs to be comfortable that interest rates and/or inflation do not surge higher during the forecast period to be confident of a 5%-6% annual appreciation assumption. On this score, each individual needs to evaluate whether $1 trillion annual budget deficits beyond 2022 (only $900 billion in 2019), on top of the $22 trillion national debt (http://www.usdebtclock.org/) currently, will at some point exert volatility and upward pressure on interest rates. A tsunami of new U.S. Treasury debt is coming

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over the next decade and it is not clear if the available global savings pool will be willing and able to finance the U.S. deficit. Buyers having to be enticed by ever higher yields seems a safe assumption at this point. Here the CBO projections seem generous in that they estimate the average interest rate on publicly held debt will rise from 2.4% in 2018 to 3.5% in 2029 as the publicly held debt rises from ~$16 trillion to ~$29 trillion and will represent 93% of GDP versus 78% in 2018.

Conclusion

Five to six percent annual earnings growth and equity appreciation over the next twenty years is a sound planning assumption. Neither cash nor bonds can provide capital appreciation potential. Bonds theoretically could if 10-year yields ever fell from their already low levels of ~2.4%-2.5%, but that seems unlikely. Long term investors seeking growth have only one major decision – their percentage allocation to equities. Integrating the tactical and the strategic is the long term growth investor's challenge.

As the table on page 4 shows, in December 1998 a long term investor with a twenty year time horizon investing in the S&P 500 would have recorded 4% compound annual capital appreciation through December 2018. This was less than the 6% S&P 500 annual earnings growth because of 3% per year P/E contraction. This contrasts with the 14% compound annual appreciation over the previous twenty years that the long term growth investor would have recorded. Appreciation in this prior period was comprised of 6%-7% annual earnings growth and 7% per year P/E expansion. While that is indeed a wide spread in terms of annual appreciation achieved (4% to 14% annual) over those twenty year intervals, it does highlight how appreciation is tethered to earnings growth and how P/E changes can often rival earnings growth as driving influences. Three percent a year P/E contraction in the recent example and 7% a year P/E expansion in the earlier timeframe example put a healthy range around potential outcomes. Today's twenty year growth investor should plan on 5%-6% annual earnings growth and hope that deficits continue to have little effect on interest rates and P/E's. Looking back in December 2038 (twenty years on from 2018) the probabilities are high that 5%-6% a year compound annual appreciation will have been recorded by today's long term investor. ♦

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First Quarter 2019, Financial Markets Review: A Wild Shift Up

Maureen J. Murphy

The behavior of equity markets in the first quarter of 2019 was nearly the mirror image of the fourth quarter of 2018. Global equities rallied strongly with U.S. stocks leading the way, reversing the sharp U.S.-led downturn in the fourth quarter. After falling by -13.52% in the fourth quarter of last year and by -4.38% for all of 2018 including dividends, the Standard & Poor's 500 Index returned +13.65% in the first quarter of 2019, its best quarterly return in ten years. The S&P 500 ended the quarter just 3.3% shy of its all-time closing high established on September 20, 2018. While concerns around slowing global economic growth, reduced corporate earnings expectations, and political uncertainties persisted, equity markets moved higher.

Much of the rally in U.S. stocks has been attributed to a significant shift in Federal Reserve strategy away from its monetary tightening bias and renewed optimism around a U.S – China trade deal. Mostly positive U.S. economic data points, along with solid reported fourth quarter 2018 corporate earnings, provided additional fuel to the rally. For the quarter, all eleven S&P 500 sectors posted positive gains, with seven of the eleven sectors advancing in price by double-digit percentages. The first quarter's rebound in U.S. stocks was widespread with stocks of both small and mid-capitalization stocks, as measured by the Russell 2000 Small Cap Index and S&P 400 Mid Cap Index respectively, modestly outperforming the S&P 500 large company index. International stock markets rebounded strongly but still underperformed U.S. stocks (see Market Barometers table below for details).

The monetary policy environment for equities improved considerably in the quarter, providing a powerful tailwind to investor sentiment, as major central banks backed away from pursuing tighter monetary policy.

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After raising the federal funds interest rate in mid-December by another 25 basis points, the fourth such rate hike in 2018 and the ninth hike since this rate cycle began in 2015, the late 2018 market downturn and signs of slowing global economic growth spurred the Fed to communicate an indefinite pause in its rate tightening. Following its March meeting, the Fed indicated there would likely be no interest rate hikes in 2019 and perhaps only one in 2020. This was a significant about-face in monetary policy and a shift from the Fed's previous forecast in December. Market expectations switched from anticipating several more rate hikes in 2019 to no hikes, with some market participants and Fed futures even suggesting a rate cut in 2019. National Economic Council Director Larry Kudlow said the Fed should even lower its benchmark federal funds rate by 50 basis points to help protect the U.S. economy. The Fed also announced that it would stop shrinking its balance sheet later this year, leaving its bond holdings at a higher level than previously anticipated. For bonds, concerns regarding the strength of the economy, modest inflation and the Fed's shift from hawkish to dovish fueled a decline in yields. The yield on the benchmark 10-year U.S. Treasury note started the year at 2.69%, hit a 15-month low of 2.39% in March and ended the quarter at 2.41%. Bond yields and prices move in opposite directions.

Driving the policy shift was the downside to the economic outlook—continued signs of a moderation in U.S. economic growth and a much sharper slowdown overseas. At their March post-meeting press conference, Federal Reserve Chairman Jerome Powell indicated that the policy revision was a result of a changing economic backdrop. He acknowledged that growth in U.S. consumer and business spending had slowed in recent months and pointed to a more pronounced slowdown in European economies. Likely concerns about December's stock market drop, the 35-day U.S. Federal government partial closure, and trade negotiations with China also had a part in influencing the Fed's pivot. Chairman Powell stressed a much more patient approach to monetary policy reasoning that with core inflation failing to threaten the central bank's 2% target, the Federal Open Market Committee can be patient and wait to see how the economy evolves in the coming months.

The Fed was not the only central bank to shift to more accommodative monetary policy. Notably, in a major policy reversal, the European Central Bank (ECB) altered its forward guidance at its March meeting, stating that rates would remain unchanged at least through the end of 2019 and it said that it will start its third program to stimulate bank lending to counter a softening economy. The dovish announcements came as the bank lowered its 2019 European growth forecast to 1.1% from 1.7%. China's economy continued to slow, pushing authorities toward more policy stimulus which should provide support to both China and the global economy in the coming months.

The same signs of slowing economic growth that led the Fed and the ECB to take their feet off the brakes were accompanied by a signal from the U.S. bond market that the likelihood of a recession is increasing. In March, amid signs of a moderating U.S. economy, some portions of the Treasury yield curve inverted, as yields on bonds with shorter maturities declined less than yields offered by longer maturities. The 3 months – 10-year Treasury yield spread inverted for the first time since 2007. An inverted yield curve has historically been one of the most accurate predictors of a recession, though the lead time from the inversion has varied significantly and has tended to signal onset of a recession by a year or more.

At this juncture, global economic growth remains positive although it has become more uneven and many major economies have progressed toward more advanced stages of the business cycle. The economic growth rate of many European countries has slowed to one percent or less and Italy's economy is already in recession. The U.S. economy appears stronger than the economies of many developed countries and is decisively in late-cycle but with low near-term risk of recession. U.S. economic growth is expected to slow in 2019 but remain healthy with real Gross Domestic Product (GDP) expected to grow closer to 2% in 2019, down from 2.9% last year.

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Corporate earnings growth is expected to slow but remain positive in 2019. Fourth quarter 2018 earnings for S&P 500 companies grew +13.4% year-over-year, making it the fifth consecutive quarter of double-digit year-over-year growth. Earnings growth is expected to decelerate sharply in 2019 to single digit territory as year-over-year comparisons become more challenging in light of the tax cut-related boost to corporate earnings in 2018. Continued U.S. dollar strength and the impact of trade tariffs could be additional headwinds for earnings.

The U.S. equity bull market marked its tenth anniversary on March 9, 2019 (subject to a new closing high) and the S&P 500 was up 319% over the 10-year period (+15.32% annualized) and up 417% with dividends reinvested (+17.76% annualized). Increased market volatility and significant gyrations in quarterly market returns are indicative of a late market cycle.

Given our expectations for moderating, yet still healthy U.S. economic growth and corporate earnings growth, the environment should be conducive to gains in equity prices, but downside risks are growing as we approach the end of the economic cycle. A recession is likely many months away. However, equities may remain volatile, and we may see periods of both strength and weakness in 2019. After such a significant price advance in equities in the first quarter, we are mindful of several potential market risks going forward. These include: any reversal in the view that the Fed will not raise interest rates this year (driven by stronger than expected economic data), outcomes of U.S.– China trade negotiations, Brexit, difficult year-over-year earnings growth comparisons, and political uncertainties as we enter the U.S. Presidential election cycle. We continue to believe equities of well-managed companies with strong financial characteristics and sustainable competitive advantages, with holdings diversified across most S&P 500 economic sectors, are the right posturing in the environment we anticipate. Equity selection will be particularly critical and our active investment management strategy should have an opportunity to continue to shine in 2019. We recommend maintaining appropriate levels of cash and short-term bonds for clients who draw upon their accounts. As always, we remain focused on investing for the long-term. ♦

Maureen Murphy is Vice President and Portfolio Manager at Woodstock Corporation. You may contact her at mmurphy@woodstockcorp.com.

MARKET BAROMETERS

KEY INDEX PERFORMANCE
TOTAL RETURN (%) FOR PERIODS ENDING MARCH 31, 2019

	12 Months	1Q 2019
U.S. STOCKS		
S&P 500 Index	9.5%	13.7%
S&P Mid-Cap 400	2.6%	14.5%
Russell 2000 Small Cap	2.0%	14.6%
INTERNATIONAL STOCKS		
MSCI World Index Ex-U.S. (US$)	-2.6%	10.6%
MSCI Emerging Markets Index (US$)	-7.4%	9.9%

U.S. FIXED INCOME YIELDS	12/31/2018	3/29/2019
3 Mo U.S. T-Bill	3.45%	2.40%
6 Mo U.S. T-Bill	2.56%	2.44%
2 Yr. U.S. T-Note	2.48%	2.27%
10 Yr. U.S. T-Note	2.69%	2.41%

Tax Update

So what is the good news about retirement plans and savings? On the private side, which by the way makes up two thirds of US GDP, there is good news. Seventy-five percent of retirees tell the Federal Reserve's Survey of Consumer Finances that they have "at least enough to maintain their standard of living". Eight of ten and six of ten of retiree households and of working age households, respectively, tell Gallup they have enough money to "live comfortably".[1] According to the Social Security Administration "the median retiree born during the great depression has an income equal to 109% of his average inflation - adjusted pre-retirement earnings". The projections using the same computer model show that for citizens born from 1966 to 1975 "a median replacement rate of 110% of real average pre-retirement earnings" is projected.[2]

Where does the retirement crisis talk come from? On the government side, which makes up eighteen percent of US GDP, the figures are less good. In 2018 there was $8 trillion of state and local liabilities, approximately half is owed to bond holders and half is owed to pensioners. According to Pew Charitable Trusts those pension obligations were 86% funded in 2007 and are only 66% funded in 2016.[3] However, the American Legislative Exchange Council determined that several irresponsible states, Connecticut, Illinois and New Jersey, are approximately 20% funded.[4] The municipalities within those states are considered to have less flexibility even though they may be at a higher funding percentage than their respective states. If you or any of your other advisors have questions about the issues raised here, please contact your investment manager or one of us.♦

William H. Darling, CPA - Chairman & President
Jeanne M. FitzGerald, CPA – Tax Manager

[1] WSJ 3/1/2019
[2] WSJ 3/1/2019
[3] WSJ 10/27-28/2018
[4] WSJ 10/27-28/2018

Taxes are reacted to and felt on a very personal level. As you have questions about your personal tax situation, we hope that you will reach out to your portfolio manager or one of us with your questions. On a macro scale, however, how is the Tax Cuts and Jobs Act of 2017 ("TCJA") doing? Covering its costs? Stimulating the US economy? Still providing refunds? Of course, "costs" in the Alice in Wonderland verbiage of taxation are still odd. Lower gas prices at the pump are not a cost, but a benefit to the consumer. The tax cut for working Americans in the TCJA is a benefit to the taxpayer but a "cost" to the federal government. When the Congressional Budget Office wants to know the "cost" of a tax reform, it is solely concerned with federal tax revenue, not benefits to the taxpayer. Well, with 3.1% growth from the 4thQ of 2017 to the 4thQ of 2018 in the US economy, the Congressional Budget Office reported that "even if the current surge in economic growth isn't sustained, the revenue residual from our current strong growth rate will pay for some 80% of the projected cost of the 2017 tax reform".[1] If we have one more year of 3% growth, the tax reform will pay for itself completely.

On stimulating the economy both business investment and personal income are growing impressively. Business investment "in equipment, intellectual property and new plants pays off for years to come in better productivity and higher wages".[2] Personal income, remember the gas pumps, grew at 5.7% in the last half of 2018 and there are "one million more job openings than there are people looking for work".[3] The signs are good for 3% growth in 2019, too. Refunds? As of March 15, 2019, 75.8 million returns have been filed, 73.5 million processed by the IRS, 60 million returns have refunds averaging $2,957,[4] almost unchanged from 2017. We know we have far fewer clients subject to the Alternative Minimum Tax ("AMT") this year compared to last, but most taxpayers are both winners and losers this year and it is the net effect that counts.

If you or any of your other advisors have questions about the issues raised here, please contact your investment manager or one of us.♦

William H. Darling, CPA - Chairman & President
Jeanne M. FitzGerald, CPA – Tax Manager

[1] WSJ 3/5/19
[2] WSJ editorial 4/27-28/2019
[3] WSJ 3/28/2019
[4] WSJ 3/25/2019