Summer 2018

The Eagle's View

By Paul J. Tully, CFP®, RICP®

As I mentioned in my previous letter, I am testing the idea of sending a letter semiannually instead of quarterly in part due to the fact that we have been, at least up until now, in a much less hectic economic world than we were a few years ago. Unfortunately, the resulting letter becomes a bit lengthy and I would appreciate your input as to whether it's too long and perhaps where it could be reduced.

Economy & Investment Markets

The first half of 2018 saw the unemployment rate drop to 3.8% in May, which was the lowest level in 18 years. The economy grew in the first quarter by 2.7 % and was followed by a stellar 4.1% in the second quarter.

Much of the growth is attributable to the lower corporate and personal taxes combined with increased business investment and additional consumer spending. Confidence and investment markets both rose as a result. Earnings in the second quarter rose over 20% above last year, retail sales were up, and industrial production rose over 6% in the second quarter. Housing starts are up over 7% over last year, though that trend has slowed in recent months.

The US stock market, as measured by the S&P 500, rose by a rather pedestrian 2.7%, giving one the impression that the first 6 months were tame, but nothing could be further from the truth. Technology was the best performing sector and saw an impressive jump of 11.5%. On the other hand, consumer staples was the worst performing and was down 8.4% with telecommunications (which currently contains just three stocks – AT&T, Verizon, and CenturyLink) right behind,

...Continued on next page

Inside this issue

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down 8.4% as well.

After rising sharply in January, stocks dropped by over 10%, with the decline ending on February 8. For the 10 years ending June 30, 2018, the S&P 500 was up an average of 10.2% per year, while the 10 years prior to that, ending 6/30/08, the average was only 2.9% per year. Many analysts project the next 10 years to fall somewhere in the middle of that range. As of August 22nd, it is the longest bull market in US history.

Of the 11 bull markets for the S&P 500 since 1949, only the 1990-2000 bull market had more closing high days (308) than the current bull market, which stands at 202 days. An interesting fact (and probably somewhat irrelevant) is that if you missed the best 5 days of the latest 10 year bull market, your average return dropped from 10.2% to 5.8%. Of course, there is a corollary in that I'm sure if you managed to miss the worst 5 days, your returns would have been higher. Unfortunately, no one knows when the best or worst days will occur. The good news is that since 1928, 73% of the years have been positive, though only 58% of the months and 54% of the days have been positive. It pays to stay the course! (Statistics source: Standard & Poor's)

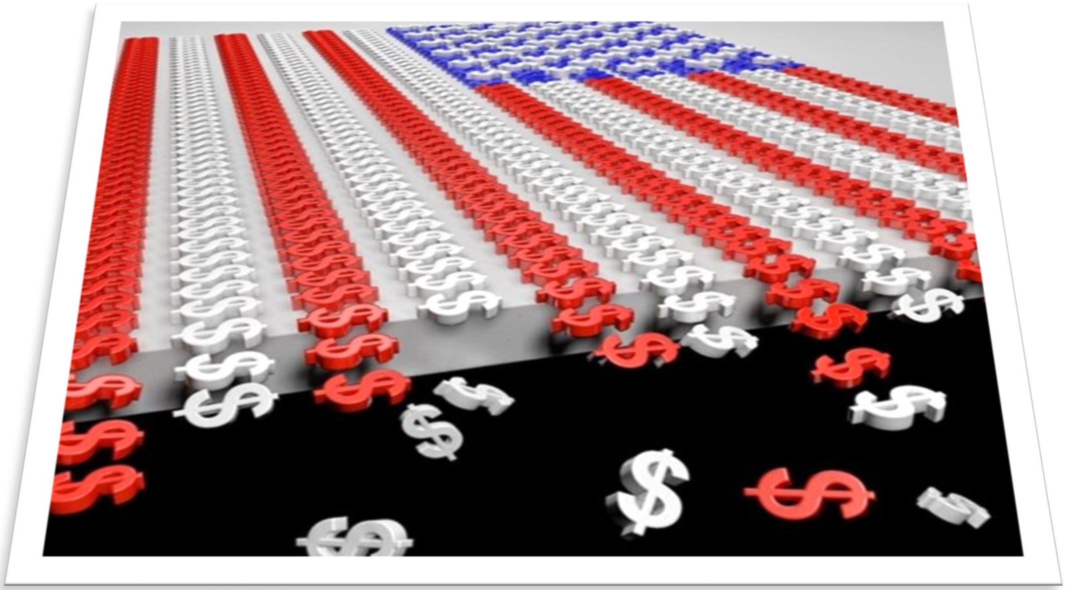
Will the growth in the economy, earnings, markets, and jobs continue at the current pace? No one knows the answer, although there are some strong tailwinds in the economy (continued low interest rates, strong employment, and earnings to name a few), but there are also some gathering storm clouds, including inflation, increased government spending that may cause trillion-dollar

deficits for the next decade, and rising interest rates. Any combination of these could slow the economy and impact the investment markets.

For now, the consensus through 2019 is that things will continue to be positive with no recession in sight, but any number of events could rapidly change that outlook. The trade war we seem to be heading for with many of our trading partners (we have targeted two of the countries, Germany and China — that along with the US and Japan represent 55% of the worlds manufacturing), the costs of significant tariffs, the upcoming midterm elections, and the ongoing federal investigation and potential fallout of Russian interference in our 2016 and perhaps 2018 elections have potential to make significant impacts.

Earnings in the first and second quarters have been robust with 80% of the companies in the S&P 500 beating estimates, the strongest performance in 20 years. Revenues are also up sharply.

Raymond James' Chief Market Strategist, Jeff Saut, believes we are in a "secular bull market" like 1982-2000. Rather than paraphrase his thoughts, on the next page are his memos from March 12, 2018 and May 21, 2018 in their entirety (italicized):



May 21st, 2018 – "*As often stated, secular bull markets have three "legs." We think the first leg began in October 2008 and ended in May 2015. The second leg started in February 2016 when the Royal Bank of Scotland's strategist said, "Sell everything except high quality bonds." The second leg is always the longest and strongest. When it ends is unknowable, but if past is prelude the equity markets will go into another upside consolidation, like the one between May 2015 and February 2016, and then breakout to the upside and commence the third leg. To size that, in the 1982 – 2000 secular bull market the third leg began in late 1994 and ended in March of 2000."*

March 12th, 2018 *– '"What do you mean when you say 'secular' bull market?" It is a valid question because most folks believe a 20% rally, or a 20% decline, represent bull and bear markets. However, that is not what a secular bull market is. Secular bull markets last 14+ years and tend to compound money at a double-digit return per year. The secular bull market of 1949 to 1966 compounded money at 11.41% per years basis the S&P 500. The 1982 to 2000 secular bull market compounded money at 14.38% using a 20-year rolling return (Chart 1). Were there pullbacks in those secular bull markets? You bet there were, but it didn't stop the secular bull market. And there, ladies and gentlemen, is the most misunderstood point about bull markets. Most pundits cut the 1949 – 1966 Bull Run off in 1956 when the stock market took a ~21% "hit" because Egypt attempted to take over the Suez Canal, but as can be seen in Chart 2 that did not stop the bull market. Fast forward to the 1982 – 2000 secular bull market, which many participants cut off in 1987 due to the crash, but hereto that did not stop the bull market (Chart 2). We think the current secular bull market is going to be bigger than both of those secular bull markets."*

Although it has been over nine years since the last recession ended in June 2009, recessions don't occur because of the length of the recovery. Generally they are caused by (or there is an eerie coincidence with) rapidly rising interest rates sometimes accompanied by rapid increases in oil prices, but more frequently, it is Fed induced. Currently the Fed is handling this well and net of inflation, interest rates are still pretty close to zero in much of the world, including the US. They are expected to continue a slow and steady rise and the Fed funds rate, closely watched by economists and investors, is expected to rise from 2% today to almost 3.5% by the end of 2019.

Although issues like these described in Jeff Saut's commentary can roil markets in the short term and perhaps even a bit longer, there is plenty of evidence globally for modest longer term optimism. We are now almost ten years removed from the ***"Great Recession"*** and although some things have still not returned (including NJ home values), I think it's well accepted that the world survived, more significant damage was avoided and that central banks were able to circumvent what easily could have been a global depression.

Those banks including our own Federal Reserve did not get everything perfect, but like an emergency room doctor who first has to stabilize the patient before you can fully treat the illness, central banks were able to buy enough time for an ongoing financial recovery to occur.

So where do we go from here?

I am still concerned that, at least in the US, we continue to live well beyond our means. Americans increased their personal debt for 14 consecutive quarters, to over $13 trillion at the end of 2017. Total asset value grew even faster (US total net worth is now ***over $100 trillion***), but debt still needs to be serviced and ultimately paid off.

Growing federal deficits, to some degree a result of recently enacted tax cuts, but more so because of structural issues like underfunded state pensions, Social Security (reserves to be depleted by 2034, three years earlier than expected) and Medicare Hospital trust funds (estimated to be depleted in 2026) will need to be dealt with sooner or later.

The current federal deficit is over $21 trillion, up from just under $10 trillion in 2008 and projected to increase by over a trillion dollars annually beginning in 2019. In February, the White House forecasts it will hit almost $30 trillion in 10 years. By next year, it will be the equivalent to 107% of our annual economy (GDP) - the highest percentage since 1947.

Today, the federal government spends $1.24 for every dollar it collects in taxes (GAO). Large deficits are understandable and acceptable in difficult economic times, but in a solidly growing economy with full employment, there is something fundamentally wrong. The deficit continuing to rise as conditions improve is the exact opposite of what one would expect.

According to the Social Security Administration, between 2018 and 2027, Social Security will pay out more than it takes in for the first time since 1982 when the first "baby boomers" were 36 years old. The US Government Accountability Office, an entity considered nonpartisan (but with a name that seems to be a bit of an oxymoron), issued a report on June 21 on the ***"Nation's Fiscal Health."*** The sixty page analysis describes our country's fiscal future if policies don't change. In June, the US Congressional Budget office estimated that in 2048 (not exactly just around the corner, but decades fly by) that we would spend the same amount on interest on the debt as we do on Social Security. Today, we spend 3x as much on Social Security.

The conclusion: ***"The government's current fiscal path is unsustainable and the longer action is delayed, the greater and more drastic the changes will have to be"*** (GAO, US Treasury Department).

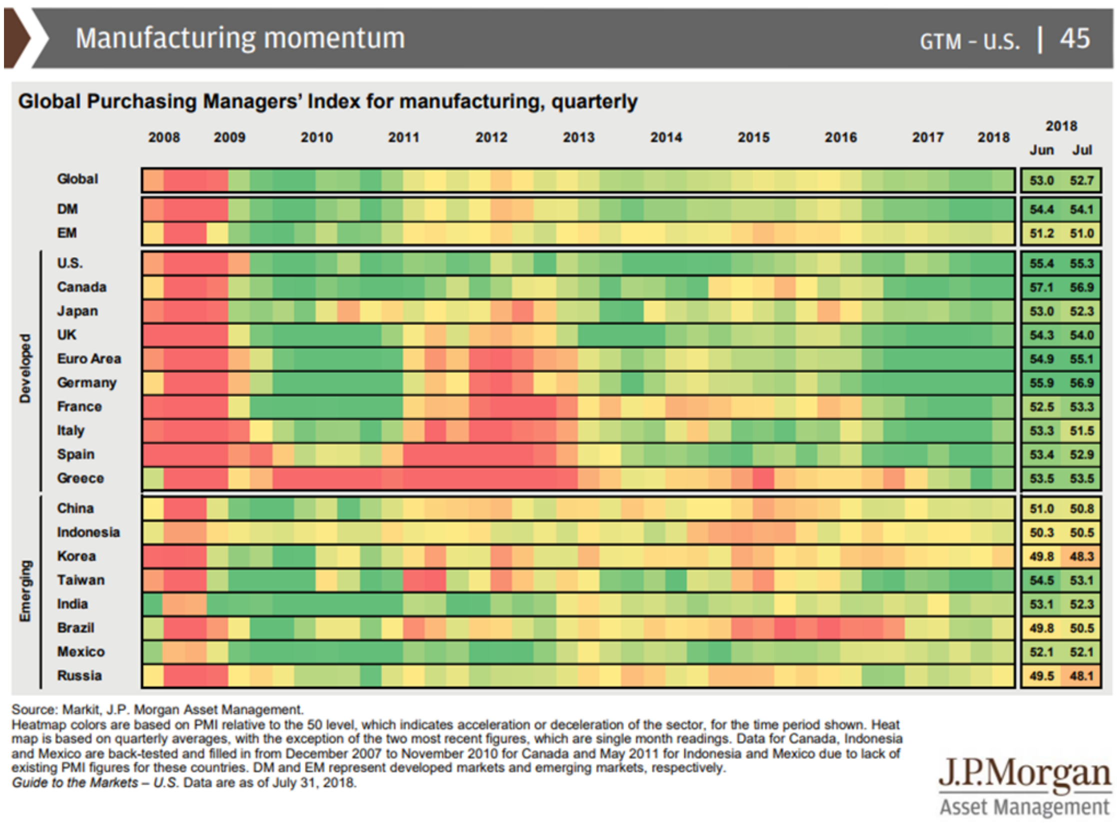
Generally, I see no one in public life of either political party (or independent) willing to take on these deficits and I suspect if they did in today's climate they would be unelectable. Common sense says that if rates continue to rise even modestly and we continue with our habit of outspending revenue by a trillion dollars per year, this won't end well. The question is, when will it end?

Global Economy

Most of the world is in a sustainable recovery, and as the below chart indicates, manufacturing in virtually every country is in the best condition in over 10 years (green is good, red is bad). As populations in emerging markets continue to grow their middle class this trend is likely to continue, though as in the past, there will be periods of both growth and contraction.

As a result, and with the expectation of at least modestly rising interest rates, we are more optimistic about stocks than bonds and in the longer term about international stocks than US, though we will continue to own more US companies because of the size and stability of US economy and markets.

While we see a few clouds on the horizon, we also see the current growth business cycle as having several more years, absent an extraneous "black swan" type situation.



Politics

It's difficult to have a conversation these days on politics and we have clients on both sides of virtually every issue imaginable. Suffice it to say that opinions are strong, not likely to change, and the current climate is volatile, occasionally impacting the investment markets in the short term.

In the long term it will depend on policies enacted by Congress and that of course depends on who controls Congress. Ultimately the economy, at least in the US, rises above politics and there are numerous examples of different combinations White House and Congress control that do not inhibit the remarkable American story of growth. We have survived wars, natural disasters, impeachments, assassinations, and more yet always seem to continue moving forward. While I may personally continue my concern about runaway debt, somehow we will deal with that as well.

Interesting Financial Trivia

*According to U-Haul, the cost to rent a moving truck to go from San Jose, CA to Las Vegas is $1,990, but the opposite trip is only $174, due to the number of people moving from California.

*The new IRS form 1040 has 23 lines vs the old form with 79 lines. Nice improvement there!

*LeBron James' new contract will pay him $370,000 per game. I suspect he will have to file something a little more complicated than the new 23 line 1040 form.

*People talk frequently about averages in our profession. This can be very misleading. For example, did you know that the average geography graduate at the University of North Carolina makes $1 million more in career earnings than those with the same degree from other colleges? That is largely because Michael Jordan has a degree from NC in geography. True, but not particularly useful. The same often occurs in investing!

Personal Financial Planning Issues

For many years, surveys have shown that the number one fear of retirement age people is running out of money and/or becoming a financial burden.

Along similar lines, a recent survey from Nationwide Insurance shows the biggest fear is out-of-control healthcare costs, with 64% of respondents using the term "terrified" to describe their fear in relation to their retirement plans.

It is truly unfortunate that with the good news of expanding life spans, the downside is a reliance on a healthcare system that scares people enough that they fear it more than death. Our job, however, is to make sure people are as prepared, especially financially, for the costs of healthcare, including long term nursing care whether at home or in a residential facility.

We are now in the tenth year of below average interest rates available for "safe" investments like bonds, certificates of deposit and savings accounts. Although the low rates have helped fuel the rise of global equity markets, it has been at the expense of conservative savers who have previously relied on a competitive interest rate on their savings to supplement their other income sources.

We see rates continuing to rise but at a slow pace with considerable pressure from government officials who want them low because of the federal debt load. It's a bit of a juggling act, but that is why we have preached and practiced balanced portfolios for our clients.

After what is almost a record length of the current bull market, we remain optimistic for the future but are a bit more risk sensitive as stock prices have risen to levels that are described by many professionals as being "fully priced." While that may be a reason we have come down from the all-time highs of January, continued improvement in earnings and issues like mergers and companies buying back their own shares will continue to provide some support for the equity markets.

News at EWS

Biggest news first: Dana and her husband Andrew are expecting a baby! We are excited for them and proud that regardless of gender, the baby will have Eagle as his or her middle name. Here is their pregnancy announcement which of course had to include their furry children!

Steffanie had a very active first half of 2018. In the community, she kept busy with United Way's Women United as well as Rowan's Rohrer College of Business Alumni Advisory Council where she was elected to serve as President. A few notable activities: Women United funded a $1,500 grant to the Boys and Girls Club of Gloucester County to purchase computers for a new computer lab for their Paulsboro location and Steffanie took part in the unveiling of the room to the children. She also participated in the Gloucester County Day of Action on June 21, volunteering at Mothers Matter in Sewell by assisting them with inventory and organization for their care bags that they distribute throughout the year.

Family time so far this year consisted of several running events with her husband Mike and other family members. She took part in the Run the Vineyards 5-Miler at Heritage Winery and also took part in the Pitman Freedom 4-mile Run on 4th of July. Her son Landon ran the last ¼ mile with her and helped her cross the finish line. Finally, she ended the first half of the year taking a much needed vacation to Disney with the family.

One of our quarterly "teambuilding" events was a visit to Escape Room in Glassboro, where you are given an hour to find clues and solve puzzles to get out of a themed room. We are pretty proud to say we completed the "Jersey Devil Room" challenge with twenty minutes to spare!

Continuing Education

Chris is headed "back to school" this fall at Wharton School at the University of Pennsylvania to complete his studies for the CIMA designation. His pursuit of this designation, which stands for Certified Investment Management Analyst, shows his professionalism and dedication to the field and is increasingly important in a more volatile world of investing in the future. And volatile it is! In February, the S&P 500 had a 1% daily gain or loss 11 times in 20 days. Prior to that, it took 305 trading days for 11 daily gains or losses of 1%.

Earlier this year, Jessica completed her work to obtain the Retirement Income Certified Professional® credential, and now all four of our advisors have both the CFP® and the RICP®. I honestly am not aware of another firm whose advisors earned both credentials, which are relevant and vitally important to the clients we serve.

Melissa, who is currently in the process of studying for and taking her Series 7, 66, and 9/10 exams (usually this takes a few years - she is doing it in one) somehow also had the time to attend the Raymond James National Conference in Washington, D.C.

Conferences:
Steffanie and Jessica were also in Washington D.C. in May at the Raymond James National Conference for Professional Development and will be heading to St. Petersburg in September for the Raymond James' Women's Symposium.

Earlier this year, Paul attended conferences in Miami, St. Petersburg, and Washington D.C., and has another upcoming in Jersey City.

Chris was in St. Petersburg twice and Washington D.C. For the RJ National Conference as well.

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