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Is it Time For Tulips?

It seems like we are heading into what could be the last phase of a remarkable stock market run. For the past several years investors were waiting for Armageddon. In the Fall of 2018 they thought it had finally arrived. Interest rates spiked and resulted in over a 20% drop in the markets. But the Fed reversed course and the markets made a full recovery in the first half of 2019. Then, in the last quarter of the year, the markets took off like a rocket and ended up notching a return between 25 and 30 percent for 2019. This was shock and awe that left the naysayers in the dust. Throughout 2019 no one knew what to think. Every day there was a new story or tweet that moved the market. Many investors preferred the sidelines.

Now, after the market surge, everyone wakes up to the headlines. With the markets at a record close, individual investors may put the uncertainty aside. They may succumb to just wanting a piece of the action. At the same time, the institutional pros are under pressure to climb in or face the guillotine for underperformance. This can lead to the classic tulip mania of the 1600s. It was the precursor to what a former Fed chair called "irrational exuberance". No one wants to be left out! Everyone wants a tulip, or two. Then someone realizes that tulips don't last long and you can't eat them.

The gains in 2019 were pretty solid but still a good portion of the overall market gains were the result of the tech sector and a handful of large cap tech companies like Apple, Microsoft and a few others. These companies dominated in 2018 and it was surprising to most for them to come back even stronger in 2019.

While tech continues to soar, the overall index of manufacturing production has slowed for several quarters. There could be a cooling of physical manufacturing production but the slack is being picked up by gains in artificial intelligence and cloud services that continue to be implemented in all industries. It is difficult to dis-

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The first mania was the famous tulip craze. They were imported from Turkey in the 1600s. Everyone, including governments, invested. Prices shot up until suddenly they realized that it was just a tulip! Its price dropped to that of an onion! People lost fortunes.....Happens all the time!

What's New in 2020?

In the last quarter I reported that Charles Schwab and T.D. Ameritrade dropped trading fees to zero. This was pretty revolutionary. Everyone wondered how they would make money. A big part of the answer is through volume. So they decided to merge. This was big news in the financial industry. Fidelity and other firms followed to the zero transaction fee model and for sure there will be more mergers of these currently massive firms.

It remains to be seen if this is a help or a hindrance for the retail investor. Heads will roll, departments will be consolidated and who knows how all that will effect services. At the same time automation will increase dramatically. This will make it easier and quicker to process applications for various services but as we know these programs that get created are by no means perfect, so we adjust to the new age.

Changes in Tax Laws

A lot of the changes that are taking place are based on the fact that people are working longer and living longer. When a lot of these laws went into effect, life expectancies were much shorter than they are today. For this reason, it would seem that as time goes on, these age-related mandates will continue to increase.

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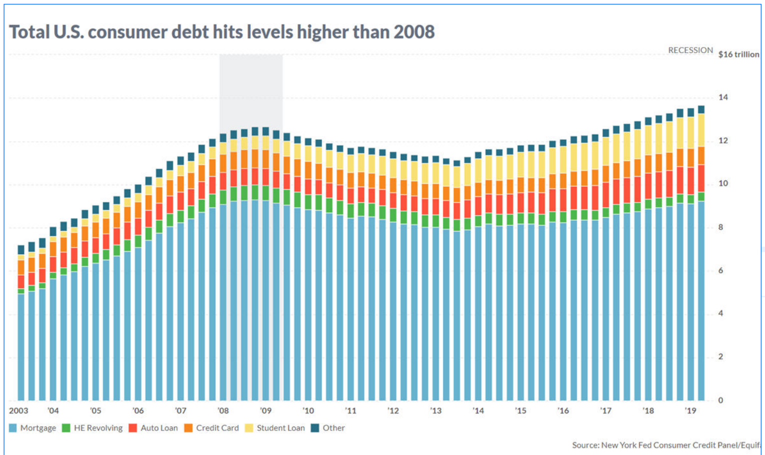

pute that the U.S. economy remains strong.

Interest Rates and the Fed

The prime mover in the markets is still the attitudes and actions of the Federal Reserve with respect to interest rates. In the fourth quarter of 2018, the Fed thought it could get away with raising rates. It couldn't. The markets got crushed and the Fed was forced back into its cave, reversing the increases it was confident it could hold onto. But the Fed did more than that. It also restarted the bond buyback program.

Early in the last decade, the Fed engaged in what was called "quantitative easing". It purchased bonds in the market to drive bond prices up and yields down. It was stuck with a 4 trillion dollar stockpile of bonds. In 2018 it set course to unload the bond inventory it had accumulated. This put more upward pressure on interest rates. In late 2019 it started to reverse that position. The Fed will not admit to be reinstating the policy of quantitative easing. The buybacks, it says, are necessary to provide short term "liquidity" to its member banks. If this sounds complicated, it is. But the big picture is easier to understand.

The economy and the stock market are driven by the availability of credit. That can be short or long term credit and it is called liquidity. The Fed controls this liquidity by making cash available quickly and easily. Too much liquidity leads to rampant inflation; too little, we have less spending and a recession. The markets melted down in October of '18 because the Fed was trying to drain this excess liquidity out of the system. It was trying to slowly take the opium away from the user. It didn't work. The user turned green and the fed quickly issued more opioid shots. Now the addict is feeling great! The markets got the fix they needed: lower rates, once again, and more bond buying from the Fed. No one cares about the technical mechanisms behind the Fed's moves. What matters is that investors got their fix!

But what matters even more is that it is going to be difficult

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The required minimum distribution (RMD) for retirement accounts is being moved from 70 1/2 to age 72. To qualify, you must attain the age of 70 1/2 after January 1, 2020. If you are already taking the RMD, then nothing changes. You continue to do so on the same schedule.

The maximum age to contribute to an IRA account has been eliminated. You can continue to contribute up to $7,000 per year if you are over age 70. What you contribute, however, must be earned income and to have the tax deduction, income has to be under the thresholds (single:$65,000-75,000, married:$104,000-$124,00). The good news is that if you have a part-time job and earn $7,000 or more per year and you are required to take an RMD, then you could put $7,000 back into an IRA and save the tax.

Roth IRA income limitations will be:
single $124,000-$139,000, married $193,000-$197,000.

401k/403b maximum contributions are now $19,500 + $6,500 if over age 50.

SIMPLE IRA limit is $13,500 with $3,000 catchup if over age 50.

The overall defined contribution plan limit for combined SEP, 401k or IRA accounts is now $57,000, up from $56,000.

The rules on Inherited IRAs have also changed significantly. You can no longer take an RMD on an IRA inherited from a non-spouse IRA. The entire account needs to be liquidated over 10 years. This is for newly inherited IRAs during or after 2020.

Employers will be allowed to offer group 401ks for their businesses. This means that companies can pool resources with other companies under the umbrella of a Chamber of Commerce or other business entities in order to save administrative costs.

In addition, 401k laws are broadening to allow annuities to be offered in 401k plans. Some caution with annuities is advised. They can be complex and laden with fees.

With the increase in the standard deduction to $12,400 for singles and $24,800 for married couples, it becomes more difficult to take deductions for charitable contributions. For those over age 70...or now 72, donations made from an IRA directly to a charity will not be considered as personal taxable income. This is only for the amount of dollars considered under the RMD. So, if your RMD is $10,000 and you divert $1,000 of that directly to a charity you will only pay tax on the $9,000. For this to work, the money has to go directly from the IRA to the Charity.

Of course there is more ...but this will get you through the weekend.

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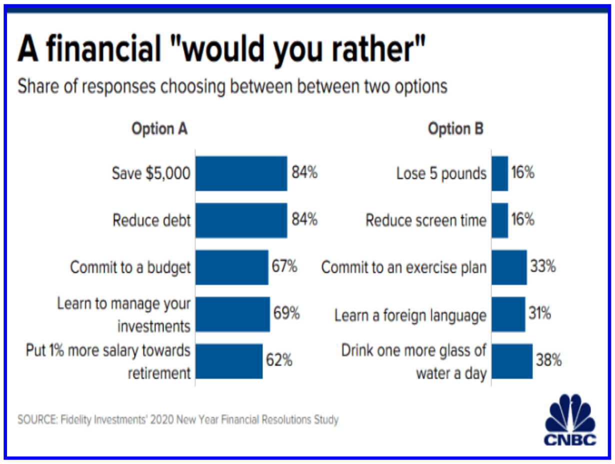

for the Fed to stick its nose out of the cave and raise rates again after it was bitten so badly a year ago. For this reason it appears that the Fed will not come out until it really has to. This may be good in the short term but it may force it to hesitate raising rates. They could easily end up moving too late and then raising much more rapidly to catch up. That will put a lot of pressure on stocks.

The bottom line is that there is an abundance of cash in the world and it has to go somewhere. With interest rates so low, this cash has nowhere to go...so it continues to find its way back into stocks. This is what has been happening for over a decade. The entire stock market recovery from 2008 has been generated by low interest rates that forced money from safe interest bearing accounts into stocks and that is what is happening now.

But in order to keep stock prices up, corporations are going to have to continue to earn enough money to justify these valuations. This is the key to a growing economy. Consumers are going to have to continue to purchase goods and services. Right now, the consumer is strong. People are gainfully employed, credit is readily available and, with stock prices up, some are cashing in some stock to finance projects. Also, the Wall Street Journal recently reported that many homeowners are refinancing mortgage debt with larger mortgages at a slightly higher interest rate to finance projects or to consolidate other debts they have accumulated.

So debt levels on the consumer side are rising to record levels. Actually, along with credit card, mortgage and student loan debt, federal, state and municipal debt are also growing. This is simply a function of low interest rates and high valuations on assets. It only makes sense to borrow cheap money and invest it in higher earning assets. It makes perfect sense ...until it doesn't make any sense at all!

Tariffs and Taxes

One of the prime movers of the markets in the early Trump years was the tax reform package that was passed. This tax break instantly added cash to the bottom line of most corporations. The excess money, diverted from the government, went to investment. Some argue that a significant share of that cash went to corporations buying back their own stock. The benefit of this is up for debate. Other parts of this actually did go into corporate expansion and investment in stock of other corporations. So this move spurred corporate profitability and the increase of stock prices.

What distorted the picture was the implementation of the tariffs. These were aimed mostly at China, but were targeted at a host of other countries. There were two problems. One is that tariffs simply cost everyone more money. It is really a tax on the consumer and corporations. So, in a sense, Trump gave us the corporate tax break but it was taken away, at least partially, by the tariff. The second problem was not really the tariffs themselves, but the fact that no one knew what the tariffs really were (or are). If there was a meeting and a specific set of tariffs were implemented at a specific rate, then everyone (corporate America) would understand the situation and adjust to it. The biggest problem has been that for the past two years no one has understood what the final tariffs would be. This has stifled corporate America from investing in plants, offices and equipment because they do not know how to restructure themselves with this large unknown hanging over their heads. This could be the cause of the slowing of manufacturing overall.

Meanwhile China is struggling. Its economy is definitely slowing. What happens in China is hard to understand. On the 2nd day of January, 2020 China reduced the reserve requirements of its banks. This is what spurred the 300 point rally that took place January 2nd of this year. This was a form of interest rate cut for China. Once again, (effectively) lower rates mean more borrowing to keep the economy afloat. There has been concern that with all the pressure (from tariffs) on the Chinese economy, something, like a bank, could

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snap and have ripple effects. China is a massive economy and a meltdown in China will have a worldwide impact.

Over the past month the investment public has come to believe that the tariff war is going to end. They have come to believe, through a series of recent tweets, that China will offer us a favorable trade deal that will be accepted by both parties. This news contributed greatly to the last 2000 point move on the Dow since October.

Politics

Usually politics is a side show to the overall market picture. It is a subject best left to the TV evangelists that pontificate on their views of all forms of scandalous behavior. Apparently they have not been to one of the seminars that expound on the virtues of never saying anything negative about anyone....but I digress. At this time politics has become a relevant force in understanding some of the underlying psyche of today's investor. Obviously, it is an election year. So what does that mean?

The President has been impeached. The day he was impeached, the market was up 100 points! One would think that investors would be just a little concerned, but they weren't. Maybe it was fake news, but, more than likely, they just feel pretty strongly that nothing will come of it. If he were actually removed from office, then Republican Mike Pence would come in. He probably would not make any major changes to policies currently implemented and, more than likely, would be more moderate than the current President. So, other than the initial shock, there does not appear to be any real problem to the market if for some reason Trump is actually removed.

Investors are more concerned about a democratic victory. They fear that democrats will quickly reverse out the tax cuts put in by Trump. That would be a big negative for corporate profits and the stock market. If you call a company on the phone and say "Write me a check for 10% of your profits", its stock will go down.

Of course, it depends on who exactly gets in and this will all be a part of the drama that will plague the markets as the year progresses.

Oil Wars

As this letter is being written, there has been an assassination of a major Iranian General. Only time will tell if there is a concern here. It is only one of the many unpredictable wild cards that could derail a perfectly fine stock market rally. It also confirms the fears that many have. Every day is a new story. No one knows what will happen next! Everyone is waiting to push the panic button. The only good news is that we have been through this before.

Conclusion

The markets have climbed a wall of worry this past year. Many investors, flush with cash, were surprised by the big jump in stock prices that happened in the last quarter. This makes everyone happy, but the fear of being left out may drive that idle cash into the market and push stock prices even higher. Investors are banking on the fact that, because it is an election year, the incumbent President will do everything in his power to hold this market together. It is important to remain diversified and not get sucked in with the crowds. We need to extract as much return as we can from these markets and control the risk. We need to have some tulips in our garden, but not have just a garden of tulips. Some boring green stuff will hold up a lot better! HAPPY NEW YEAR!

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