Investor Insights & Outlook

October 2018 3rd Quarter Concorde Investment Management

Domestic Economic Overview

A Message from Concorde Investment Management

We are rolling out a new client access portal and app for your phone or tablet and we hope you will enjoy using it. We are doing our best to provide our clients with an improved and more transparent view and welcome any feedback or suggestions you have with using the portal or app. If you have not already been contacted by us to set up your access, we will be reaching out to you soon.

We are in the ~~105th~~ ~~108th~~ 111th month of economic expansion (vs. the historical average of 47 months) and there is no end in sight. This expansion has been long, slow, and deliberate however accelerating over the last few quarters given the passage of the tax cuts at the end of 2017. Q3 GDP came in at 3.5% following 4.1% in Q2. Consumer spending grew at 4 percent during the third quarter which is the strongest showing since the fourth quarter of 2014. There was a decline in business spending however that was on the heels of a strong number in Q2. All other components of GDP growth are expanding however the smallest component, housing at 3.9%, is starting to feel the effects of higher interest rates. New home sales, existing home sales, and refinances are all under pressure as the U.S. 10-year treasury creeps above 3%.

Consumer balance sheets are extraordinarily healthy. Total Assets across the board for consumers are $122.7T vs. Total Liabilities of $15.7T. Of the Assets group, homes make up 23%, or $28.2T, of the assets, and 66%, or $10.3T, of the liability portion. Household debt service as a percentage of disposable income (lower is better) is at 9.9% vs. a peak of 13.2% in the 4th quarter of 2007. For reference, the ratio was at 10.6% in Q1 of 1980. The point of those numbers and ratios is to say that households and consumers, which drive GDP, are healthy. There is room, from a consumer debt service perspective relative to historical levels, for interest rates to rise.

continued on next page

The Concorde Team

A Registered Investment Advisory Firm

(972)701-5400
www.concordeco.com

CONCORDE
Concorde Investment Management

Gary B. Wood, Ph.D.
President

Greg B. Wood
Vice President

John A. Stetter
Principal, Sr. Portfolio Manager

Barbie E. Bellah
Dir. of Portfolio Administration

Marisa A. Parrott
Office Manager

Domestic Economic Overview (continued)

Cyclical activities such as vehicle sales, trade inventories, capital goods orders, and housing starts are all at or slightly above their 20 year average. Risks to continued economic growth center in Federal finances and tariff impacts. No doubt our readers are aware we had a federal deficit of $804B during the federal fiscal year ending 9/30/18. Revenues for the government were up year over year, which includes the tax cuts, however spending increased more. Federal spending has locked in annual increases across the board and while a 17.2% contributor to GDP, those increases are unsustainable. The portfolio management team recently met with an outside advisor to the current Administration and asked what, if any, discussions were ongoing about getting some of these expenditures in check and the answer we got back was ‘not prior to 2020’.

Tariff impacts related to China are an issue we discussed in the Q2 letter and some of the impacts are starting to materialize in the Q3 earnings calls of companies. Higher import and raw material costs increases are, where possible, going to be passed on to consumers. This will impact economic growth depending on how long this persists. We wrote that the Administration is making the gamble that domestic short-term pain could lead to long term gains. There is a meeting scheduled in November between President Xi of China and President Trump and we will see if they begin to get a deal in place.

International Economic Overview

Global economic growth may be starting to slow. That’s not to say shrinking, just slower growth. The Global Purchasing Managers’ Index for manufacturing shows a slight decrease for both developed and emerging markets on a quarter over quarter. They are slight but broad based across all countries. The 2 big regions, the European Zone and China, are both showing signs of slowing growth via the Index. These are leading indicators but require further attention as the next year progresses.

One item of China’s GDP that is positive is consumption. The year over year consumption percentage increased 5.3%. This is the 2nd highest consumption percentage reading since 2008. The theme for the last decade is for the Chinese economy to transition to a consumer-based economy rather than a demand economy and that consumption number has to continue increasing if they are going to make that switch.

Given news cycles tend to be shorter and shorter these days, our readers may have missed that a new NAFTA was agreed to at the end of Q3. The United States-Mexico-Canada Agreement, or USMCA, was agreed to and is expected to be signed

continued on next page

International Economic Overview (continued)

by the end of November (not coincidentally at the end of the current President of Mexico's term and prior to the newly elected President Obrador's term begins) and voted on by Congress next year. Frankly, there are not a lot of major changes, other than the name, but the devil is in the details. There will be an opening of the diary market in Canada, a sunset clause was added in, dispute resolution agreement, protections put in place for American workers, and it added in some modernization related to the technologies that were not around 25 years ago (think anything related to the internet). The item that is not getting a lot of press is essentially related to China. In the agreement the U.S. added in that if Mexico or Canada sign a different trade deal with any non-market-based economy (aka China) then the U.S. will exit the Treaty. We expect the U.S. trade representatives negotiating this deal will apply this language to every other agreement that is signed. This is a not so subtle shot at the Chinese and will further box them in.

Fixed Income

U.S. fixed income yields moved higher during the quarter as fundamental factors such as firming inflation and labor costs and the recent quarterly Federal Funds increases continue to impact this trend. The surprising strength in economic growth and the acknowledgement that the expansion may continue to extend have also contributed to the persistence of the increased yields. Of course, the higher yields have created negative total returns YTD in most traditional government and corporate bond sectors while convertible bonds (equity influence), floating rate notes and the high yield corporate (high coupons) markets have been able to generate modest positive total returns. As we have noted the last two years, particularly regarding short term government note yields, much of the significant rise has corresponded to the normalization of markets from the intentionally suppressed conditions subsequent to the credit crisis induced recession of 2007-2009.

We are now closer to traditional relationships which should lead to better capital allocation decisions in the investment universe, giving reducing the chance for a severe bubble in some financial asset sector and also giving the Federal Reserve room to reduce short rates if policy measures are needed the next time an economic slowdown is severe enough to require action. We deem this transition back to a more normal structure to be healthy. We have positioned fixed income investments conservatively (primarily through shorter duration exposure) in recent years and this is finally reaping benefits as short to medium term yields have risen significantly during the last 1-2 years. Currently we are emphasizing higher quality credits as the expansion is at least in the middle stages but are also considering holding some slightly longer maturities as yields have become more competitive. Bond yields are likely to move higher as long as the economy exhibits positive growth, but the largest part of this transition has likely already occurred.

U.S. Treasury Notes		
	09/30/15	9/30/18
2-Year	0.64%	2.81%
5-Year	1.37%	2.94%
10-Year	2.06%	3.05%
30-Year	2.87%	3.19%
		Source: U.S. Treasury; JPM

Equity Markets

Domestic equity returns in the third quarter continued to surge, representing over half of the year to date performance for some indices. Corporate results have certainly supported performance to some degree although markets typically are forward looking. However, at the end of the quarter and into the early trading days of the new quarter some weakness began to appear in some of the sectors and individual equities that have been important drivers of recent market strength. This change in some growth and technology segments could represent a correction in securities that have gotten ahead of themselves, driven by index fund demand, or may be foreshadowing the slower growth that is likely for 2019.

International markets were mixed and continued to lag the U.S. for the year. Emerging markets have underperformed developed indices, although there is a wide dispersion of results. The attention grabber this year has been the internal Chinese markets which are down significantly, representing not only uncertainty over potential trade fights, but also generally slower growth and concerns over debt levels. Other large emerging markets such as India and South Korea are down between 5-10% year to date. Although global growth on a consolidated basis is still advancing at a healthy pace, local and regional components are becoming less synchronized.

With regard to the domestic market, even though the well-recognized indices were near all-time highs, there are many individual stocks and sectors which are currently significantly below their highs. In fact, over the 2015-2017 time period most of the eleven S&P 500 sectors have either experienced a correction (down 10%) or bear market (down 20%) including financials, energy, healthcare, industrials, telecom, utilities and materials. This mixed performance has presented many opportunities in individual equity investments for longer term, fundamentally based investors. Although selectivity is crucial as always, we believe there are many stocks worth holding and investing in currently with good risk reward characteristics. The investment case for these securities is based on modest earnings and cash flow growth forecasts and assumes interest rates will continue to trend higher. We have also seen positive signs for some value stocks which have been out of favor for many years, as many have rebounded nicely, particularly in media and healthcare.

Select Indices		
	Q3 2018	**YTD 2018**
S&P 500	+7.7%	+10.6%
Russell 3000 Growth	+8.9%	+17.0%
Russell 3000 Value	+5.4%	+4.2%
AC World (ex U.S.)	+0.7%	-2.7%
Emerging Markets	-0.9%	-7.4%
China Shenzhen Composite	-13.2%	-27.3%
		Source: JPM; Factset; Morgan Stanley

Conventional wisdom of bonds dominating a portfolio in retirement is now outdated

Source: CNBC.com

- Returns are too low today for bonds to provide what they've traditionally fueled in retiree portfolios: inflation protection and income.
- A fixed-income portfolio provides security during market corrections and recessions.
- A "two portfolio" approach to retirement finance will balance bond security with equity to grow wealth and hedge against inflation over the average 30-year retirement.

The Retirees typically look for bonds to provide two things in retirement: income and inflation protection. But bonds are not what they used to be.

Rates today are too low to comfortably address just one of those issues, let alone both. The "conventional wisdom" of having bonds dominate a portfolio in retirement is outdated and was based on past market conditions and philosophies.

To that point, 30 years ago the retirement and bond market landscape looked quite different from the one we're currently experiencing. In 1988, the 10-year Treasury yielded between 8 percent and 9 percent, and the inflation rate was about 4 percent. Additionally, many people who retired in the 1980s had pensions that covered most of their living expenses so they could afford to take a conservative approach with their retirement portfolio. They could invest their portfolio in 10-year Treasuries, live on 4 percent of the bond income and still keep up with inflation, all while many had the security of multiple guaranteed income streams via Social Security and a pension.

High guaranteed incomes and a high-interest bond market are two comforts that today's retirees do not have. Here in 2018, pensions are disappearing at an alarming rate, the 10-year Treasury is yielding around just 3 percent, and inflation is about 2 percent. Safe to say, it is a very different environment. Yet despite these low rates, the "conventional wisdom" of overweighting bonds in a retirement portfolio has not changed.

Sticking with this outdated retirement strategy in such a low-rate environment all but requires retirees to invest in lower-quality, longer-term bonds to have any chance of providing the income and inflation protection they're seeking. I've observed this is increasingly the case.

Unfortunately, this approach exposes their portfolio to additional credit and interest-rate risk while also increasing the correlation to their equity portfolio. The more your fixed income portfolio acts like equities, the more you are taking the exact risk (albeit a little less) that many retirees are trying to avoid without even realizing it.

As you've probably surmised, I believe many retirees are looking at bonds and their overall portfolios all wrong. I think bonds, especially in this interest rate environment, should be viewed solely as a safe harbor in the face of significant market declines rather than an income stream through all stock market environments. This being the case, I believe the use of high-quality, short-term bonds held in less quantity than conventionally discussed is a better overall approach to retirement income planning.

The goal of fixed income in a retirement portfolio shouldn't be total return, but stability and this is where many retirees are missing the boat. In retirement, when the market goes south, there needs to be a dependable asset class to provide the income needed. And generally, short-term high-quality bonds are more likely to provide that stability.

continued on next page

Conventional wisdom of bonds dominating a portfolio in retirement is now outdated (continued)

So how much of your portfolio you should invest in these high-quality short-term bonds is entirely dependent on your personal financial situation and risk tolerance. Estimate the annual income needed from your portfolio and establish multiples of that amount while ensuring that the equity portion of your portfolio can hypothetically support the needed withdrawals, as well.

I've seen retirees with anywhere from about four to 10 years' worth of expenses in this asset class, depending on the investor.

The larger your portfolio is relative to your income needs, the more flexibility you have to hold more or less than others in a similar situation. Having this safe harbor is often what gives retirees the confidence and patience required to ride out the inevitable storms that accompany their equity investments.

"Striking the proper balance between stocks and bonds is where the rubber meets the road for true retirement planning, as every retiree's situation is different."

This approach encourages retirees to look at their portfolio as two separate portfolios with two distinct purposes. The purpose of the equity portfolio is to continue growing your wealth and to provide an effective hedge against inflation over an average 30-year retirement.

The fixed-income portfolio is there to provide the income needed during market corrections and recessions. Striking the proper balance between stocks and bonds is where the rubber meets the road for true retirement planning, as every retiree's situation is different.

I have found that the retirees who embrace this purposeful "two portfolio" approach feel more confident during times of market volatility and are more comfortable spending in retirement. Because when the market falls, they have years to let it recover without sacrificing their lifestyle while they wait.