2020 New Year Update

Dear Members of Flower City Capital,

Happy New Year! We hope you had a wonderful holiday season and are looking forward to a successful 2020 ahead. Quarterly investment reports have all been uploaded to your secure portals; please don't hesitate to let us know if you have any questions.

There are many reasons to feel uneasy about the markets. And while uncertainty will always be present, a new year presents a fitting opportunity to focus on what you can control by revisiting your overall plan and sticking to it.

Executive Summary

As always, we begin with an executive summary:

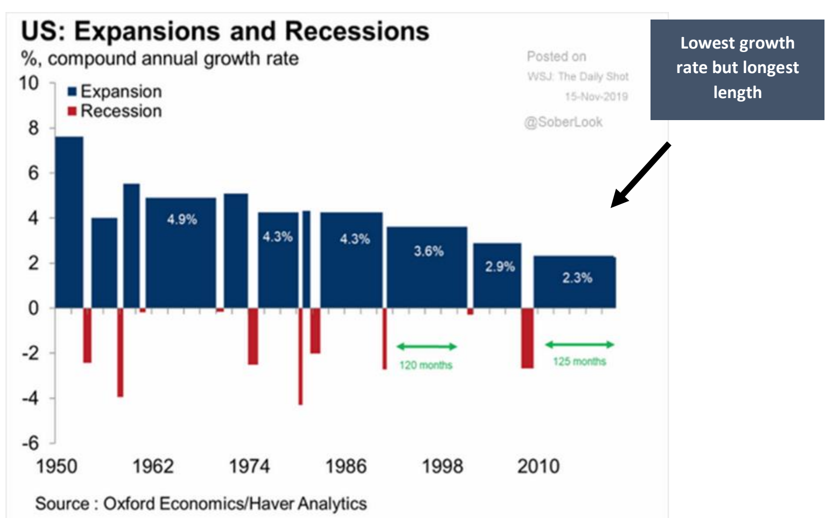
- Signs are pointing to an upward trajectory in global economic growth, with no signals of an imminent near-term recession
- Global markets managed to end the year and decade on a high despite tweets and trade wars, manufacturing recessions, and record government deficits among other things
    - The S&P 500 Returned 31.5% while the global stock market was up over 26%
- However, overall data remains mixed and we are watching for convincing proof that it's time to adjust our portfolio risk exposures
- From a planning perspective, tax season is upon us with 1099s and W-2s becoming available within the next month
    - We will be reaching out to those who are eligible for making IRA contributions
- Also, in our Spotlight segment we provide an overview of the recently passes SECURE Act and what it means for retirement planning

Economic Overview

This continues to be the longest US economic expansion in history. It is also the slowest, driven by strong consumers and households. Combined with favorable monetary policy (low interest rates), subdued inflation, and signs of improving economic data, a near-term recession is unlikely.

A similar story is playing out internationally with turning economic indicators and supportive central banks, largely attributed to Chinese stimulus.

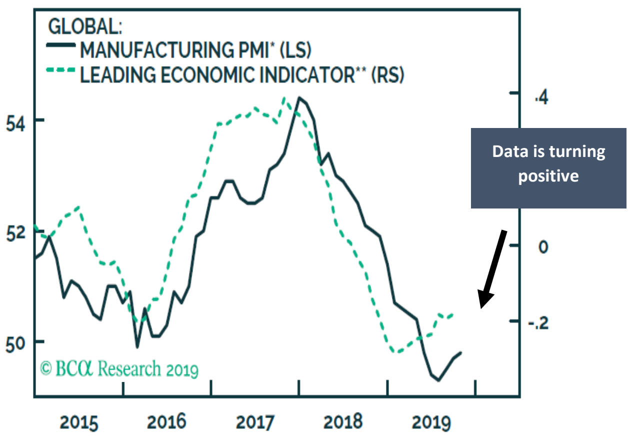
Figure 1. Low and Slow US Economic Expansion



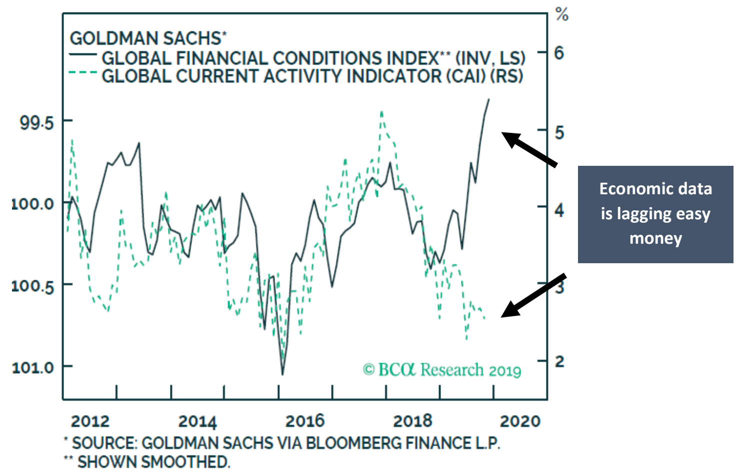
2020 New Year Update

Arguably the economic concerns over the past year or so look more like a regular cycle than a fundamental imbalance in the global economy (such as an asset or debt bubble) which more often precede recessions.

Figure 2. The global manufacturing cycle may be bottoming…



… Figure 3. While economic activity should follow easy financial conditions

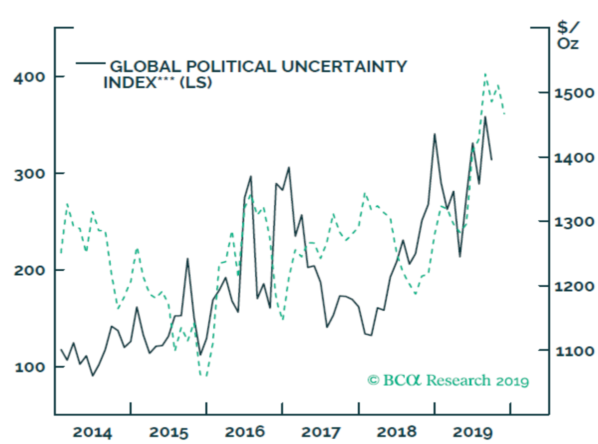


While the probability of a recession is arguably quite low, there are notable risks that could disrupt the 2020 upside case of a return to coordinated global growth, not to mention the lack of solid evidence supporting it and the potential for things to get worse.

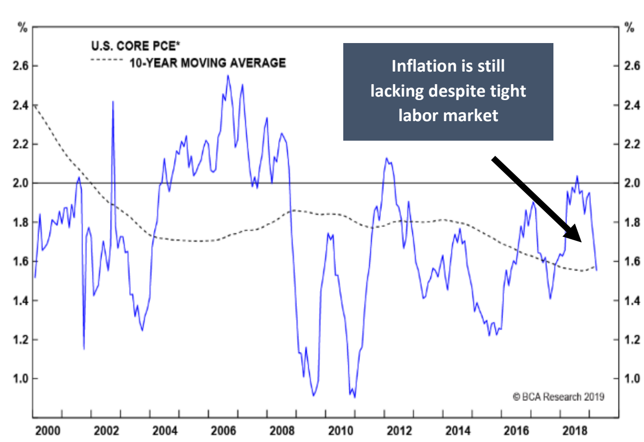
1. **Trade Policy/Geopolitics**
   Though a great deal of progress has been made on some of the key geopolitical issues over the past year: Brexit, Tariffs, etc.

2. **Inflation**
   Inflation occurs when an economy overheats, and has not been a problem throughout the low and slow expansion (hovering below the Fed's target of 2%). There is much debate as to when the tight labor market will trigger wage inflation and spill over to the rest of the economy, prompting the Fed to raise interest rate, spelling the end of the expansion.

Figure 4. Political Uncertainty is still a risk…



…Figure 5. While inflation has yet to present itself

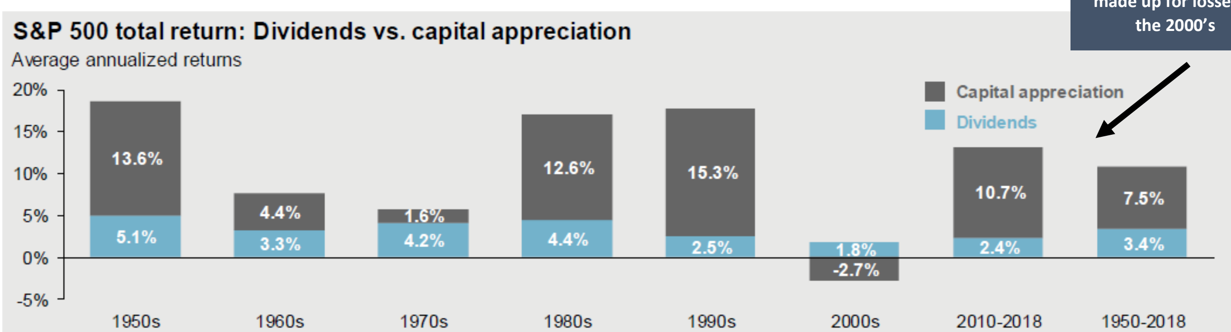


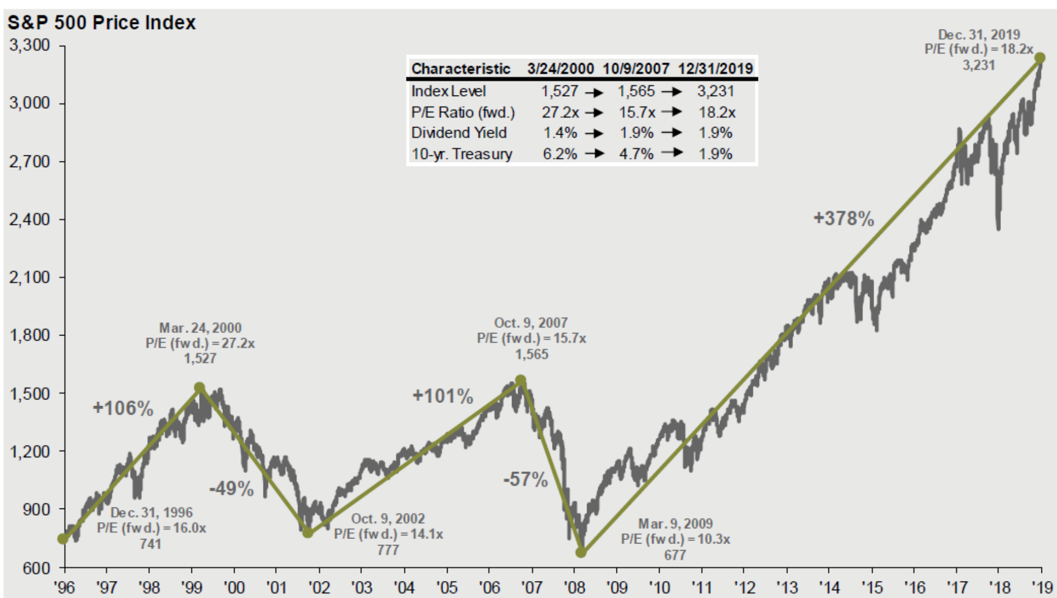
Market Overview

The US stock market capped the decade up over 31% year-to-date in 2019, in what was largely a return to levels seen before the 2008 financial crisis.

Figures 6 and 7. The US market has recovered over the past decade and ended on a strong year

The 2010's have made up for losses in the 2000's





Source: Compustat, FactSet, Federal Reserve, Standard & Poor's, J.P. Morgan Asset Management.

This may seem odd given everything that has been happening with concerns related to trade wars and manufacturing recessions. Part of the explanation lies in bond markets where US 10-year treasury yields dramatically collapsed from close to 3% at the end of 2018 down to a 2019 low of 1.4% in August. This reflects fixed income investors fleeing to the safety of government bonds, which drove up the prices and decreased yields. As a result, stocks looked relatively more attractive than bonds, especially the US market which is composed of safer, less economically sensitive sectors like utilities and real estate.

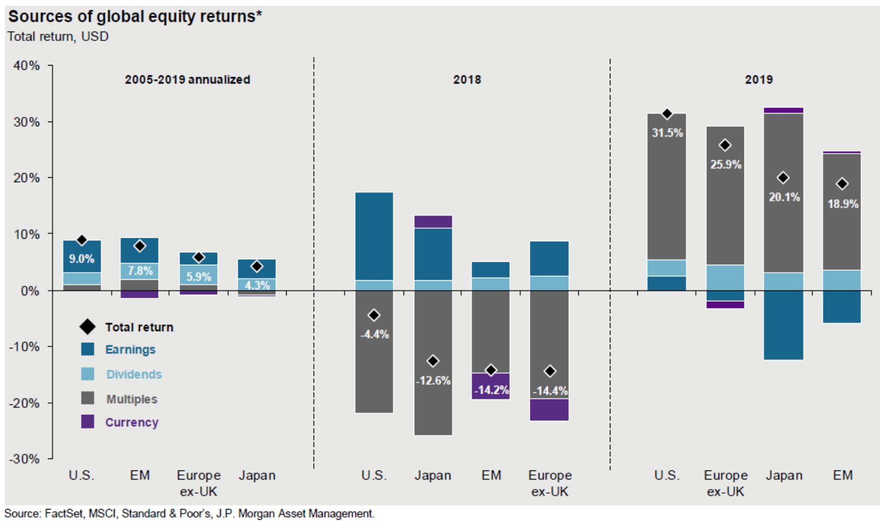
It's also worth noting the massive policy pivot by the Fed from raising rates in 2018 to cutting rates in 2019. These easy money policies have helped to prop up markets and signal that the Fed is not going to be the one to the spoil the party, at least for now.

2020 New Year Update

Digging a bit deeper into 2019's record returns, it's clear that just about all of it can be attributed to increasing multiples. In other words, company earnings and dividends didn't increase that much - the big game changer was how much investors were willing to pay for those earnings and dividends.

Figure 8. 2019 Returns mostly came from multiples

Over the long term, returns come from earnings and dividends

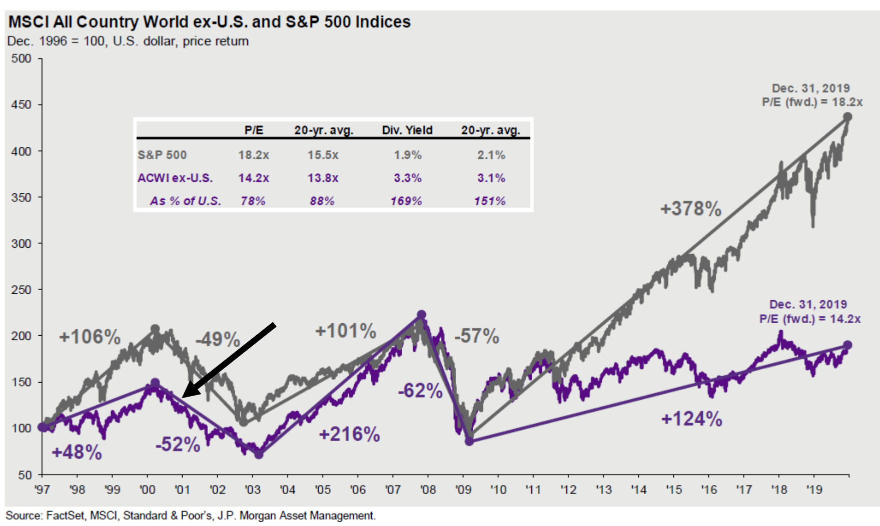


Though that wasn't the case in 2019

Naturally, higher multiples beget higher valuations relative to history or what would be expected based on fundamentals. Other evidence supports a bit of a "stretched" equity market including elevated measures of investor optimism, perhaps anticipating a return to global economic growth a bit too soon.

On the other hand, there are some potential bright spots in out-of-favor international stocks which are relatively cheaper and stand to gain if global economic growth does improve.

Figure 9. International Stocks cheaper relative to the US



Lower starting valuations relative to earnings

In summary our portfolios remain neutral to respective policy (risk) targets, lacking conviction in a return to global growth coupled with a testy equity market. On the fixed income side, we are looking to exit riskier bonds which served their purpose in 2018-19 but now have an unattractive risk/reward tradeoff.

2020 New Year Update

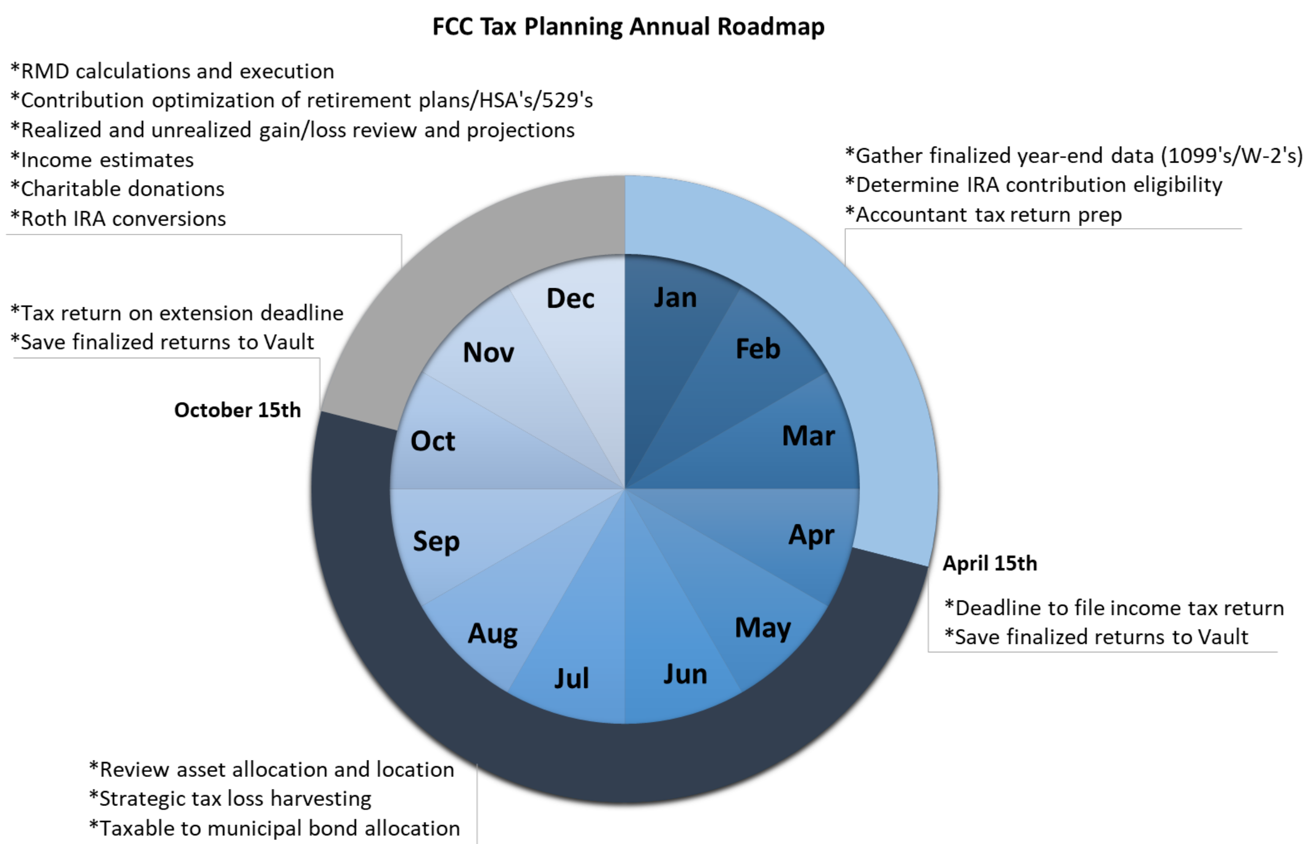
We would be remiss to not mention the upcoming election. First, it's extremely difficult to forecast a presidential election with any degree of certainty. There will likely be some added volatility as the market digests and adjusts in real-time. However, we can say that it is unlikely to unseat an incumbent president when the economy is good based on what has happened in the past.

This is exactly why we diversify portfolios among different asset classes, industries and geographies. The right portfolio is the one you can stick with over the long-term even in times of political uncertainty.

Tax Planning

Tax planning is important pillar of comprehensive wealth management. It is a year-round process that has many aspects, some of which we work directly with clients and others are more behind the scenes. In the upcoming months we will be assisting clients and their accountants with income tax preparation and IRA/Roth IRA contributions. Over the next month or two you will be receiving 1099's and potentially W-2's if you are still working. We will review this information and discuss if you are eligible to make IRA/Roth IRA contributions for 2019 and/or 2020, which if desired will be processed prior to 4/15/2020.

For reference, we have included an overview of our annual tax planning process below.



FLOWER CITY CAPITAL

2020 New Year Update

Planning Spotlight: SECURE Act

On Friday December 20th the SECURE Act was signed into law. The general premise of this new legislation is to help incentivize and encourage more retirement savings for individuals and businesses. There are many changes within the 124 pages of legislation, but we want to focus on the key updates that are most relevant to our clients. One of the most notable changes on the IRA front is the elimination of the lifetime stretch provision for non-spouse inherited IRA beneficiaries. Previously non-spouse beneficiaries were required to take annual distributions from inherited IRAs over their estimated remaining lifetime, which "stretches" the tax impact and allows for more tax deferred growth. Non-spouse beneficiaries are now required to distribute all inherited IRA assets within a 10-year period, thus compressing and potentially increasing the tax impact.

On the other hand, there are changes with favorable tax implications. IRA account holders are now able to wait until age 72 instead of age 70.5 to start withdrawing required minimum distributions (RMDs). Also, individuals who work and have earned income past age 70.5 are now able to continue making IRA contributions. Both of these updates create more tax advantaged savings opportunities.

The bill also has some notable provisions on the 401k front, including new rules making it easier for smaller employers to join together and offer a single 401K plan, increased tax credits for small businesses, and opening the window for offering annuity products as an investment option. While we don't recommend annuities, these provisions are generally designed to encourage more retirement plan participation and savings.

Depending on how you look at it, the SECURE Act is either a positive step forward for retirement savers or doesn't really change much (except for the elimination of stretch IRA.) We will discuss on an individual basis how these changes impact your financial plan.

Please do not hesitate to contact us with any questions, investment or otherwise.

Michael Rizzolo
Managing Partner

Thomas Hawks III
Senior Partner

Mark Moretti
Wealth Planning Manager

Vince Crane
Senior Analyst

132 Allens Creek Road, Suite 220, Rochester, NY 14618