



# Southern Capital Perspective

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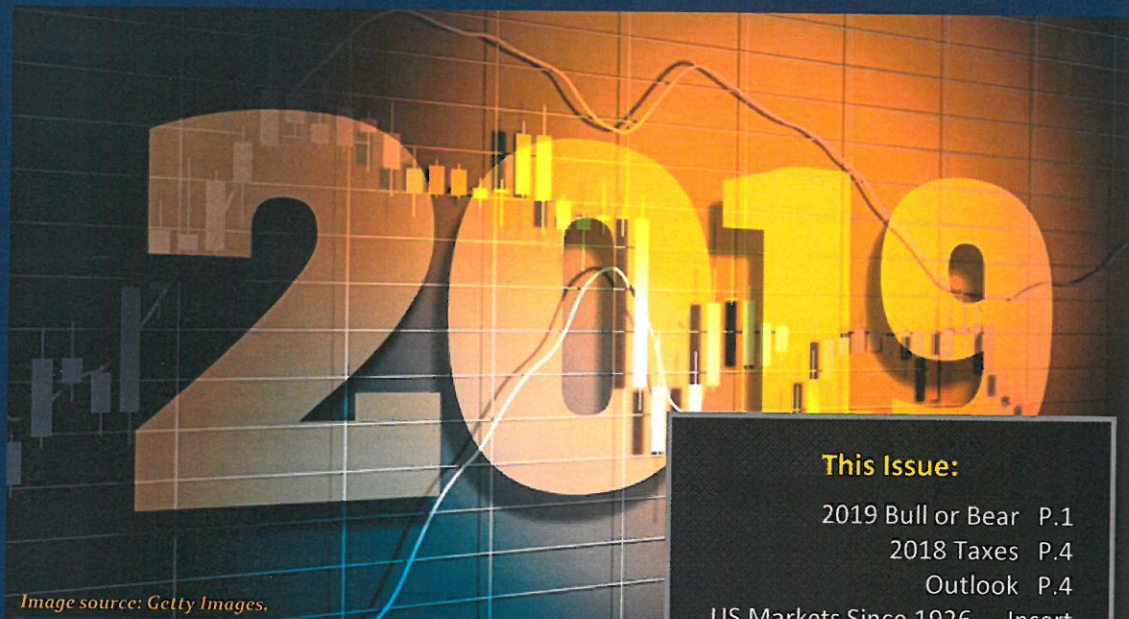


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## 2019 — BULL or BEAR?

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First, a little historical background of Bull & Bear Markets: The bull market that began after the “Great Recession” of 2008-2009 has been running for almost ten years and gained about 385% as of 9/28/2018. Since 1926 the average bull market has lasted 9.1 years and gained about 480% which indicates that our recent bull is rather average (*see graph enclosed*). These statistics do not indicate the future direction of the market but it is important to know from an historical perspective. It is also noteworthy that the average bear market lasts only 1.4 years and has an average cumulative loss of -41%. The clear conclusion that can be drawn is that the stock market has been a great way to accumulate wealth over time with the average bull market lasting 6.5 times longer than bear markets and gaining over 10 times as much. All of that history is interesting, but now we need to examine the factors that may give us a clue as to the market direction in 2019.

The first factor will be the actions of Chairman Powell and the Federal Reserve Board (FED) – the FED has an enormous impact on the markets. Recently in the last couple of years, the FED has been in a tightening mode which means that they have been raising interest rates and also shrinking the money supply (called Quantitative Tightening or QT). This is a reversal

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***Southern Capital Services paperwork.***

*[TD Ameritrade must wait on the final reportings from each individual mutual fund before preparing their 1099s. Therefore, TDA mails them out usually in late February/early March.]*

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of their policy of Quantitative Easing (QE) which they did to combat the effects of the "Great Recession" - we have commented about this at length in previous editions of this newsletter. Through their QE policy, the FED had injected about \$3.5 trillion into the market and economy which proved effective in reversing the impact of the 2008 financial debacle. Also, they had reduced short-term interest rates to near 0%.

Presently, the FED has raised interest rates to 2.5% which is still low but a dramatic increase from 0%. Also, their QT policy has drained about \$400 billion from the system out of the \$4.5 trillion FED balance sheet. Powell's stated objective is to do two more  $\frac{1}{4}\%$  interest rate increases in 2019 and to continue to do \$50 billion per month in QT. Recently, Powell has come under much criticism from President Trump and also from many members of the financial and investment communities. He is not being criticized for his objectives, he is being criticized for the speed in which he trying to accomplish them.

The FED has what is called a dual mandate, that is: they are supposed to maintain price stability, which means control inflation while at the same time promote full employment in the US economy. Currently, the US unemployment rate is near record lows and a report on jobs showed that there are more job openings than there are people to fill them. On the inflation front, the rate has been around and currently just under the FED's target of 2%. It seems as though the critics have a point. The FED is fulfilling its dual mandate and should pause while the actions it has already taken work their way through the economic system. Powell has given some indications that he may hold off on the rate increases; we will have to wait and see because the FED is the 800 pound gorilla in the economy.

The second factor impacting the direction of the market in 2019 will be trade relations between the US and China. The two largest economies in the world must avert a trade war in order for the market to pros-

per in 2019. China has been an abuser of trade policies of the US and with almost all nations of the world since it joined the World Trade Organization (WTO) in 2001. The US and the rest of the nations put up with it because they were trying to help China become a member of the international economic community and to gain access to China's billion+ population that could become their customers.

China is now the second largest economy in the world, yet they still engage in abusive trade practices, intellectual property theft, and required technology transfers from companies wanting to do business in China. President Trump campaigned on the issue of unfair trade with China with the intention to take the necessary actions to bring the trade into fairness and closer to being in balance. Once Trump realized that the US economy would be strengthened by virtue of the rollback of regulations and tax cuts, he believed that he could pressure China from a position of strength. He told them that he would impose tariffs on their goods unless they dropped their trade barriers and stopped the unfair practices. He then put on the tariffs and China responded in kind. Then talks were scheduled that went off and on for months. In the meantime, China's market and economy have been suffering along with a negative but much lesser effect on the US. Now it appears that there may be actual substantive talks in January or February. If these talks are fruitful, the markets will benefit; but if they breakdown or if China is proven to be duplicitous, then it will be a negative for the markets.

### Three other significant factors that could impact markets in 2019

First, is what is called Brexit which is the United Kingdom's (UK) decision to leave the European Union (EU). The vote actually took place June of 2016 and the actual departure date is to be the end of



March 2019. Negotiations have been going on for over two years in the attempt to reach a deal to soften the break and retain favorable trading relations without the UK having to submit to the governance of the EU. At this point it is not looking favorable but, like most political bodies, deals seem to only come together at the last moment. If it does come down to a “hard” Brexit, then the impact on the UK and the EU will be difficult, but it will be somewhat limited as to the impact on the US and the rest of the world. (A “hard” Brexit basically would mean the deadline comes and there is no deal.)

Second, Italy and its contentious relationship with the EU. Italy is objecting to having to comply with the EU’s budget constraints regarding debt limits. If this issue isn’t resolved it would represent a much bigger problem for the EU than the Brexit. Once again this will likely be resolved even if it on a temporary basis, and if not would be a much bigger EU problem than to the rest of the world.

Third, a global economic slowdown is occurring. It is not expected to be dramatic. Goldman Sachs predicts a slowing from 3.8% growth in 2018 to 3.5% growth in 2019. Nevertheless, it could turn out to be more severe and would then represent another headwind for the markets in 2019.

On the more optimistic side, we have the continued strength of the US economy. The overall US unemployment rate has been hovering near its 50 year low (3.7%). The rates for women, minority groups, and youth are at or near record lows. The JOLTS report (Job Openings and Labor Turnover Survey) showed that there were over 7 million job openings for the first time since the survey began in the year 2000. The report also showed that there were more job openings than there were people looking for work. Additionally, it noted that more people quit their jobs than ever before reported meaning that the confidence level in finding better higher paying jobs was very high.

The growth in corporate earnings, which were extremely high (20+%) in 2018, are expected to slow, but they are predicted to come in at the mid-single digit level which is more normal and still indicating economic growth.

The forecasts from many of the large investment banks regarding where 2019 will finish in terms of the S&P 500 represents their views as of the November-December 2018 time frame as shown below.

Morgan Stanley:	S&P 500 2019 Target 2750	2018 close 2506.85 (+ 9.70%)
Bank of America:	S&P 500 2019 Target 2900	2018 close 2506.85 (+15.68%)
Jefferies:	S&P 500 2019 Target 2900	2018 close 2506.85 (+15.68%)
Goldman Sachs:	S&P 500 2019 Target 3000	2018 close 2506.85 (+19.67%)
Barclays:	S&P 500 2019 Target 3000	2018 close 2506.85 (+19.67%)
Citigroup:	S&P 500 2019 Target 3100	2018 close 2506.85 (+23.66%)
JP Morgan:	S&P 500 2019 Target 3100	2018 close 2506.85 (+23.66%)
BMO:	S&P 500 2019 Target 3150	2018 close 2506.85 (+25.66%)
UBS:	S&P 500 2019 Target 3200	2018 close 2506.85 (+27.65%)
Deutsche Bank:	S&P 500 2019 Target 3250	2018 close 2506.85 (+29.65%)
Credit Suisse:	S&P 500 2019 Target 3350	2018 close 2506.85 (+33.63%)

(Above we have added the percentage gain that those year-end numbers would represent from the 12/31/2018 close in order for the data to be more meaningful.) Sourced from [finance.yahoo.com](http://finance.yahoo.com)

We are not saying that their predictions are right (and to be fair they were *not* taken at the end of December), but even if they are half correct, 2019 will be a good year.

The FED’s Chairman Powell stated on December 19, 2018 that the US economy would slow in 2019 and reduced his predicted growth rate from 2.5% to 2.3%. That is a drop from the 3% rate of 2018, but it is still growth and is greater than most of the last 10 years leading up to 2018. The point is that it is a decent growth rate and not a recession.

## Conclusion

We feel that the good outweighs the bad, and the underlying strength of the economy will carry us through to a positive year regarding the economy and the market. We are assuming that Chairman Powell and the FED act rationally and that China and the US do not devolve into a trade war. We will elaborate more in the outlook section



## 2018 TAXES

*(For Taxable Accounts—Expect to Pay Taxes This Year)*

One of the most difficult items to explain to clients is why they may have to pay taxes in a year that their account experienced a decline in value. This happens because taxation takes place when gains are realized (which means when sales take place) not necessarily when the gains were made. In the case of mutual funds, realized gains can come from two different sources:

- First, the sale of the shares of the fund itself that we generate on your behalf.
- Second, sales of the fund assets (shares of stock) that are sold by the fund manager (remember, mutual funds are not taxed – all gains and losses are passed through to the investors).

Although it may be difficult to understand, taxation is only done once on your gains. For example:

Fund XYZ which trades at \$10 a share has a \$1 taxable distribution that is reinvested in additional shares. In the year of the distribution, the investor has to pay tax on the \$1 gain. However, when the investor ultimately sells the share in the fund (at an assumed \$12 per share), s/he will only have to pay capital gains tax on \$1 instead of \$2.

*~ \$12 sales price - \$10 original basis - \$1 additional basis from the distribution = \$1 gain ~*

Our longtime investors will remember also that it can be very pleasant to have large gains and not have to pay taxes at the time. For example, in 2017, gains were in the 15% to 20% range but taxes were nowhere close to that amount.

If you or your tax adviser need further assistance, give us a call so we can help clarify what is often a confusing topic for all.

## Outlook

2018 was the year that volatility returned to the stock market. After 2017, which was remarkable for its lack of volatility, investors were caught off guard by the first bout of volatility in February when the market declined by about 10%. The market then rallied to an all-time high by the end of September and at that point, the high volatility kicked in. October saw a sharp decline, November rallied part way back and then in December the bottom fell out until the final week of the year.

We know what happened last year, but it is important to determine why it happened. There were a number of reasons: first, the FED withdrew about \$400 billion of liquidity in 2018 under QT, second the uncertainty created by the potential for a China/US trade war, third, political division in the US, such as: the Mueller investigation, the government shutdown, etc., fourth, computerized trading which exaggerate the market swings and generate more volatility.

Looking ahead into 2019 (at least through the first half of the year) we believe that volatility will remain high although considerably less than what we saw in December. The reason is that the factors driving it are still present. Hopefully as these issues get resolved, the volatility will lessen back to a normal pace.

The stock market in 2019 has more positive aspects than negative ones. The primary one is the state of the economy which is good, although it is slowing down, it is still favorable (growth of 2.3% to 2.5%) which is down from 2018's 3% pace but does not indicate recession. Second, we believe that the FED will moderate its stance, third, we think that it is in the interest of both of the presidents of China and the US to come to an agreement on trade, fourth, the decline in the stock market has created more value in terms of P/E ratios. All of these factors are the reason that we feel 2019 will end up as a positive year. Of course, as always there are no guarantees.

*We wish all of our readers a happy and prosperous 2019!*



# History of U.S. Bear & Bull Markets Since 1926

This chart shows historical performance of the S&P 500 Index throughout the U.S. Bull and Bear Markets from 1926 through September 2018. Although past performance is no guarantee of future results, we believe looking at the history of the market's expansions and recessions helps to gain a fresh perspective on the benefits of investing for the long-term.

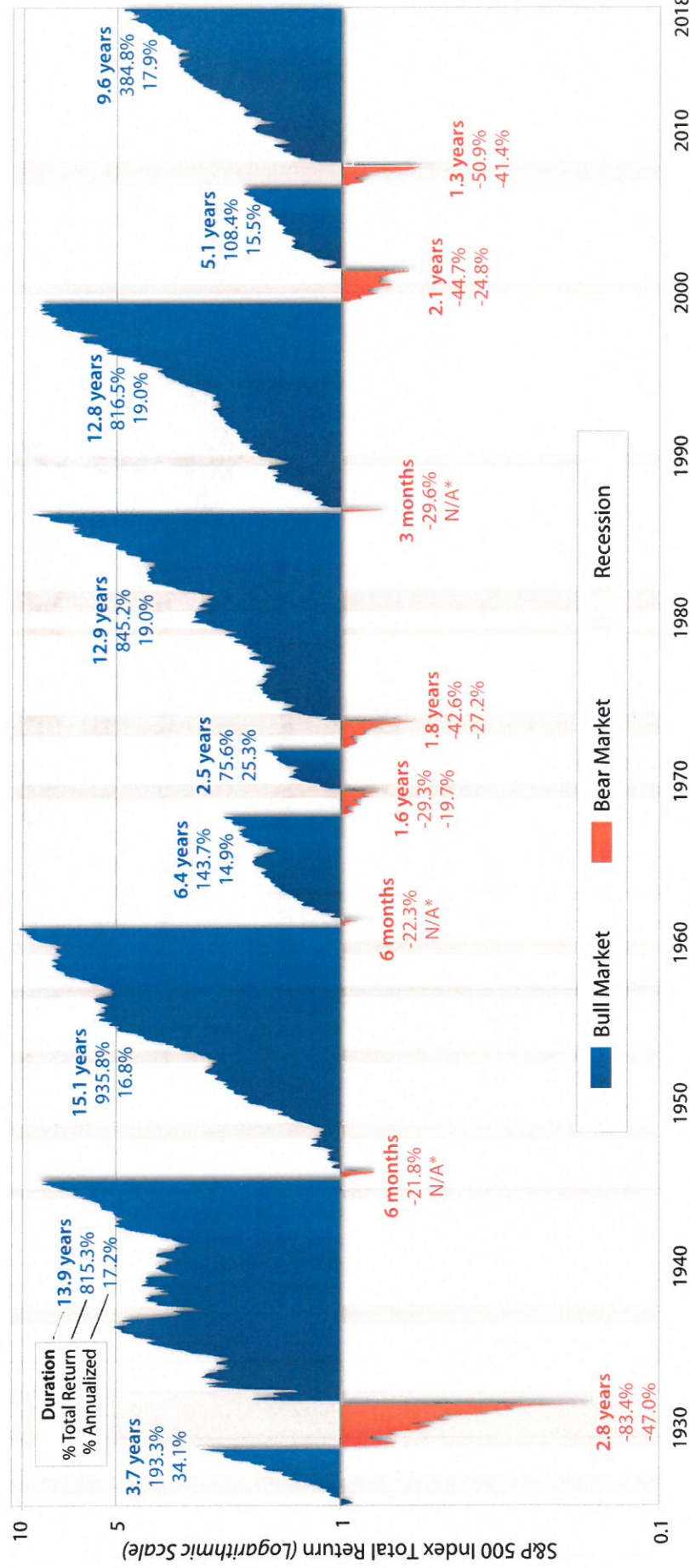
- The average **Bull Market** period lasted 9.1 years with an average cumulative total return of 480%.
- The average **Bear Market** period lasted 1.4 years with an average cumulative loss of -41%.

## Bull

From the lowest close reached after the market has fallen 20% or more, to the next market high.

## Bear

From when the index closes at least 20% down from its previous high close, through the lowest close reached after it has fallen 20% or more.



Source: First Trust Advisors L.P., Morningstar. Returns from 1926 - 9/28/18. \*Not applicable since duration is less than one year.

These results are based on monthly returns—returns using different periods would produce different results. The S&P 500 Index is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. Index returns do not reflect any fees, expenses, or sales charges. This chart is for illustrative purposes only and not indicative of any actual investment. These returns were the result of certain market factors and events which may not be repeated in the future. Past performance is no guarantee of future results.

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