ACADEMY FINANCIAL, INC.
EVALUATE • ENVISION • EXECUTE

2019 1st Quarter Review

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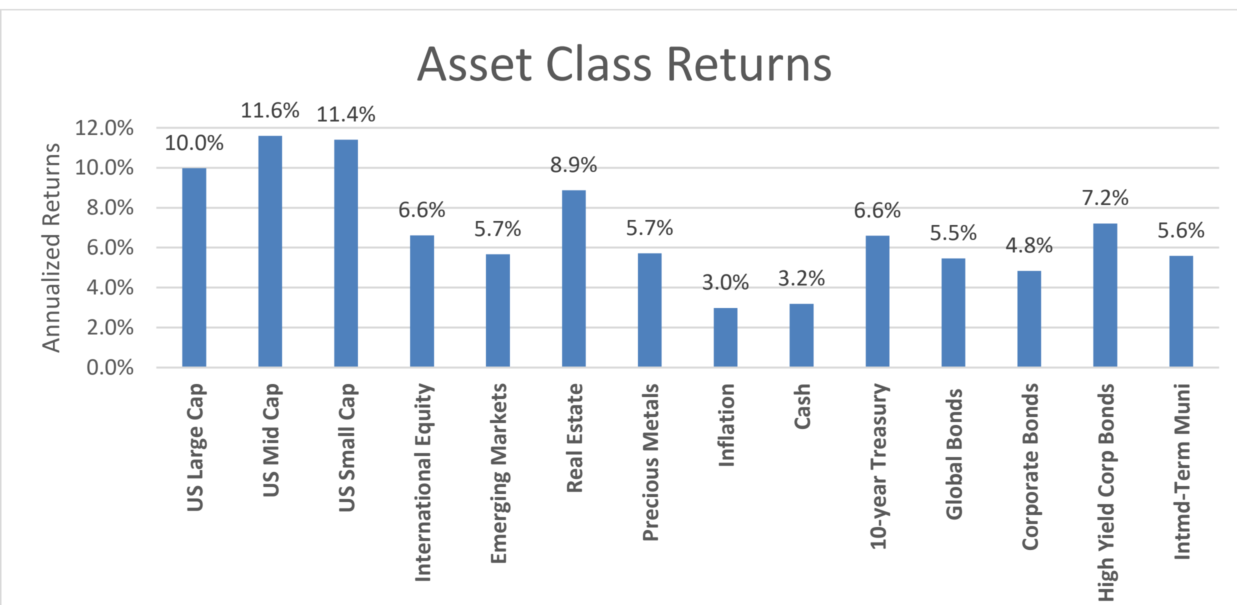
Chief Investment Officer

"Listening to and understanding our client's financial goals allows us to provide the highest level of investment planning advice and service."

Equity Markets

A focus of nearly any investment review is the importance of diversification and asset allocation. One of the important tools we use is the expected returns for the different typical asset classes. That isn't to say we should invest 100% in the equity markets and look to outperform. Over longer periods of time, that has proven to play out, but an important consideration is the risk and volatility of the equity markets relative to less risky markets such as the various fixed income asset classes. The key to ensuring the proper allocation is to reflect on your individual approach to risk and the reaction you have to volatile markets.



https://www.portfoliovisualizer.com/historical-asset-class-returns

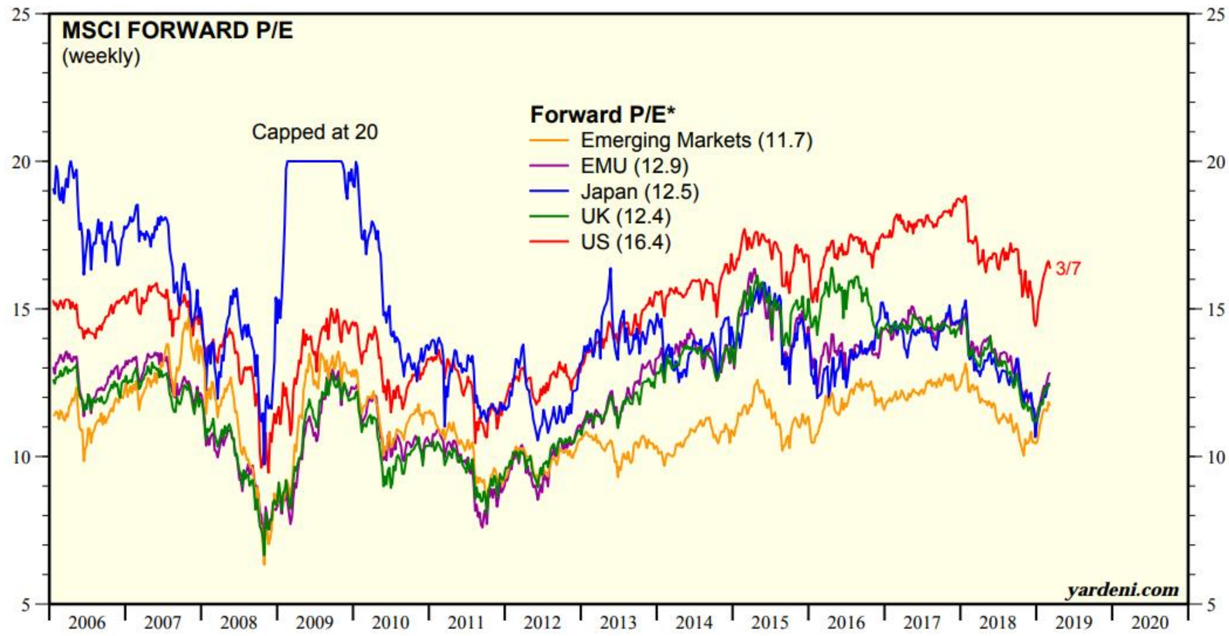
https://www.portfoliovisualizer.com/faq

The “quilt chart” below gives a perfect visual of how diversification works. Any one asset class can outperform or underperform over a short-term period. The performance, by calendar year, of any one asset class ranges from best to worst performing. A blended portfolio shown in white and connected by the dotted line reduces the volatility as compared to any single asset class. This is important, again, as we analyze our risk approach.

															2003 - 2017	
2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Ann.	Vol.
EM Equity 56.3%	REITs 31.6%	EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	EM Equity 37.8%	EM Equity 12.7%	EM Equity 23.0%
Small Cap 47.3%	EM Equity 26.0%	Comdty. 21.4%	EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	DM Equity 25.6%	Small Cap 11.2%	REITs 22.3%
DM Equity 39.2%	DM Equity 20.7%	DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	Large Cap 21.8%	REITs 11.1%	Small Cap 18.8%
REITs 37.1%	Small Cap 18.3%	REITs 12.2%	Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%	Small Cap 14.6%	Large Cap 9.9%	Comdty. 18.8%
High Yield 32.4%	High Yield 13.2%	Asset Alloc. 8.1%	Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Asset Alloc. 14.6%	High Yield 8.6%	DM Equity 18.4%
Large Cap 28.7%	Asset Alloc. 12.8%	Large Cap 4.9%	Asset Alloc. 15.3%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	High Yield 10.4%	DM Equity 8.6%	Large Cap 14.6%
Asset Alloc. 26.3%	Large Cap 10.9%	Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	REITs 8.7%	Asset Alloc. 8.3%	High Yield 11.3%
Comdty. 23.9%	Comdty. 9.1%	High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 3.5%	Fixed Income 4.1%	Asset Alloc. 11.0%
Fixed Income 4.1%	Fixed Income 4.3%	Cash 3.0%	Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Comdty. 1.7%	Cash 1.2%	Fixed Income 3.3%
Cash 1.0%	Cash 1.2%	Fixed Income 2.4%	Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%	Cash 0.8%	Comdty. -0.3%	Cash 0.8%

Source: Barclays, Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management.
Large cap: S&P 500, Small cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Comdty: Bloomberg Commodity Index, High Yield: Barclays Global HY Index, Fixed Income: Barclays US Aggregate, REITs: NAREIT Equity REIT Index. The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Barclays US Aggregate, 5% in the Barclays 1-3m Treasury, 5% in the Barclays Global High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. Annualized (Ann.) return and volatility (Vol.) represents period of 12/31/02 – 12/31/17. Please see disclosure page at end for index definitions. All data represents total return for stated period. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of December 31, 2017.

One of the recent trends of the past decade has been the U.S. equity markets outperforming international equity. Earnings and earnings growth are a key part of the market moves as we see in the Price to Earnings ratio in the chart below. Notice over the past 10+ years, the U.S. P/E ratio has been consistently 20% higher than the various international markets. That continues in 2019 with the U.S. P/E at 16.4 compared to 11.7 to 12.9 for the various international markets. Is the premium for U.S. equities worth it? We believe so, but there is a compelling case for value to be had in the international equities as well. Our view is that both should be held in a diversified portfolio. It is always easy to look back and wish we had ignored international and only bought U.S. equity. With investing we should look forward to the probabilities and the fundamentals that give us the valuations and corresponding expected returns.

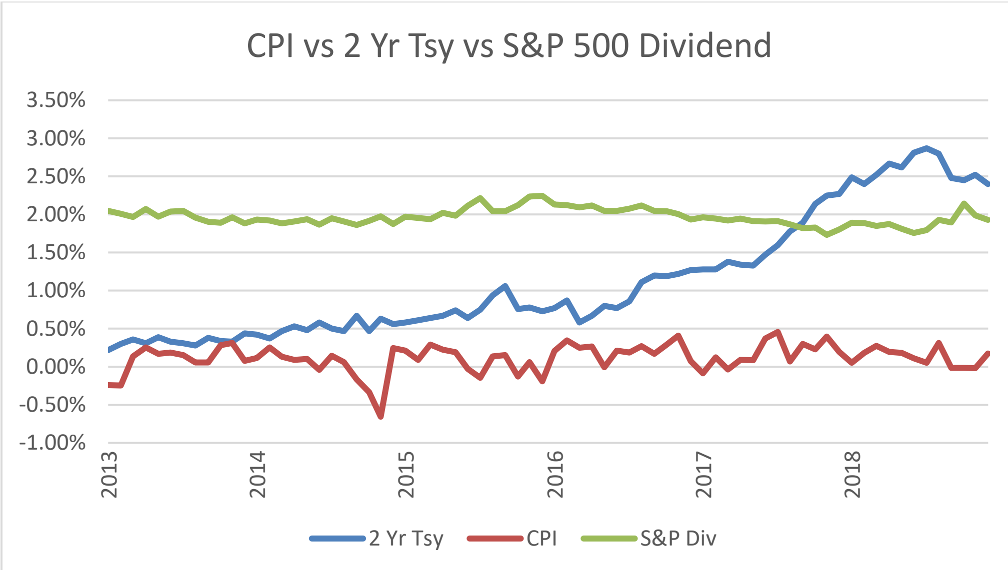


* Price divided by 12-month forward consensus expected operating earnings per share.
Source: I/B/E/S data by Refinitiv.

Fixed Income Markets

The Fed announced in late 1st quarter that they would put a hold on raising interest rates in 2019.[1]. Looking at the 2-year treasury as a barometer for short term rates, we see climb in rates because of the Feds tightening since 2015. Inflation, as measured by CPI, hasn't budged, fluctuating between 0.0% and 0.50%. The Fed and the various treasury rates that make up the yield curve have a huge impact on the bond market. An interesting overlay is to see the dividend rate of stocks (S&P 500) in relation to CPI and the 2-year Treasury, displayed in the graph below. One benefit to stocks is the approximately 2.0% dividend that has stayed consistent in recent years. The dividend alone has yielded better than a 2-year Treasury up until late 2017. The spread of bond yields vs inflation has also increased over the last few years.

Late in the 1st quarter the yield curve went just negative as the 10 Year Treasury yield dipped just below the 2 Year Treasury yield. This created a bit of headline risk with volatility high the day it occurred. Our view is that until the yield curve stays negative and becomes increasingly negative, we remain in a neutral environment both for interest rates and for increased volatility for equities.

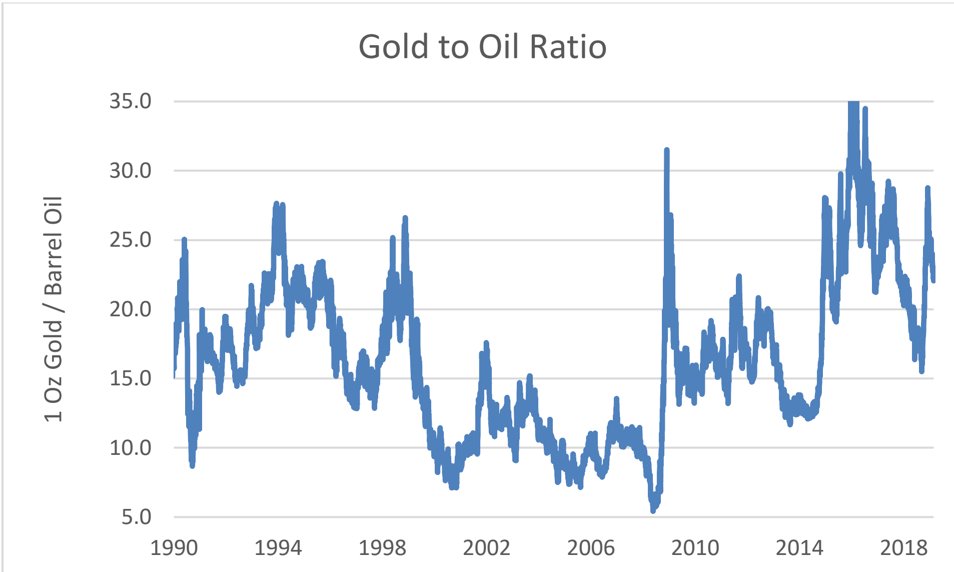


https://ycharts.com/indicators/consumer_price_index
https://ycharts.com/indicators/2_year_treasury_rate
https://ycharts.com/indicators/sandp_500_dividend_yield_ttm

Commodities and Real Estate

An interesting comparison, not often cited, is the Gold to Oil ratio. It's a great way to gauge how commodities are reacting without the influence of the price in dollars. Spikes in the chart below show when gold is priced high relative to oil and dips show the opposite. Though not a perfect correlation, higher oil prices often mean a growing economy. If gold is high, it often means an increase in anxiety for finance and the economy in general. In addition, we mustn't forget that technological advances or other geopolitical events will affect supply which then affects prices for both commodities and this is a counter consideration than those just discussed.

Still, end of 1st quarter Gold/Oil ratio is close to 22 which is a bit higher than historical averages in the high teens. Lower prices of oil may indicate a somewhat slow economic growth rate and a somewhat higher level of economic anxiety. Increased supply has also influenced prices lower.



https://ycharts.com/indicators/gold_price
https://ycharts.com/indicators/crude_oil_spot_price

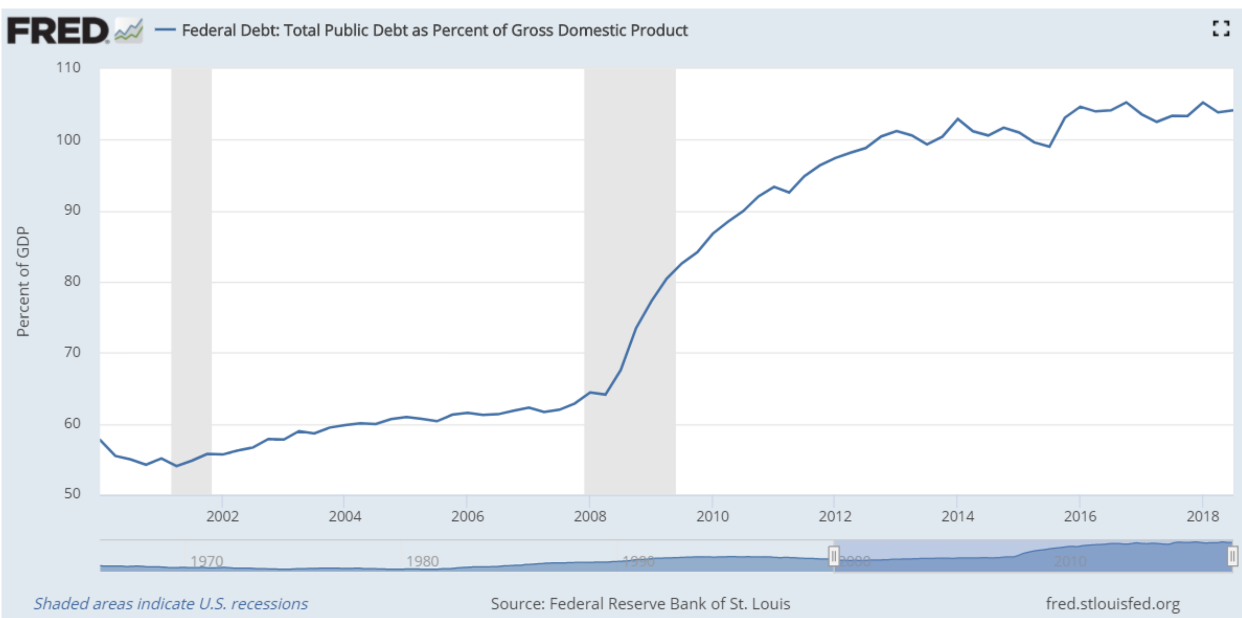
Another comparison to note is Real Estate vs Equity returns, see chart below. Over the past 5 years, the only item to note is that both gained similarly with lower correlation than we might have expected. Another justification for a diversified portfolio.

U.S. Economy

U.S. debt can be concerning. At over $21 Trillion, the magnitude alone is hard for us to truly comprehend. When we compare it to U.S. GDP we can better consider it as usable information. We note that we entered the 2008 recession at 60% Debt/GDP and by 2012 the ratio increased to 100% where we have stayed at or above ever since. For comparison below, we can see how other countries measure in 2018.

If the U.S. economy had sluggish growth or higher interest rates, this would be a more worrisome issue. As rates stay low the interest payments shouldn't overwhelm the budget. As economic growth continues, the overall debt load remains manageable.

There's a balance for the Fed and U.S. government. With a prudent path of debt reduction, spending could slow the growth of the economy, initiating a downward cycle. Indications of a move in that direction, would likely cause increased volatility in markets.



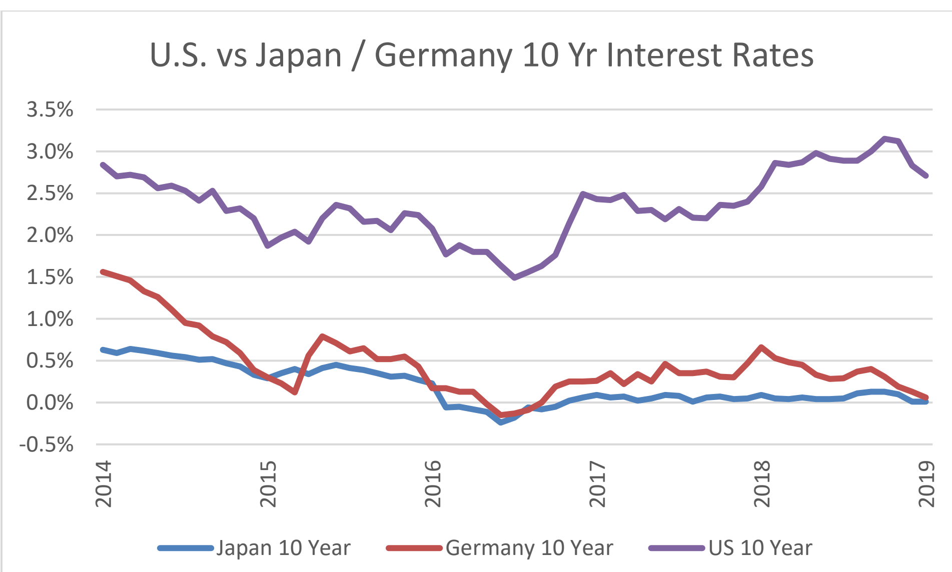
Federal Reserve Bank of St. Louis and U.S. Office of Management and Budget, Federal Debt: Total Public Debt as Percent of Gross Domestic Product [GFDEGDQ188S], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/GFDEGDQ188S, March 26, 2019.

Country	Debt to GDP	Population (Millions)
India	67%	1369
U.K.	86%	67
Brazil	90%	212
France	96%	65
U.S.A.	109%	329
Italy	128%	59
Japan	234%	127

http://worldpopulationreview.com/countries/countries-by-national-debt/

World Economy

Over the past 10 years, a common refrain has been that "rates are at all time lows and can't possibly go lower." We would agree that rates are fairly low with the U.S. yield curve flattening at 2 - 2.5%. Yet compared to the international yields, there is a dramatic difference. For example, Germany and Japan have had 10-year bond rates near zero (and at times, negative). This has been a longer-term trend as well. Certainly, when credit becomes an issue we see higher rates such, as with Greece and Italy, but for economically balanced countries, rates are at historic lows.



https://fred.stlouisfed.org/series/IRLTLT01DEM156N#0
https://ycharts.com/indicators/10year_treasury_constant_maturity_rate
https://ycharts.com/indicators/japan_10_year_government_bond_interest_rate

Forecast

1st Quarter 2019 was a classic rebound quarter from a significant correction in 4th Quarter 2018. Nearly all the 14% losses have been recovered. The most significant change to fundamentals and the economy was the Fed moving towards neutral and indicating the increases in interest rates would come to a short-term halt. There are still stubborn issues: trade discussion with China continue, Brexit is a convoluted mess, and international growth has slowed. Equity valuations are above average as are recent moves in real estate, and interest rates remain low. This presents the challenge of where to put new money. We continue our neutral stance towards equity relative to bonds, while slightly overweight domestic securities relative to international.

An important reminder with any forecast or market moves: We believe investors should not attempt to time the market and that the key to successful wealth management is to coordinate with your financial planner and establish the risk and return expectations for your unique situation.

[1] https://www.bankrate.com/banking/federal-reserve/fomc-recap/