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The Waypoint

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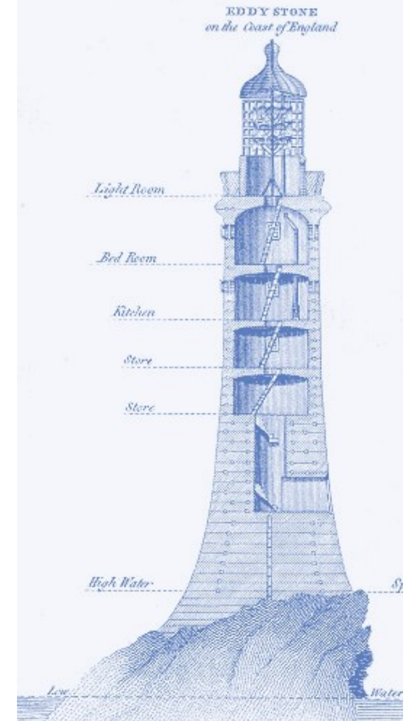

A Moment to Reflect

Our spirits were certainly tested over the past few weeks, as we work to get back on our feet after Hurricane Florence. While the many unknowns have been frightening and overwhelming, we take heart in seeing our community come together. It has been so humbling to hear stories and meet people from far and wide that have lent a helping hand. We know for many, the road to recovery will be long. Interested in helping out? Here are some ways that you can donate.

Donate Stock: Have low basis stock that will be taxed heavily when sold? Many charitable organizations have a brokerage account where they can receive stock donations in kind.

IRA Required Minimum Distributions (RMDs): Do you still have a required IRA distribution to take before year end? Qualified charitable distributions can be made to satisfy your RMD while also being excluded from taxable income.

Employer Matching Contribution: Often times, employers of all sizes will match donations that their employees make to charitable organizations as part of their corporate philanthropy programs. It is always best to make sure that the organization is on the approved list of charities before donating.

These are just a few ideas that can help make a meaningful impact on the rebuilding of our community. Please reach out to us if you are interested in utilizing these opportunities to get involved.

October 2018 Market Update

- **The move in the long end of the yield curve is significant by our measure:** It signifies future growth and an end to the decade of cheap money or future inflation and a decade of high margins. Neither is good for stocks.

- **Within stocks, we remain convinced that the rotation to value is upon us:** The stock market had been getting more defensive quietly and then, seemingly without a catalyst, suddenly. We are strongly convinced that this will continue, heralding a market moment when future expectations for growth collide with reality.

- **The American First trade has gotten long in the tooth:** With the revised NAFTA looking curiously like an update to the previous NAFTA, US equity markets are slowly starting to wane as earnings comparisons will become more challenging. While the more attractive overseas markets come with risks, we see the overall market ripe for a rotation abroad where earnings comparisons will be easier going forward.

Inside this issue

Introduction 1
Market Review 2
Going Forward 2-3

About "The Waypoint"

This ninth edition of The Waypoint includes data from Oxford Economics, provided by Gina Sanchez, an independent investment consultant who has partnered with Lumina Wealth Management. She is an economist, former portfolio manager and regular contributor on CNBC, as well as a member of the Oxford Global Centre for Economics in London.

Market Review: Sigh of Relief Breathes Life into Equity

The U.S. Federal Reserve raised interest rates on Sep 25th and left plans intact to steadily tighten monetary policy, forecasting the US economy would enjoy at least three more years of modest growth. In a statement that marked the end of the "accommodative" monetary policy era, Fed policymakers lifted the overnight lending rate by a quarter percentage point to a range of 2.00 percent to 2.25 percent. The U.S. central bank foresees another rate hike in December, three more next year, and one increase in 2020. The hope is to put the benchmark overnight lending rate at 3.4 percent, roughly half a percentage point above the Fed's estimated "neutral" rate, at which rates neither stimulate nor restrict the economy. Their tight policy stance is projected to stay level through 2021, the timeframe of the Fed's latest economic projections.

U.S. job growth accelerated in August and wages saw their largest annual increase in more than nine years, the clearest signs that the US economy is weathering the escalating trade war with China so far. The Labor Department's closely watched employment report published in early-September showed slack in the job market was rapidly diminishing, with a broader measure of unemployment falling to a level not seen since 2001.

U.S. stocks reached new highs in late-September on news from China that tariff and currency moves could ease trade tensions. Treasury yields remained near their highest level this year, while the dollar slid. The S&P 500 Index soared to a record close -- led by the technology, health-care and financial sectors -- lodging its biggest gain in over a month, although volatility has reappeared over the last few weeks. The Dow Jones Industrial Average also reached a new pinnacle, with 28 of 30 constituents flashing green. Most European and Asian shares gained as well. China announced that it plans to decrease the average tariff rate on its imports from the majority of its trading partners as soon as next month.

Global Brent crude jumped more than 3 percent to a four-year high, exceeding $80 a barrel after Saudi Arabia and Russia ruled out any immediate increase in production. The Organization of the Petroleum Exporting Countries and non-OPEC states, including top producer Russia, gathered in Algiers for a meeting that ended with no formal recommendation for additional supply to counter falling supply from Iran.

The world economy remains on shaky ground a decade after the 2008 financial crisis as global economic growth is has been sporadic with many economies are operating below potential. The trade tariff tussle between the two major economies, the US and China, is a symptom of a "deeper malaise". However, the four BRICS nations, including India, are doing better because of increased domestic demand. According to the UN, many advanced countries have abandoned domestic sources of growth since 2008, most noticeably with the turnaround of the Eurozone from a deficit to surplus region.

The European Central Bank kept policy unchanged, as expected, staying on track with ending bond purchases this year and raising interest rates next autumn. With inflation rebounding and growth leveling off at a relatively healthy pace, the ECB has been gently removing stimulus for months in the belief that a range of risks from trade disputes, to emerging market turbulence, to Brexit, will not be enough to derail an economic expansion that is now in its sixth year. In a subtle shift, the ECB said it would halve its monthly bond purchases to 15 billion euros in October, firming up its previous language, which said that such a move was only anticipated.

China's fixed-asset investments decelerated further in August, to the slowest growth rate since official records were kept. Overall, Chinese economic growth continues to decline, notably due to the effects of U.S. tariffs on business sentiment. The yuan inched lower after the US imposed duties on an additional $200 billion of Chinese imports, drawing a sharp rebuke and warning from Beijing that it will be forced to retaliate. The escalation in the trade talks between the two economic giants caused some wobbles in Chinese stocks. However, they bounced back after Beijing vowed to fight back. A rally in infrastructure stocks supported the broader market, with some investors betting that China will step up investment in roads and bridges to offset the impact recent tariffs, much of which has already been priced in by the markets.

Going Forward: Slowly, then Suddenly

Much of what is playing out in the markets has, in our view, been playing out slowly and now suddenly. We see multiple themes in the market which have been developing over time; largely observing various campaign promises come to fruition in the context of a pre-existing economic recovery in full swing. While the markets celebrated corporate tax cuts and earnings reflected the massive windfall to corporations, the markets have fretted over trade policy, though the former significantly more than the latter. The result was a highly skewed market that rewarded growth despite the unsustainability of that corporate profit growth. With the economic recovery in full swing, interest rate normalization would eventually lead to the end of a decade of monetary accommodation and cheap access to debt. Moreover, it could potentially bring about an end to a decade of low inflation, particularly wage inflation. While inflation may still largely be argued, the normalization of interest rates is now in full swing and the markets are grappling with the reality of tightening financial conditions.

The Long End of the Yield Curve

While the Fed has been steadily normalizing the overnight interbank lending rate, the Fed Funds Rate, the longer end of the yield curve has been slower to rise. At times, concerns around trade policy actually caused the longer end of the curve to fall, leading to concerns about a potential for an inverted yield curve, normally a indicator for recession. And then, quite suddenly, the longer end shot up almost 15 bps. We draw an interesting parallel between the timing of the curve move and the signing of the United States Mexico Canada Agreement (USMCA), which turned out to be less threatening than the markets had priced in. In fact, the markets initially celebrated the non-toxicity of the agreement, then longer rates rose to rain on this parade. Though, to put this move into context, in the past twelve months, the long end has moved up 45 bps while the one-month rate has moved up 105 bps. This begs the question- is the long end pricing in expectations for growth, inflation or both? If this is driven by growth, then in the most optimistic scenario, we are now at the stage of economic cycle where economic growth is steady but financing costs will start to rise significantly. This would hurt corporations that have become heavily reliant on a steady stream of debt to finance stock buy backs in order to further support the earnings picture, but equities are still more attractive than bonds. In a slightly more pessimistic scenario, the bond market could be playing catch up and the economic growth picture is starting to peak and naturally slow. Without additional stimulus, earnings could see a dramatic slow down, in which case the still frothy multiples will have to be repriced leaving equities less attractive than bonds, even in a rising rate environment. If, however, this move in interest rates is driven by inflation, particularly wage inflation , this could weigh down margins considerably. Corporate profits are then left suffering a double whammy with the unsustainability of tax stimulus plus shrinking margins. Here, we would also favor bonds over equities despite the rising yields. From our read on the markets, we place the likelihood to be somewhere between the second and third, which leaves us less excited about US equities than previously.

The Value Rotation

After a few months of teasing, there seems to be more evidence that value is coming back into favor and the market is becoming more price conscious, looking for more defensive sectors. The high-flying technology stocks have been beaten down over the past several weeks, which we don't see changing much. Perhaps a round of earnings growth in the high teens could breathe life into that bubble again, which we would view as a selling opportunity. While trade concern has taken the wind out of the small cap trade, which has been quickly unwinding, we see the value trade as one that is just at the beginning of its long journey. Quality and defensiveness will also matter and cash will be king. In an environment of tightening financial conditions, we see further room for multiples to reprice along fundamental lines.

Conclusion

The clear winner for the year has been US equity. However, the recent move in interest rates, which should have heralded a sell off in Emerging Market debt, actually sparked a rally as the NAFTA saga concluded. While Chinese tensions are still flying high with currency an additional concern to the trade rhetoric, there is probably still more headline risk to owning Emerging Market equity or debt. Japan has been tainted by the same trade brush with Japanese equity still reflecting some concern. However, European equity is starting to look more attractive. Italy presents the potential for another Greek Tragedy, but on the whole, growth has continued, albeit more slowly and corporate earnings in Europe continue to improve. While we aren't diving headlong into international equity, we are certainly eyeing it with great interest.

Thank you for reading The Waypoint from Lumina Wealth Management. If any specific financial topics pique your interest, or you want to hear our thoughts on a global or domestic event, please contact us.

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