RIVERVIEW QUARTERLY INSIGHTS

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RECESSION IS COMING . . . SOONER OR LATER

We are now at what must be the tail end of the second longest U.S. economic expansion. Corporate earnings are fairly strong, bolstered by lower tax rates. Jobless rates have hit a 17-year-low. The Fed raised short-term rates again in June, and is signaling a total of four such raises for the year.

And for every action, there is an equal and opposite reaction. As the jobless rate decreases, salaries eventually will increase. This increase, combined with higher costs of materials arising from possible trade wars, will put a lot of pressure on U.S. businesses. Analysts are already predicting lower earnings growth once the benefits of the tax cuts have been absorbed. Recent S&P 500 performances are indicative of the difficult position the economy is in: the index rallied early in May, driven by strong earnings. But by the end of the month, international developments (weakening in emerging markets, European instability, possible trade wars, threats of Italy withdrawing from the EU) dragged down performance (although still ending up for the month). By the end of June, the S&P 500 dropped 18 points from the end of May.

So there has to be a recession soon, right? Eventually, of course. But do we see signs of one coming soon? To attempt an answer, let's start by defining what a recession is. One common description is that a recession is indicated when Gross Domestic Product (GDP) growth is negative for two consecutive quarters. However, that is just a rule of thumb, and a recession can already begin before the completion of the second full quarter. A better definition is when there is a six-month decline in the economy, as defined by five economic indicators: real GDP, income, employment, manufacturing and retail sales. That's the measurement used by the National Bureau of Economic Research (NBER). However they are defined, recessions are damaging because they lead to decreases in consumer spending, business expansion and hiring.

Once they begin, recessions can vary in length and attributes. The attributes come in the form of various "shapes:" a sharp decline followed by a quick recovery is often called a "V shaped" recession, while a more gradual drop and recovery can be said to be "U shaped." There are even "double-dip" recessions, which are said to be "W-shaped." The latter is especially bad, because it can seriously affect consumer confidence.

Although there are no reliable predictors of a coming recession, the following provide some clues:

- An "inverted yield curve," where the yield on a ten-year Treasury security actually drops below the yield of a two-year Treasury (ordinarily, the longer the maturity of a bond, the higher its yield). An inverted yield curve becomes a bigger problem as the Fed continues its pattern of raising short term interest rates, but the longer term rates remain unchanged.
- A 3-month increase in unemployment rate and initial jobless claims.
- A fall in asset prices (like stocks or real estate).
- A drop in the Index of Leading Economic Indicators (roughly speaking, a change in most or all of the above).

Government reactions to recessions can include tax cuts (unlikely now, because we just had them), increased government spending (also unlikely in this environment) or decreases in the short term lending rates between banks (also hard in this environment because of how low rates already are).

Are we near a recession now? In the very near term, probably not. Corporate debt levels are a little high, job markets are overheated and the Fed is raising rates. But the economy is still strong. Russell Investments, for instance, has predicted recession in late 2019 or 2020. Like any other projection, of course, this is simply a best guess.

So a recession is coming, and perhaps relatively soon. What do we do about it? In a word, nothing.

Research from Dimensional Fund Advisors, LP shows that the proportion of daily stock market returns above 7% (in other words, a very significant one-day increase) to all days is 0.04%, while the proportion of daily returns of -7% or more is 0.06%. Big swings in either direction are rare. The rest of the time, stock market returns are pretty dull. This means that missing only a few days of strong returns can drastically impact overall performance. The annualized compound return on the S&P 500 from 1990 to 2017 was 9.81%. However, if an investor missed the 25 best single days over that 28-year period, his or her return dropped to only 4.53%. By comparison, one-month Treasuries over the same period returned 2.77%. Market timing doesn't work; it only increases the odds that your stock returns will more closely resemble T-Bill returns.

Dimensional's research also demonstrates that increased volatility, like we're experiencing now, does not indicate an increased likelihood of a market downturn. Volatility is just that. It's uncomfortable, but it doesn't indicate darker days will necessarily follow. The same research shows that the stock market returns for three or five years after either a market decline of more than 10% or a new market high are very similar. It doesn't matter whether the stock market has dropped 10% or more, or hit a new high: your return as an investor within a relatively short time of either event will be about the same.

So, in the end, only one scenario is bad: when an investor hasn't rebalanced his or her portfolio following a large stock market run-up, resulting in the investor owning too much in stock and thereby taking a bigger hit than they were prepared for when the recession does happen. Recessions come and go. The US economy has been growing for so long that another one probably isn't too far away. So (as always) be sure to allocate your assets and diversify appropriately, rebalance at least once a year, and don't read the financial papers (too much).

WAKE-UP CALL
FOR FUTURE RETIREES

Two recent front-page articles from the Wall Street Journal provide a troubling picture for those nearing retirement age. The first, from June 21, describes how there were 25 Americans 65 or older for every 100 of working age in 2017. This is up from 21 retirement-age Americans in 2010, and that number is expected to rise to 35 in 2030. As a result, “the U.S. safety net for seniors will become even more stretched for cash.”

The second article, from June 23 - 24, was even more disturbing. It points out that Americans nearing retirement “are in worse financial shape than the prior generation, for the first time since Harry Truman was president.” Many have high average debt, are paying off their children’s educations and are reaching into meager savings to support aging parents. More than 40% of households headed by people aged 55 or older “lack sufficient resources to maintain their living standard in retirement.” Many of these people will find themselves working past 70, possibly in menial jobs, just to make ends meet. Others may have to rely on their children, who may also feel the squeeze in their paychecks from higher social services withholdings to support the aging population. The retiring Baby Boomers are the first generation that have had to rely on their own savings rather than employer pensions to support themselves in retirement. Their failure to adequately prepare, coupled with the rising cost of long term care and the obligations to support children and parents, have left many Boomers financially vulnerable.

These findings are sobering, not just for those considering retiring, but also for their children. So how can someone considering retirement have a better sense of security about their retirement prospects? In our opinion, the answer is to reset their expectations.

EXPECTATION #1: DETERMINE HOW MUCH YOUR SAVINGS WILL GENERATE.

The most important thing to keep in mind when assessing the adequacy of your retirement savings is not the total amount that you have saved, per se, but rather: what is the amount that can be safely withdrawn from those savings each year without outliving your money? Although this number can be determined through detailed financial planning, it can also be roughly estimated using rules of thumb.

A widely accepted rule of thumb (the 4% rule) is that a person can withdraw 4% from their retirement portfolio each year over 30 years without significant risk of going broke. Using this rule of thumb allows a soon-to-be retiree to determine a sustainable distribution amount that should keep pace with inflation. Mechanically, you would calculate 4% of your total portfolio value at retirement and then withdraw that amount, increased for inflation, each year. For example, if a person had a $1 million portfolio, in the first year of retirement, 4% would be a $40,000 distribution. In the following years, that amount would be increased for inflation, to maintain purchasing power. This rule of thumb assumes that the person’s portfolio is invested 60% in large company stocks (like the S&P 500) and 40% in intermediate term US bonds.

However, experts disagree on whether the 4% rule will continue to remain sustainable over the next 30 years. Recent research from the American College of Financial Services indicates that, although 4% has held up historically as a valid measurement, it failed in almost half of the forward-looking studies that professors from the College ran. In light of that failure rate, the College recommends using 3% as the new safe withdrawal rate. This means that a retiree who has saved $1 million should only plan on withdrawing $30,000 per year from those savings. Sobering.

EXPECTATION #2: DETERMINE WHAT YOUR LIFESTYLE WILL BE.

If you find the 3% withdrawal assumption to be troubling, you have two choices: save more (which may mean working longer); or change your expectations about what retirement will look like. In an April 23 article in The Wall Street Journal, Dr. David Ekerdt notes that "busy boasting" is a status symbol: Baby Boomers who have bragged about how busy they were at work are applying that same ethos to retirement. Peer pressure, cultural norms and commercial interests are leading retirees to stay constantly involved with classes, trips, new businesses and new languages. All of which cost money. This "busy boasting" trend creates demands that retirees can't always afford. To combat this, Dr. Ekerdt recommends letting retirement be retirement. Consider planning for a not-so-busy, and not-so-expensive, retirement.

EXPECTATION #3: RETHINK HOW CONSERVATIVE YOUR INVESTMENTS SHOULD BE.

Even if you are comfortable with a modest 3% withdrawal rate, as discussed in Expectation #1, the assumption is that you are invested 60% in equity throughout retirement. Many retirees, however, follow a program of moving their portfolios to more conservative positions at retirement, in an effort to avoid market volatility. By doing this, retirees also sacrifice the long-term returns needed to support their withdrawal strategy. The important point here is that volatility does not equal risk. Volatility is the normal and natural movement in markets over the short-term (three to five years) and only actually matters if you have a short investment horizon. Most retirees, however, have a very long time horizon of 25 to 30 years, and likely need a reasonably large allocation to equity to support their withdrawal needs over that time. The real threat to their portfolios is not volatility but inflation, and the best hedge against inflation is investing in stocks. Retirees should avoid following rules of thumb regarding asset allocation and instead select an asset allocation that is customized to their circumstances, time horizon, and withdrawal needs.

EXPECTATION #4: DETERMINE WHAT OTHER RESOURCES ARE AVAILABLE TO YOU.

When preparing for retirement, an important step is to consider all the resources available to you, including government benefits. Social Security and Medicare are programs available to U.S. retirees, and should be factored into your plans. However, with the retired population quickly outpacing the working population and with life expectancies increasing, the Social Security Board of Trustees expects program assets to be depleted by 2034. This doesn't mean social security benefits will stop after 2034, in fact that is highly unlikely. But it does mean that Congress needs to come up with a solution, and that could include a reduction in benefits. Most likely the solution will multifaceted and include, among other things, an increase in the taxable wage base, increase in the FICA tax rate, cuts to future retiree benefits, and later retirement ages.

Retirees also commonly expect that Medicare will cover all their medical expenses. However, while Medicare does cover some expenses, retirees still have to cover a lot themselves, such as deductibles, co-pays, co-insurance, vision care, most dental care, and long-term care. These potentially costly medical expenses need to be considered and planned for.

While it is impossible to determine exactly how much you'll need in retirement, how long retirement will last, how much support you'll truly get from government programs, and how well your investments will perform, planning ahead, being realistic and adjusting your expectations are a great way to get prepared and have confidence as you approach and enter retirement.

ECONOMIC SNAPSHOT

MARKET SUMMARY – SECOND QUARTER 2018 INDEX RETURNS

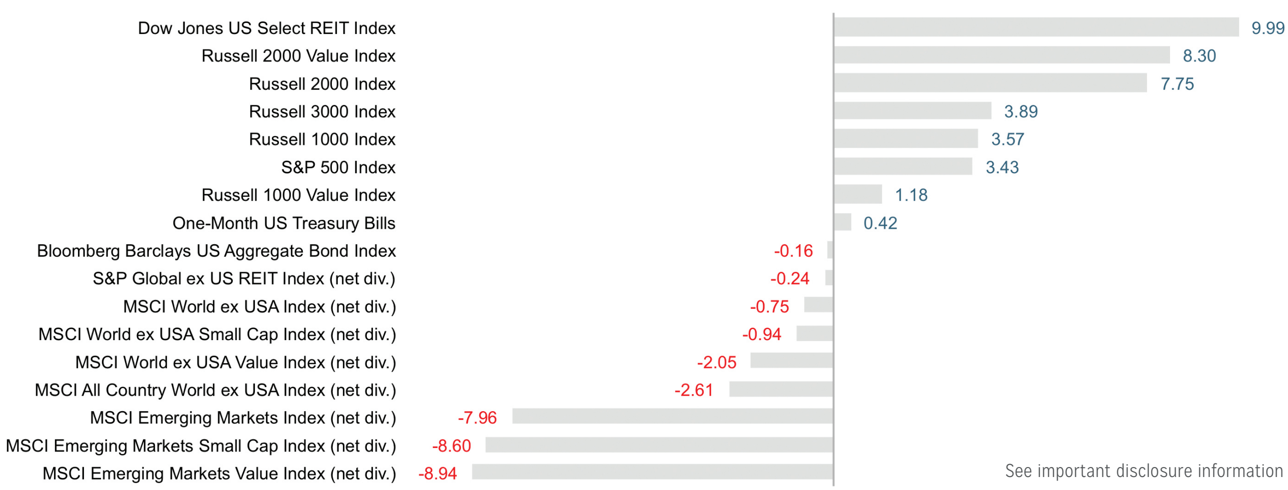
Global markets have seen a return of volatility in 2018. However, US equities has mostly recovered in the second quarter, after a slightly negative first quarter. The US equity market outperformed both non-US developed and emerging markets this quarter.

	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
Q2 2018	**STOCKS**				**BONDS**	
	3.89%	-0.75%	-7.96%	6.05%	-0.16%	0.48%
Since Jan. 2001						
Avg. Quarterly Return	2.0%	1.5%	3.0%	2.6%	1.1%	1.1%
Best Quarter	16.8%	25.9%	34.7%	32.3%	4.6%	4.6%
	Q2 2009	Q2 2009	Q2 2009	Q3 2009	Q3 2001	Q4 2008
Worst Quarter	-22.8%	-21.2%	-27.6%	-36.1%	-3.0%	-2.7%
	Q4 2008	Q4 2008	Q4 2008	Q4 2008	Q4 2016	Q2 2015

See important disclosure information.

WORLD ASSET CLASSES - SECOND QUARTER 2018 INDEX RETURNS (%)

Looking at broad market indices, the US outperformed non-US developed and emerging markets during the second quarter. Small caps outperformed large caps in the US but underperformed in both non-US developed and emerging markets. The value effect was negative in the US as well as markets outside the US.



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WORLD STOCK MARKET PERFORMANCE

MSCI ALL COUNTRY WORLD INDEX WITH SELECTED HEADLINES FROM PAST 12 MONTHS

These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

Graph Source: MSCI ACWI Index [net div.]. MSCI data © MSCI 2018, all rights reserved.
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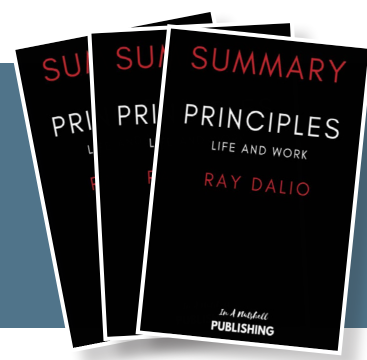

BOOK REVIEW

PRINCIPLES
By Ray Dalio

Bridgewater Associates, an investment management firm that manages about $160 billion for some of the biggest institutional clients in the world, was founded by Ray Dalio in 1975. You'd think that creating a business that successful would be enough for a person. But Mr. Dalio has written out the principles that have guided him through that success in the recent bestseller, Principles.

It is equal parts impressive, egotistical, insightful and repetitious. A book everyone should read, even though at times it will frustrate.

The most important idea, the one that recurs throughout the book, is presented in the Introduction. Mr. Dalio's first principle is "[t]hink for yourself to decide 1) what you want, 2) what is true, and 3) what you should do to achieve #1 in light of #2 . . . and do that with humility and open-mindedness so that you can consider the best thinking available to you." Keeping this first principle in mind while reading the book is critical to give it context and to keep the reader from getting lost in the many details.

The book is divided into three sections. The first is a 131-page autobiography of Mr. Dalio; of his roots and his journey with Bridgewater. This is fairly standard stuff, although it would make an interesting read on its own. Mr. Dalio is honest about his failings and applies a lot of self-criticism to his story, which is refreshing in an autobiography. Mostly, though, the first section is a necessary set-up for the principles that follow.

The second section, and in my view the best, is his section of life principles. His first, and most important, is to "embrace reality and deal with it." Standing by itself, this statement appears obvious and even trite, but Mr. Dalio goes on to explain his detailed process for deciding what's real and dealing with it. This includes being radically transparent and open-minded. Mr. Dalio's approach, it seems, is to treat every problem coldly, working on his own personal evolution based on the facts around him. Great advice, but very hard to accomplish. This bloodlessness is reflected in principles like, "[t]hink of yourself as a machine operating within a machine and know that you have the ability to alter your machines to produce better outcomes."

Perhaps the most useful part of this second section on life principles is his description of the five-step process of having goals, diagnosing obstacles and designing and implementing strategies to gain results. As Mr. Dalio envisions it, this is not a single process but a continual feedback loop, in which progress and setbacks are constantly informing each other, taking the practitioner of the process on a path of continuous improvement. It is a challenging idea; although it seems almost unachievable, it is an idea I knew I should come back to as I read it.

The third section on work principles is the longest. It is also in my view the least applicable. In it, Mr. Dalio applies the same general life principles to the workplace: constant improvement, radical transparency, and radical open-mindedness. The problem is not with the principles, which are obviously appropriate (or at least they should be obvious). Rather, the problem is in the application. There is a name for a middle manager or line worker who is radically transparent: unemployed. Nevertheless, for those who do have the power to influence the direction of their companies, it is a section that is worth spending time with.

Although a very worthwhile read, there is a lot about this book that makes it challenging. First, Mr. Dalio refers to decision-making tools that Bridgewater uses to implement these principles. He claims that they will be provided to the public in the future, but they are not a part of the book itself. Second, the principles he lays out are coldly logical, with the aim of taking emotion out of the decision-making process. This is a worthwhile goal, but taken to the extreme they might be counterproductive. The principles may work, but you may not like yourself very much for following them.

In the end, Principles, like any book that lays out the path a very successful person has taken, is less about providing a roadmap for others to follow to achieve similar success and more about providing insight into how an already driven person was able to focus that drive. As Mr. Dalio says at several points, the book should inspire the reader to develop a set of principles of the reader's own, not simply copy Mr. Dalio's. It is rare to find a book that causes the reader to reexamine his or her entire life. For this reason alone, Principles is a must-read.

IMPORTANT DISCLOSURE INFORMATION

INVESTMENT AND INSURANCE PRODUCTS ARE: NOT FDIC Insured | NOT Bank Guaranteed | MAY Lose Value.

Past performance is not a guarantee of future results. Asset allocation does not guarantee better performance and cannot eliminate the risk of investment losses. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.

Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net div.]), Emerging Markets (MSCI Emerging Markets Index [net div.]), Global Real Estate (S&P Global REIT Index [net div.]), US Bond Market (Bloomberg Barclays US Aggregate Bond Index), and Global Bond ex US Market (Citi WGBI ex USA 1-30 Years [Hedged to USD]).

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