RIVERVIEW QUARTERLY INSIGHTS

RIVERVIEW trust company

ECONOMY, RECESSION, BONDS:

HOW SHOULD WE THINK ABOUT FIXED INCOME?

Every time something crazy happens in the world, investors check to see how it affected the stock market. The Dow and the S&P 500 flutter around like dry leaves in the wind, their prices reacting minute by minute to every news item, forecast or tweet. Nervousness about what might happen in the future seems to override solid data in the present.

Bonds, on the other hand, have a different relationship to world events. Because their values are driven by relative worldwide interest rates, bonds are sensitive to actual economic data and developments in ways that stocks are not. This article will discuss the current state of the economy and global interest rates, the outlook for recession, and the impact that those factors have on an investor's decisions about how to use bonds in his or her portfolio.

The Economy and Interest Rates.

The two biggest developments in the bond market over the last 12 months have been the complete reversal in the direction of interest rates (in the United States the Fed has gone from steadily tightening to steadily cutting our overnight policy rate – the "Fed Funds" rate), along with the unprecedented proliferation of negative interest rates throughout the rest of the developed world. In looking at interest rates in 19 developed countries, only five currently have positive overnight policy rates (the equivalent of our "Fed Funds Rate"), and only seven have positive rates on 15 year bonds.

We recently read that a Danish mortgage lender, Jyske Bank, was offering a fixed rate mortgage loan with a negative interest rate of -.05. In other words, each month when you make your mortgage payment to them, your mortgage

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balance goes down by more than the amount of your payment (before you book your flight, though, our understanding is that it's only available to Danes). The bank is marketing the home loan as a complement to taking out a car loan with the same bank with a positive interest rate. The two offset each other, and with the fees the bank charges, it comes out ahead.

Still, that's insane!

These very low/negative rates are the result of (and in the case of overnight policy rates, a response to) weak economic growth worldwide. During the eight-year period from 2011-18, world GDP (gross domestic product) growth was mostly below 3% per year. For comparison, during the fifty years before that, a growth rate that low occurred only 30% of the time. A couple of years ago there were signs that global synchronized growth might take hold, and that led many to believe that central banks would respond by (finally) raising rates. But by 2019, that growth had sputtered, led by slowdowns in South Korea and Taiwan, which happen to be two very trade-sensitive economies.

Indeed, trade turbulence most certainly has contributed to the slump in global growth. For the past two years, the current administration's aggressive approach to trade negotiations has led to greater tensions, threats and finally actual tariffs. Meanwhile, during those same two years, domestic consumer confidence was high, unemployment was at a fifty-year low and productivity seemed about to increase. Further, bond yields and measures of inflation were on the rise. As a result of that positive data, the Fed decided to raise short term rates in 2018, even though the trade storm was brewing. The stock market, concerned about growing trade tensions, disagreed with the Fed's outlook of continued growth. By the end of 2018, U.S. stocks had decreased for the year by over five percent, while international developed and emerging markets each dropped over fourteen percent. The Fed, in turn, responded by halting the rate increases and reversed course, cutting rates twice (so far) in 2019. All of which leads us to where we are now.

The U.S. Economy: A Snapshot.

When assessing data to determine the health of an economy, it's important to decide what kind of indicator you're looking at. There are three types: leading indicators (data that presents signs of things to come); coincident indicators (data that tells you what's happening now) and lagging indicators (data that tells you what's already happened). Gross domestic product ("GDP") is the biggest lagging indicator; it drops after the economy already has slumped. Housing starts, on the other hand, are a leading indicator: because houses have to be built well ahead of when they're sold, if they aren't being built it means that the builders are pessimistic about the future. So leading indicators are the most useful in helping decide where the economy is headed.

Two of the most important leading indicators are consumer sentiment and expectations (because consumer consumption makes up 68% of the U.S. GDP) and the Index of Leading Economic Indicators ("LEI"), because it is a composite of several different data sets.

Currently, consumer sentiment is good, but not as good as it was earlier in the year. Hourly earnings were up in August and unemployment is still low (but employment grew at a lower level than expected in August). On the other hand, consumer sentiment fell to a seven-month low, driven by tariff concerns. In general, consumer expectations are declining, even though they are still historically strong.

Similarly, the LEI was up in July, and the six-month average was positive. The data here suggests continued expansion (albeit at a modest pace). Specific areas, particularly manufacturing, are showing weakness from very weak overseas demand (24% of U.S. factories report falling export orders, the largest percentage in a decade). Service industries are still strong, but they often lag the manufacturing sector by three to six months.

All of which means that the probability of recession is growing, even as the U.S. economy still shows areas with strong data. The biggest risk comes from the trade war and weakness overseas. What does this turbulent outlook mean for the performance of bonds? To answer that question, we need to take a brief detour into the basics of bonds.

Some Bond Basics.

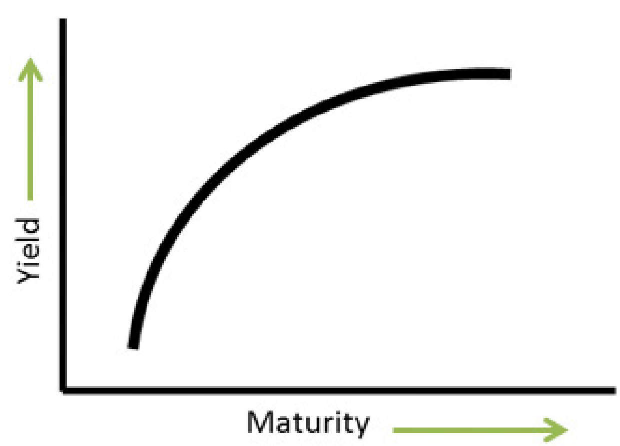
In order to understand bonds' movements in response to these recent developments, a brief description of how bonds work might be helpful. In general, bonds are promises by a governmental entity or corporation to pay a fixed amount (the "coupon rate," expressed as a percentage of the face amount) over a fixed period of time, at the end of which the bond issuer pays back the face amount. So, for example, if you bought a $100,000 10-year Treasury bond with a 2% coupon, you'd pay the U.S. Treasury $100,000 on day one, you'd receive $2,000 each year for ten years, and at the end of year ten, the Treasury would pay you back your $100,000 (when it reaches "maturity"). Seems simple.

The complication comes with the fact that most investors don't buy bonds at issuance, but rather they buy (and perhaps sell) at some point in the middle of the bond's term. And between the time the bond is issued and the time when it is later bought or sold, interest rates can change the bond's value. For instance, let's say you bought your ten-year, two percent bond at its face value. If interest rates went up to three percent and you wanted to sell your bond, you would have to sell it at less than face value (at a "discount") because a potential buyer could get a higher yield elsewhere. Conversely, if interest rates went down after you bought your bond, you could sell it for more than its face value (at a "premium").

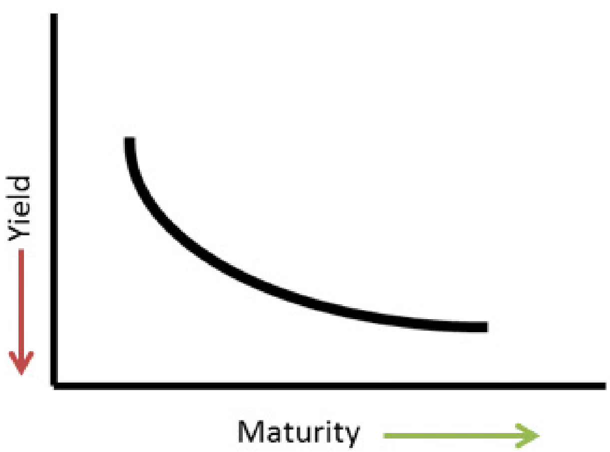
This leads to perhaps the most important point about bonds: as interest rates, and with it a bond's yield, go up, bond prices go down. (As yields go up, prices go down. Just repeat it as a mantra.) And of course the opposite is true. So the next time you read in The Wall Street Journal that bond yields went up and that strikes you as a good thing, just remember that the value of your bond portfolio just dropped a little.

Other factors affect the value and yield of a bond. Credit quality is very important: the US government doesn't have to pay as much in interest as does a start-up corporation on its bonds, because the likelihood of getting paid back by the United States is always higher than getting paid back by a corporation. Further, a drop in a corporation's credit rating can cause the value of its bonds to drop as well (but, as noted above, that makes its yield go up, which might make it more attractive to yield-seeking investors who can accept a bit more risk).

Time to maturity is another important factor. The longer you have to wait for your bond to reach maturity and therefore to get your money back, the more risk you're bearing, and therefore the higher the yield you should receive. That's why a thirty-year bond should have a higher interest rate at issuance than a 10-year bond of equal credit quality. In fact, this change in yield over time creates what's known as the "yield curve." As the time to maturity gets longer along the horizontal axis, the interest rate the bond should pay increases along the vertical axis, as shown below:



At least, that's the way it should look under normal circumstances. Remember, though, that the Fed, when it sets interest rates, only controls the shortest end of the yield curve. The rest of the interest rates are decided by market forces. If investors disagree with the Fed's outlook, market forces can drive longer-term rates below short-term rates. As a result, the curve "inverts" from its usual position, and might look like this:



This creates the bizarre result that shorter term bonds pay a higher yield than longer term bonds. This often happens after the Fed has raised interest rates to combat inflation, and investors believe that the Fed may have gone too far. Investors instead believe that interest rates should be lower. If the Fed is too aggressive in raising overnight lending rates, economic growth can stall. This is why inverted yield curves are seen as sign that recession could be coming. It's also why economists often say that economic expansions don't die of old age; they're killed by the Fed.

Bond Portfolio Implications.

OK, so now we know that interest rates worldwide are ridiculously low (and even negative), that the U.S. economy is still currently doing OK but is starting to show some cracks, and trade wars and weak overseas performance are pulling down the world economy. Further, because our low rates are higher than other countries', the U.S. dollar and Treasuries are a safe haven for worldwide investment (meaning the dollar is currently strong), despite the temporary inversion of the U.S. yield curve. Finally, all these factors seem to point to the Fed lowering rates at least one more time this year.

What do these factors mean for bond portfolio performance? While we're not in the business of making predictions, we think some expectations are reasonable.

- **First**, with a strong dollar and the likelihood of the Fed lowering rates again, we should expect that cash will yield less than it does today, as will the yields on "safe" bonds like Treasuries.
- **Second**, keep an eye on corporate bonds. We mentioned that credit quality is a factor in bond pricing. This quality is usually established by credit ratings agencies: bonds above a set rating (typically BBB or better) are considered "investment grade." Many corporations have taken advantage of the low interest rate environment of the last decade to increase borrowing (corporate borrowing has risen above $6 trillion). If a recession hits, highly leveraged corporations may find it harder to pay their debts, which could lead to a lowering of their credit ratings. Many bond mutual funds and ETFs are required to hold investment grade bonds only; this means they would have to sell their positions in newly downgraded bonds, lowering the values of those bonds, perhaps substantially.
- **Third**, the Bloomberg Barclays U.S. Aggregate, perhaps the most commonly used bond index, has a historically low yield and a heightened sensitivity to interest rate fluctuations.
- **Fourth**, a fifty-year historical study of the relationship between bond yields and subsequent bond returns implies that, given that the current low yields are likely to stay low for quite some time, we should expect low returns from bonds over the next five years.

These four factors together have overturned traditional expectations for bonds. Historically, bonds have provided three benefits to a portfolio: (1) income yield; (2) capital preservation; and (3) diversification from stocks. In this environment, it seems harder than ever to achieve all three goals simultaneously. For instance, if you seek income yield in this low-rate environment, you might be tempted by corporate bonds at the lower end of the “investment grade” spectrum to increase your yield. But an economic slowdown could result in a bond downgrade and a loss of value, which negates the higher yield that you bought the bond for in the first place. Conversely, if you are seeking safety, you will have a hard time generating adequate bond yield.

So, in this environment, be clear about your objectives for the fixed income portion of your portfolio, and expect to make trade-offs among these objectives. You may have to choose between safety and yield, or settle for watered-down versions of both. You may not get a lot of diversification if and when recession hits. Talk to your investment advisor about the role that fixed income plays in your portfolio, and how that role might be changing. Knowing more precisely what you hope to achieve allows you to gauge more effectively whether you’re achieving it.

SPOTLIGHT
ON
PLANNING

MEDICARE OPEN ENROLLMENT BEGINS OCTOBER 15

What is the Medicare Open Enrollment Period?

The Medicare Open Enrollment Period is the time during which Medicare beneficiaries can make new choices and pick plans that work best for them. Each year, Medicare plan costs and coverage typically change. In addition, your health-care needs may have changed over the past year. The open enrollment period is your opportunity to switch Medicare health and prescription drug plans to better suit your needs.

When does the Medicare Open Enrollment Period start?

The annual Medicare Open Enrollment Period begins on October 15 and runs through December 7. Any changes made during open enrollment are effective as of January 1, 2020.

During the open enrollment period, you can:

- Join a Medicare prescription drug (Part D) plan
- Switch from one Part D plan to another Part D plan
- Drop your Part D coverage altogether
- Switch from Original Medicare to a Medicare Advantage plan
- Switch from a Medicare Advantage plan to Original Medicare
- Change from one Medicare Advantage plan to a different Medicare Advantage plan
- Change from a Medicare Advantage plan that offers prescription drug coverage to a Medicare Advantage plan that doesn't offer prescription drug coverage
- Switch from a Medicare Advantage plan that doesn't offer prescription drug coverage to a Medicare Advantage plan that does offer prescription drug coverage

What should you do?

Now is a good time to review your current Medicare plan. What worked for you last year may not work for you this year.

Have you been satisfied with the coverage and level of care you're receiving with your current plan? Are your premium costs or out-of-pocket expenses too high? Has your health changed? Do you anticipate needing medical care or treatment, or new or pricier prescription drugs?

If your current plan doesn't meet your health-care needs or fit within your budget, you can switch to a plan that may work better for you.

If you find that you're still satisfied with your current Medicare plan and it's still being offered, you don't have to do anything. The coverage you have will continue.

What's new for 2020?

The end of the Medicare Part D donut hole. The Medicare Part D coverage gap or "donut hole" will officially close in 2020. If you have a Medicare Part D prescription drug plan, you will now pay no more than 25% of the cost of both covered brand-name and generic prescription drugs after you've met your plan's deductible (if any), until you reach the out-of-pocket spending limit.

New Medicare Advantage features. Beginning in 2020, Medicare Advantage (Part C) plans will have the option of offering nontraditional services such as transportation to a doctor's office, home safety improvements, or nutritionist services. Of course, not all plans will offer these types of services.

Two Medigap plans discontinued. If you're covered by Original Medicare (Part A and Part B), you may have purchased a private supplemental Medigap policy to cover some of the costs that Original Medicare doesn't cover. In most states, there are 10 standard types of Medigap policies, identified by letters A through D, F, G, and K through N. Starting in 2020, people who are newly eligible for Medicare will not be able to purchase Medigap Plans C and F (these plans cover the Part B deductible which is no longer allowed), but if you already have one of those plans you can keep it.

MARKET SNAPSHOT

MARKET SUMMARY – Short- and Long-Term Index Returns

Global real estate and bonds outperformed equity markets over the third quarter and the last one year, driven by global central bank easing and a more defensive positioning by investors.

	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
	STOCKS				BONDS	
3rd Qtr	1.16%	-0.93%	-4.25%	5.72%	2.27%	2.83%
1 Year	2.92%	-0.95%	-2.02%	15.08%	10.30%	10.84%
5 Years	10.44%	3.06%	2.33%	7.36%	3.38%	4.64%
10 Years	13.08%	4.78%	3.37%	9.71%	3.75%	4.44%

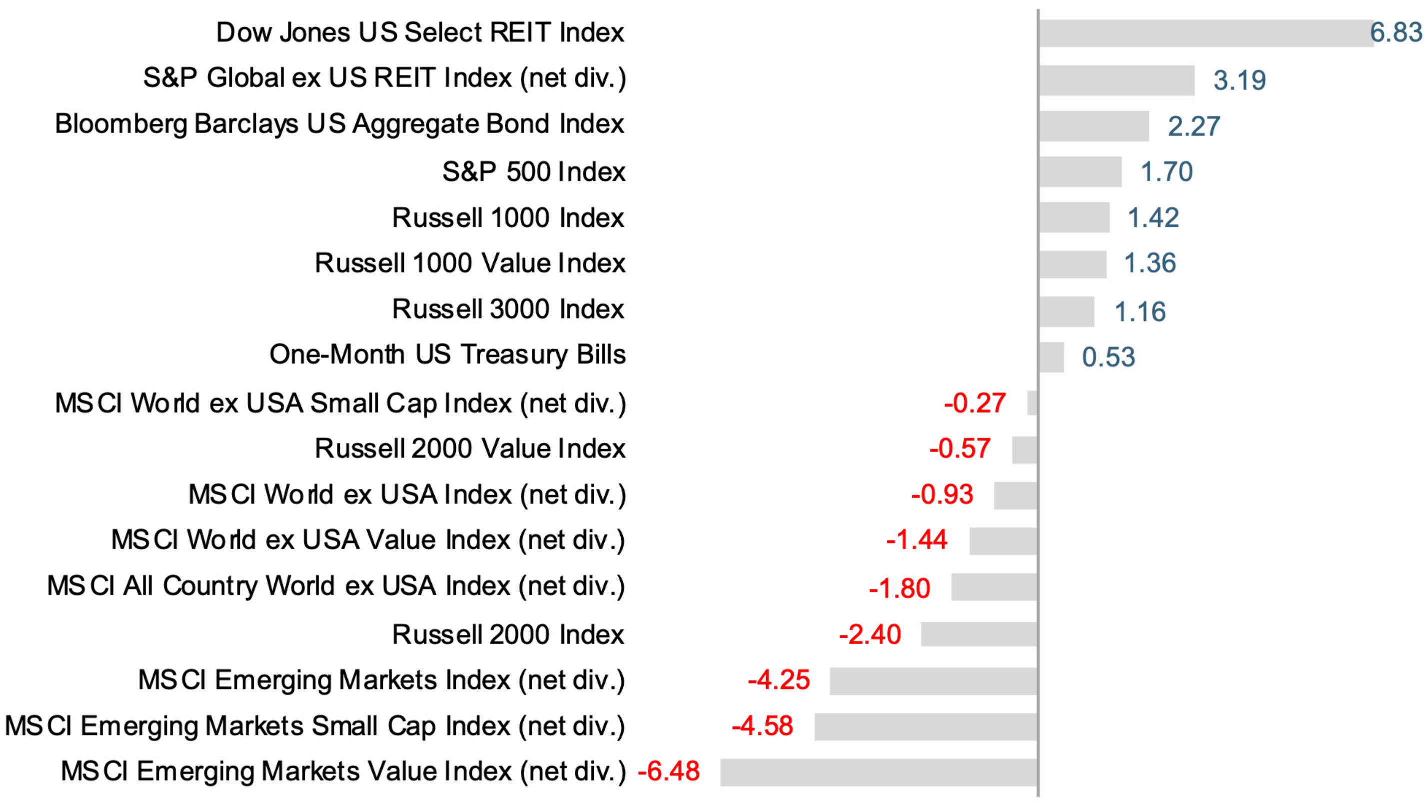
See important disclosure information

GLOBAL MARKETS - Third Quarter 2019 Index Returns (%)

Looking at broad market indices, US equities outperformed non-US developed and emerging markets during the third quarter.

Value stocks outperformed growth stocks in the US but underperformed in non-US and emerging markets. Small caps outperformed large caps in non-US markets but underperformed in the US and emerging markets.

REIT indices outperformed equity market indices in both the US and non-US developed markets.



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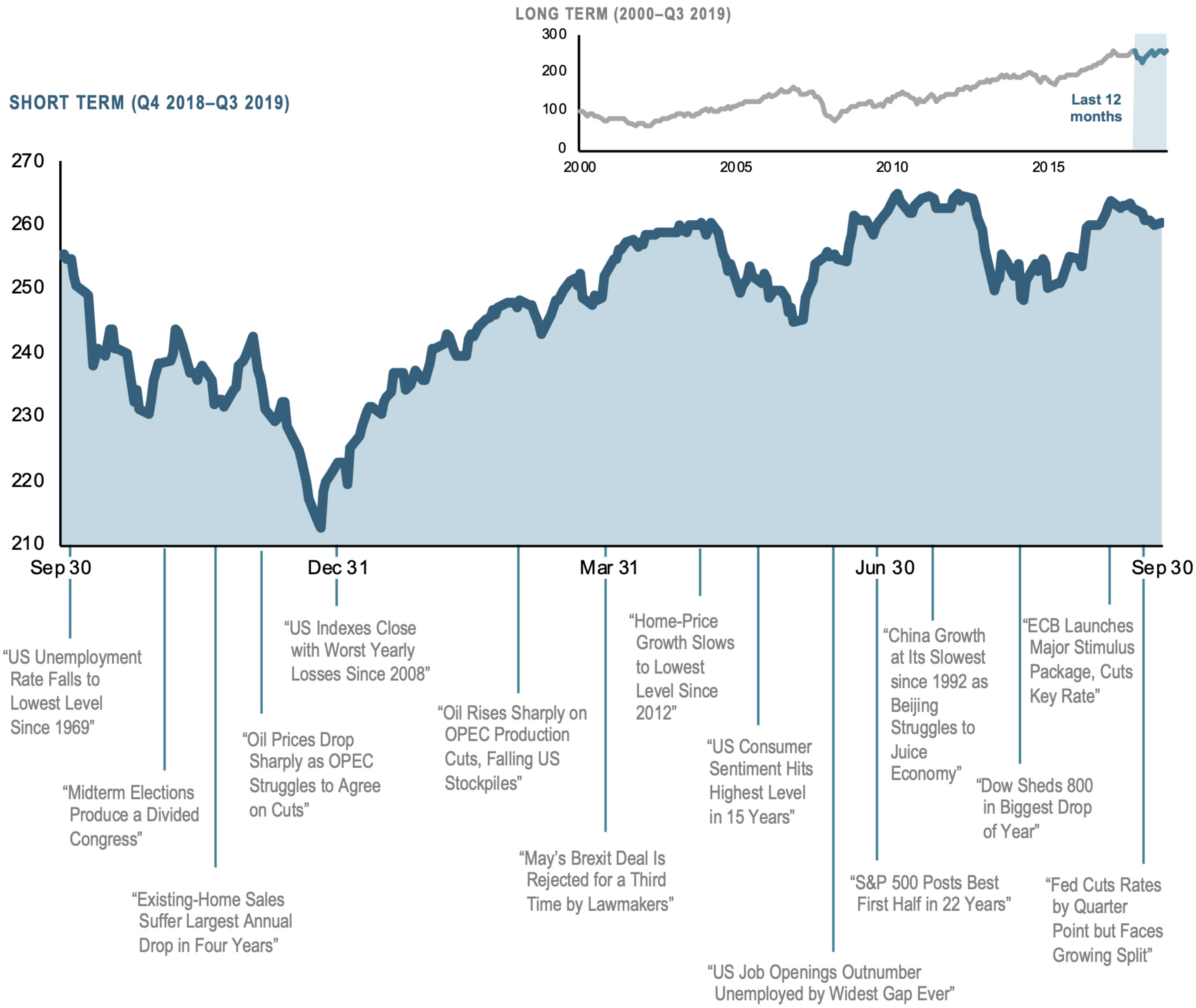
WORLD STOCK MARKET PERFORMANCE

MSCI All Country World Index with selected headlines from past 12 months

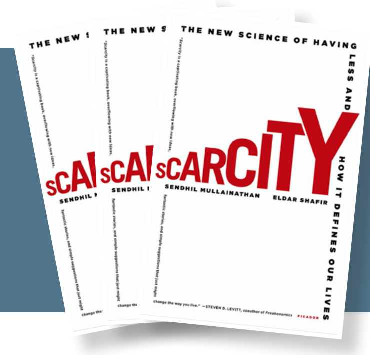
These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.



Graph Source: MSCI ACWI Index [net div.]. MSCI data © MSCI 2019, all rights reserved. It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. Past performance is not a guarantee of future results.

See Important Disclosure Information.

BOOK REVIEW



SCARCITY: THE NEW SCIENCE OF HAVING LESS

AND HOW IT DEFINES OUR LIVES

by Sendhil Mullainathan and Eldar Shafir

Every time I'm running late for work, I forget something. My phone, my wallet, kissing my wife goodbye; it's always embarrassing and the thing I forget is always important. The book, Scarcity, by Harvard economist Sendil Mullainathan and Princeton psychologist Eldar Shafir, gives me some hope that my experience is more universal and less a sign of growing incompetence than I suspect. It also, more importantly, shines a light on the ways I wrongly judge others.

Scarcity, as the authors define it, can apply to a number of things: scarcity of time, of money, of calories (in the case of dieters), of almost any resource. Superficially, scarcity has some benefits. Working under a tight time deadline causes you to laser-focus on the task at hand. A shrinking bank account at the end of the month makes you an expert budgeter.

However, these short-term benefits come with a long-term, often chronic, cost. The effect of creating a laser-focus the authors define as "tunneling;" that is, focusing on the scarce resource to the point that you can't see other obstacles or dangers. I was relieved to discover that my forgetfulness when rushed had a label. But when the issues you're facing are more important, tunneling can lead to more dangerous outcomes. Being focused on an urgent deadline (like finishing speech materials) can lead you to ignore more important issues. The problem becomes even worse when the scarce resource is money; if you are worried about being short of funds to pay your bills this month, you might charge more than you can afford on your credit card to alleviate this immediate concern. But that could create a greater financial problem a month or two later when the late charges kick in.

Related to the problem of tunneling is the "bandwidth tax," a loss of abilities to perform in other areas of your life. A person who has to exert too much effort on a single problem becomes distracted to the point that he or she does not have the energy to perform well in other, possibly more important, areas. The working parent who is constantly pressed to complete the long list of tasks ahead of her at work might fail to give her full attention to helping her child with homework, even if she is able to set aside the time to do so. And again, the problem is most dramatic in the case of poverty. For example, low-income Americans with health issues often do not eat more healthily or take medications (even if the healthy food or medicine is readily available; not always the case in low-income neighborhoods) because even something that simple can feel too hard when your attention is focused on financial survival.

Indeed, a majority of the book is taken up with the problems of scarcity as it applies to the poor, because the impacts of tunneling and a bandwidth tax are so substantial. And this is the most important message of the book: a person doesn't become poor because a failure in his or her character leads to bad choices; rather, a person makes bad choices because of the stress that poverty puts on his or her brain.

The authors make several important points in this regard. First, paying off a poor person's debts on a one-time basis, giving him or her a "fresh start," doesn't work (even though common sense says it should), because sooner or later the ongoing problems of scarcity catches up with that person and he or she ends up in the same indebted condition as before (the authors observe that this approach was actually tried, and failed, with subsistence farmers in third-world countries). Second, and even more importantly, the authors describe several psychological studies that demonstrate that tunneling and the bandwidth tax affect everyone equally, regardless of education or financial background. In other words, an affluent person put in the same conditions of economic scarcity would probably make most of the same bad choices. Failure of resources is not a failure of inherent character.

The cure for scarcity is what the authors call "slack;" that is, sufficient give in the amount of a resource that allows for unexpected shortfalls. An executive earning six figures can probably absorb the cost of a new windshield, broken from a rock chip, with little challenge (other than the annoyance of taking the car in). A single mother working two minimum wage jobs might find the cost (both the monetary and time cost) of repairing that same windshield to be incredibly stressful. The executive has financial slack(and perhaps a bit more time slack); the single mother does not. The authors use the analogy of a suitcase: if you're packing a small suitcase for a long trip, you have to make difficult choices (pack a jacket or pack an umbrella), but if your suitcase is big enough, you have enough spatial "slack" to pack everything you need (even extra items you wind up not using).

When the authors turn to specific solutions, they look to small, incremental changes that, in the aggregate, can make a huge difference. First, recognize the problem. If you're pressed for time at work, working longer hours on a regular basis won't help. In fact, by focusing too much on the scarcity of time, you start to make worse decisions both at work and at home. The resulting tunneling and loss of bandwidth create far more problems than the extra time on the job solves. Of course, this is easy to say, but very hard to implement when you're under the gun to get work projects completed.

Second, look for ways to create slack. The authors use the example of a hospital that was chronically behind on operating rooms. Because of this room shortage, critically injured patients were waiting too long for care. The problem was that urgent cases would have to take priority over less critical cases, causing them all to get backed up. A consultant provided them with a counterintuitive solution: take one operating room out of circulation and hold it in reserve for the greatest emergencies. The hospital staff thought this was a horrible idea; they were already short of space, and now they were going to be down one more room. However, the experiment worked. By dedicating one room for unexpected emergencies, the hospital built slack into its operations. The timeliness of serving patients improved dramatically.

This same approach can be used at work or at home. Build in an hour or two a week (or even a day) to handle the unexpected. Block it out on your calendar and guard the time.

Third, use reminders to end tasks (especially meetings) on time. The authors use the example of an executive who was always timely with his meetings because his assistant always gave him a five-minute warning to wrap up on time. Although most people don't have the luxury of an assistant, technology can help (timers on watches, for instance), as can designated timekeepers in meetings.

Fourth, the authors repeatedly point out that there is often an "abundance-then-scarcity" cycle. Scarcity isn't always a constant situation; there are often times of abundance. During these times, people could plan for the future but often don't. The cure for this problem is to schedule the really important but not urgent items (like time with the family, including school and sporting events) way ahead of time, including travel time, to ensure that they remain a priority even when you are pressed for time later.

The ways to create the cure for financial scarcity, however, is (as the authors themselves admit) the hardest to solve, because the cure for the problems of poverty from this perspective is to have more money. The authors do note some small incremental changes that can help, like requiring employees to opt out of automatic retirement plan contributions rather than opting in. But such small changes cannot by themselves cure the problem of financial scarcity.

In the end, what makes this book great is the way it makes me reorient my own thinking. I know that, whether it's leaving my wallet at home or not really paying enough attention to my wife at the end of long day, I suffer from my own problems of scarcity. Just knowing that I'm paying a bandwidth tax might help me pay less of it. Much more importantly, it is a much needed reminder that people without resources are still just people. No better, no worse. And my judgments about them are more a reflection of my own ignorance and lack of gratitude than of anything about their character or abilities.

IMPORTANT DISCLOSURE INFORMATION

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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