Condor Capital Reviews 3rd Quarter 2018

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Domestic equities posted a strong quarter, with the S&P 500 Index gaining 7.71% The healthcare sector led the way, and the S&P reorganized some of the largest stocks in the market out of tech and into the now expanded communication services sector.

In addition to escalating trade tensions, emerging markets were roiled by country-specific issues in Turkey and Argentina. Developed markets struggled with continued uncertainty over Brexit and the threat of a populist uprising in Italy.

The yield curve continued to move slightly higher and flatter in the quarter as the Fed raised rates for the third time this year. High-yield and short-term issues once again outperformed, with a rising dollar weighing on foreign-denominated debt.

September 2018

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Despite higher gas prices, rising interest rates, and the threat of a trade war, all major domestic stock indices posted record highs during the third quarter of 2018, with the S&P 500 Index finishing the quarter up 7.71%. Healthcare was the top performing sector in the quarter, with innovative new drug launches and an uptick in M&A activity helping to offset concerns about regulatory reform to limit drug prices. Also of note in the quarter, the S&P 500 implemented a sector reorganization affecting a large number of companies, including the so-called "FANG" stocks. Following the reorganization, Facebook, Netflix, and Google are now classified in the communication services sector, whereas Amazon will remain in the consumer discretionary sector. All told, the success of the communication services and healthcare sectors helped propel growth stocks to once again outperform their value counterparts, while large-cap companies outpaced their mid- and small-cap counterparts for the first time in 2018.

International equities lagged domestic markets in the third quarter of 2018, with emerging markets coming in as the worst performer. Intensifying trade concerns sparked a flight from emerging markets assets as President Trump levied tariffs on an additional $200B worth of imports from China. A strengthening dollar prompted an exodus of capital from emerging markets to the U.S. as well. Developed equity markets fared better than the emerging market space but still lagged the U.S. market, due in part to uncertainty over when and how the European Central Bank will go about ending its easy money policies. The impending impact of Brexit still hangs over the European Union as well, an issue that was only exacerbated in the aftermath of an Italian election that saw two populist anti-establishment parties form a coalition government.

The Federal Reserve continues to play a large role in fixed income markets, increasing interest rates for the third time this year at its September meeting. During the quarter, the U.S. yield curve continued to inch higher and flatter, with yields rising by between 20 and 30 basis points across the board. Overall, high-yield bonds were once again the top performer amid a continued risk-on attitude from investors seeking additional yield. Short-term bonds slightly outperformed longer-duration issues, and corporate bonds outpaced sovereign debt thanks largely to the strong corporate landscape and investors' appetite for yield. International debt issues were mixed, with local-currency-denominated debt generally struggling significantly due to the rising U.S. dollar. As with corporate bonds, higher-yielding municipal debt once again outperformed investment grade issues.

Outlook – Domestic equity markets have bounced back from a volatile and slightly negative start to 2018 in the second and third quarters of the year, while bond markets are flat to down. With GDP growth ticking up nicely in the short-term and unemployment continuing to fall after dipping below 4% for the first time since 2000, American workers generally have more money in their pockets, invigorating discretionary spending. A pro-business corporate landscape boosted by tax cuts and deregulation should continue to drive corporate earnings higher as well, with these rising earnings providing a further tailwind for equity markets. Rising rates will continue to be a headwind for bonds in the near term, though it should be highlighted that their coupon payments are becoming increasingly attractive as rates and yields rise.

There are of course reasons for caution. Ever-escalating trade disputes with large trading partners have added uncertainty to an otherwise strong economy. Although these disputes have dragged on longer than we would have liked, the recently signed NAFTA replacement, the U.S.-Mexico-Canada Agreement, may represent something of a light at the end of the tunnel. While negotiations were at times acrimonious, the final deal contained at least some form of various concessions the Trump administration was looking for in a manner agreeable to all parties. We have seen similar developments with the European Union in the form of an early September de-escalation of auto tariffs that sparked speculation of a larger agreement before year-end. While the trade dispute with China appears to be more severe and protracted, more of the pain has been felt abroad than at home, potentially providing the traction for the administration to begin to move bilateral talks along more rapidly.

There are also legitimate concerns that the Federal Reserve's interest rate increases could reduce demand for relatively riskier asset classes like stocks and slow the economy more than expected. It is our view that a greater level of nuance is needed here, as market reactions to interest rate increases have historically been very dependent on the speed and way central banks go about hiking rates. The fact that the Fed has made a point of being slow and deliberate with its rate increases gives us a higher level of optimism than many that equity markets can continue to thrive despite any additional hikes. Furthermore, the ultralow post-recession interest rates of recent years were always meant to be temporary, and even today's rates remain low relative to their historic averages. As a result, the Federal Reserve's moves to raise rates now should be thought of less as a disruptive force to markets and more as allowing the central bank to reload its arsenal so it can be properly prepared to assist markets whenever the next recession hits.

One point we continue to dispute outright, however, is the idea that the bull market is simply too "old" to continue. As we have pointed out through various blog posts and in previous editions of this newsletter, the stock market does not operate on any timeline, especially at a time when the U.S. economy is by some measures the strongest it has been in two decades. While it is inevitable that equity markets will post a negative number at some point in the coming years, attempts to time the market rarely work out and could cause investors to miss out on significant growth. As a result, the better approach is always to set a diversified portfolio with your long-term goals in mind that balances both growth and downside protection and to trust that portfolio over the long run.

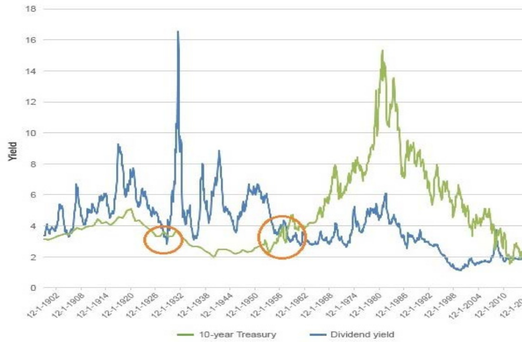
See disclaimer on final page

While indicators have historically proven valuable in evaluating the market, it is crucial to keep in mind the usefulness and reliability of each given the ever-changing nature of markets.

Don't Believe Every Indicator You See

You've heard the phrase: *"The most dangerous words in investing are: 'This time it's different.'"* Right? But sometimes the investing world DOES change, perhaps permanently, and investors have to adjust with the transition. This is made much harder when, as the markets experience adversity, people start posting all sorts of indicators and charts showing that the end is year.

A recent article on the Insecurity Analysis blog notes a couple of interesting examples. One is the idea, which dominated the pre-1950s investment scene, that stocks should always yield more than bonds. Why? Because stocks are riskier, and therefore nobody would buy them unless they produced a higher dividend yield. Whenever the dividend yield fell below what you could get from Treasuries, it was considered a strong sell signal for more than 50 years.



As you can see from the chart, where the green line is one of the safest bond investments in the marketplace, and the blue line is the dividend yield of S&P 500 stocks, this sell indicator was pretty much true until around 1955, at which time 10-year Treasuries began to out-yield stocks—and the difference persisted, and even increased, for more than half a century. Why? Because equity investors began to look for rising stock prices as the chief source of their return. The world changed.

As you look at the chart, it's interesting to note that recently Treasuries and stocks have been yielding about the same in recent years. This may be one reason why people have been willing to buy and hold stocks even though they're expensive by historical standards. The alternatives—at least in terms of yield—are not compelling.

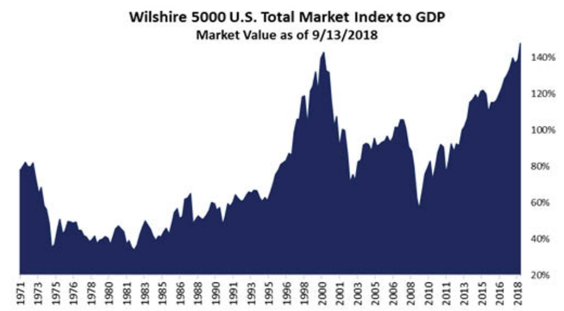
What else has changed? In the past, stock traders watched the ratio of the total value of the U.S. stock market to the total U.S. GDP, as an indicator of when the market was becoming dangerously overvalued. You can see this ratio over the years from the chart on the bottom right, going back to 1971, and indeed in the runup to the great tech crash, this indicator was sending sell signals. It was also sending lesser signals during the runup to the 2008-2009 market decline. And today—oh boy…

How could things be different today than in the past? The next chart shows that, over time, American companies have been generating a growing amount of their profits overseas, which means that comparing their value to the strictly U.S. economy—where only somewhere between 65% and 80% of their profits are coming from—becomes less relevant. The signal may have meant something the past, but today it is increasingly meaningless.

Finally, some traders have traditionally determined when equities were overvalued by looking at the ratio of U.S. stock valuations to foreign stock valuations in aggregate—the S&P 500's price-to-book ratio divided by the MSCI All-World Index that excludes U.S. companies. As you can see from the chart, U.S. stocks became quite a bit pricier in 2007 and early 2008 before the global selloff, and now the U.S. market—by this measure, at least—has moved into uncharted territory.

There's no question that American companies are currently priced at higher multiples than comparable companies in Europe and Latin America. But aggregate charts like this one may be less informative today than they have been in the past. Why? The composition of U.S. companies has moved in a different direction from the overall world index. Today, 24% of the U.S. market cap is in the technology sector, which traditionally trades at higher multiples than, say, materials or energy. By way of comparison, just 6% of the MSCI World index is in the tech sector. The U.S. market is 14% weighted in health care—another high multiple sector—compared with 9% for the rest of the world. Our companies are trading higher, in part, because they happen to be operating in more profitable sectors.

No doubt traders and analysts will come up with creative new metrics to evaluate whether the U.S. stock market is overvalued. But if you're reading about these metrics today as the markets experience unusual turbulence, and the article suggests that the metric is a sure indicator of the future, you might want to remember a new phrase: the world is constantly evolving, and whatever prediction mechanism might have worked in hindsight to explain the past may not do such a great job of predicting the future.



Down the Donut Hole: The Medicare Coverage Gap

While the Medicare provision often called "donut hole" may be confusing, here are a few items to consider that may form a clearer picture.

One of the most confusing Medicare provisions is the prescription drug coverage gap, often called the "donut hole." It may be clearer if you consider the gap within the annual "lifecycle" of Medicare Part D Prescription Drug Coverage. This also applies to drug coverage that is integrated into a Part C Medicare Advantage Plan.

Annual deductible. Prescription drug plans typically have an annual deductible not exceeding $405 in 2018. Before reaching the deductible, you will pay the full cost of your prescriptions, although you may receive negotiated discounts.

Initial coverage period. After you meet the annual deductible, your plan will pay a portion of your prescription drug costs, and you will typically have a copayment or coinsurance amount. A 25% coinsurance amount is the standard coverage required by Medicare, but most plans have different levels or "tiers" of copayments or coinsurance for different types of drugs.

Coverage gap. When you and your plan combined have spent a specified amount on drugs for the year ($3,750 in 2018), you enter the coverage gap. In 2018, you pay 35% of your plan's price for covered brand-name prescription drugs and 44% of the price for generic drugs. The gap is closing over the next two years (see chart).

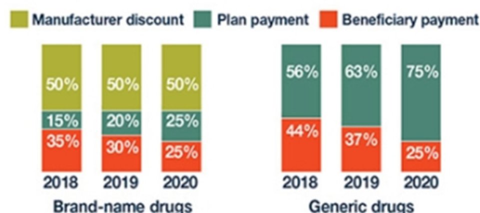
You remain in the coverage gap until you reach an annual out-of-pocket spending limit ($5,000 in 2018). Spending that counts toward the limit includes your deductible, copay, and coinsurance; the manufacturer's discount on brand-name drugs in the coverage gap; and your out-of-pocket payments in the gap. It does not include your premiums, the amount the plan pays, or your payments for noncovered drugs.

Catastrophic coverage. Once you have reached the out-of-pocket limit, you receive catastrophic coverage with much lower payments. In 2018, you would pay the greater of 5% of drug costs or $3.35/ $8.35 for each generic and brand-name drug, respectively.

Some plans have more generous coverage in the gap. You may be able to avoid the coverage gap by using generic medicine, when appropriate, to lower your drug costs.

CLOSING THE GAP

Beginning in 2013, the Affordable Care Act required drug manufacturers to provide a 50% discount on brand-name drugs, and since then the percentage that beneficiaries must pay has been gradually reduced. By 2020, beneficiaries will pay no more than the standard 25% coinsurance amount for all covered drugs, effectively ending the coverage gap.



Source: Centers for Medicare & Medicaid Services, 2017

I just received a large bill for a recent hospital visit. How can I check whether it's accurate?

Sometimes medical bills contain an error that is difficult to identify. Read on to see what you can do to spot and fix them.

In today's complex world of medical billing, you may have difficulty understanding exactly which procedures you're being charged for, or what the billing codes on your hospital bill mean.

The first step in determining whether your bill is accurate is to know exactly what your insurance does and does not cover. Review your health plan's coverage brochure or contact your insurer to find out about your plan's coverage exclusions or limitations, expenses that are fully or partially covered by your plan, and the ramifications of using an out-of-network provider.

Another helpful tool is an explanation of benefits (EOB). The EOB will provide you with a variety of information, such as the dates and type of services provided, the amount that was billed by the medical provider to the insurance company, what the insurance company paid to the provider, and the amount that wasn't covered and for which you are responsible. Review your EOB and compare it to your medical bills. If you find any discrepancies, contact your medical provider's billing department.

Unfortunately, errors are a common occurrence in the medical billing industry. As a result, it's always important to request an itemized bill, as opposed to just a summary of charges, from a medical provider. An itemized bill is critical when it comes to identifying billing errors because it will detail each medical procedure for which you are being charged. Once you've received your itemized bill, check to make sure that all of your identifying information (e.g., address, date of birth), dates of service, and insurance information are correct. In addition, you'll want to check for common billing errors, such as charges for duplicate procedures or incorrectly coded procedures.

If you find an error on your bill, contact the billing department of the medical provider to request a corrected insurance claim and/or bill. Be prepared to explain the mistake to the billing representative and provide copies of billing records that illustrate the billing error.

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When should I submit college financial aid forms?

For the 2019-2020 school year, the federal government's financial aid form, the FAFSA, can be filed as early as October 1, 2018. It relies on current asset information and two-year-old income information from your 2017 tax return, which means you'll have the income data you need when you sit down to complete the form. This is a relatively new process. A few years ago, parents had to wait until after January 1 to file the FAFSA and use tax data for the year that had just ended, which forced them to scramble to complete their tax return in order to complete the FAFSA.

If you have a new or returning college student, it's a good idea to file the FAFSA as early as possible in the fall because some aid programs operate on a first-come, first-served basis. The deadline for filing the FAFSA is typically March or April and will vary by college. But don't wait until then. It's a good idea to submit any college aid forms as early as possible, too.

The FAFSA is a prerequisite for federal student loans, grants, and work-study. In addition, colleges typically require the FAFSA before distributing their own need-based aid and, in some cases, merit-based aid. Even in cases when you don't expect your child to qualify for need-based aid, there may be another reason to submit the FAFSA. All students attending college at least half-time are eligible for federal unsubsidized Direct Loans regardless of financial need. ("Unsubsidized" means the borrower, rather than the government, pays the interest that accrues during school, the grace period after graduation, and any deferment periods.) So if you want your child to have some "skin in the game" with a small loan, you'll need to file the FAFSA. (Loan amounts are capped each year: $5,500 freshman year, $6,500 sophomore year, and $7,500 junior and senior years.) What if you file the FAFSA but then change your mind about taking out a loan? Don't worry, you aren't locked in. Your child can always decline the loan after it's offered.

The FAFSA is available online at fafsa.ed.gov. In order to file it, you'll need to create an FSA ID if you haven't done so already (follow the online instructions). You'll need to resubmit the FAFSA each year, but fortunately you can use the built-in IRS Data Retrieval Tool to have your tax data electronically imported, which saves time and minimizes errors.

What are the new rules for 401(k) hardship withdrawals?

The Bipartisan Budget Act passed in early 2018 relaxed some of the rules governing hardship withdrawals from 401(k)s and similar plans. Not all plans offer hardship withdrawals, but the ones that do will be required to comply for plan years beginning in 2019.

In order to take a hardship withdrawal from a 401(k) or similar plan, a plan participant must demonstrate an "immediate and heavy financial need," as defined by the IRS. (For details, visit the IRS website and search for Retirement Topics - Hardship Distributions.) The amount of the withdrawal cannot exceed the amount necessary to satisfy the need, including any taxes due.1

Current (pre-2019) rules

To determine if a hardship withdrawal is qualified, an employer may rely on an employee's written statement that the need cannot be met using other financial resources (e.g., insurance, liquidation of other assets, commercial loans). In many cases, an employee may also be required to take a plan loan first.

Withdrawal proceeds can generally come only from the participant's own elective deferrals, as well as nonelective (i.e., profit-sharing) contributions, regular matching contributions, and possibly certain pre-1989 amounts.

Finally, individuals who take a hardship withdrawal are prohibited from making contributions to the plan — and therefore receiving any related matching contributions — for six months.

New rules

For plan years beginning after December 31, 2018, the following changes will take effect:

1. Participants will no longer be required to exhaust plan loan options first.
2. Withdrawal amounts can also come from earnings on participant deferrals, as well as qualified nonelective and matching contributions and earnings.
3. Participants will no longer be barred from contributing to the plan

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