Condor Capital Reviews 3rd Quarter 2019

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Domestic equities posted yet another positive quarter, though the S&P 500 Index's 1.70% gain was less than in the prior two quarters. Defensive sectors, such as utilities, real estate, and consumer staples, led the way, while energy was the worst performer. Large caps outperformed their smaller counterparts, and value stocks posted their best performance relative to growth names in a number of quarters.

International equities generally underperformed, and trade remains a driving factor. On one hand, news that Japan negotiated a bilateral trade deal with the U.S. helped it post some of the quarter's top performance, while on the other, escalating U.S. trade tensions continued to weigh on Chinese stocks.

The Federal Reserve continued to cut interest rates in the third quarter, once again sending yields lower and prices higher. Corporate bonds outperformed municipals, and longer-term and higher-yielding issues generally fared best.

September 2019

Markets in the third quarter of 2019 were relatively flat, as investors appeared to be deadlocked between a persistently durable domestic economic outlook and a number of swirling uncertainties. The S&P 500 Index, a grouping of the largest 500 publicly traded companies in the U.S., ticked higher by 1.70% in the quarter, and the index has now gained 20.55% through the first three quarters of the year. Relatively defensive sectors, such as utilities, real estate, and consumer staples, were the top performers in the period, as investors looked to de-risk a bit and take advantage of the relatively attractive dividend yields offered in those areas amid falling bond yields. Large caps outperformed mid- and small-cap stocks, and while growth and value performed relatively evenly among large caps, value names led their growth counterparts somewhat notably in the mid- and small-cap spaces.

International equities tended not to fare as well as their domestic counterparts in the third quarter. Emerging markets were more negative than their developed peers, as the highly important Chinese market continues to grapple with persistent protests in Hong Kong and a U.S. tariff dispute that does not have a catalyst for a near-term solution. Meanwhile in Latin America, shock election results in Argentina cut that country's currency value in half overnight, and concerns over a ballooning current account deficit weighed on Brazil's market. As for developed nations, Japan led the Asia-Pacific region amid news that the country would finalize a bilateral trade deal with the United States. Europe, which finished the quarter slightly positive overall, benefitted from a new round of stimulative monetary policies from the European Central Bank and, as with the U.S., defensive stocks generally outperformed more cyclical names.

Amid the recent interest rate cuts by the Federal Reserve and some question marks emerging in the global growth story, bond yields across the board have continued to fall. In fact, 10-year Treasuries approached record lows early in September and the yield curve remains persistently flat. Given the inverse correlation between bond yields and their prices, these lower yields resulted in another generally positive quarter for fixed income, with corporate bonds beating out municipal issues and longer-term and higher-yielding issues tending to outperform. Beyond the Federal Reserve, a number of central banks globally are undertaking rate cut programs as well, pushing already-low (and sometimes negative) yields even lower in many foreign regions.

Outlook – The third quarter of 2019 was largely characterized by a stark contrast between persistently positive market conditions, especially domestically, and negative headlines that injected uncertainty into investor sentiment. For example, the mid-September attack on two Saudi Arabian oil facilities, which disrupted global oil production by roughly 5 million barrels per day, marked a potentially major escalation in the region. While the relatively recent increase in U.S. shale production leaves the global oil market in a better position to withstand such a supply disruption than ever, the larger threat that a serious escalation or miscalculation between feuding nations could explode into a broader conflict cast a pall over global markets. Meanwhile, the House of Representatives' decision to launch a formal impeachment inquiry into President Trump ratcheted up tensions and uncertainty on the domestic front, especially entering a campaign season and election that was already going to create question marks. Considering the ongoing issues internationally surrounding U.S.-China trade relations and the potential for a disruptive "hard" Brexit as well, investors generally appear to be taking a cautious approach.

That being said, there are still many positive factors that should continue to buoy markets. First and foremost, the underlying U.S. economy remains very robust. With unemployment at a near 50-year low, a strong argument can be made that we are in the midst of the strongest domestic labor market in decades. This is evidenced by elevated consumer spending levels which, given that consumer spending makes up almost 70% of domestic GDP, continue to support the business environment and be the main engine for U.S. growth. That this consumer strength has persisted despite potential cost increases from the various U.S.-issued tariffs is a further cause for optimism. Finally, the Federal Reserve has completely shifted from its 2018 stance and is now firmly in a position to cut interest rates and undertake other accommodative monetary policies. This positioning is much more in line with investors' appetites and is providing an important backdrop of support to equity markets.

Moving forward, it is unclear how these uncertainties will play out. Still, we at Condor remain cautiously optimistic moving forward. Any positive developments on any of the aforementioned uncertainties should be accretive to returns, and a significant number of central banks appear at the ready to spring into action should any of these situations worsen. Additionally, we see no signs that the domestic labor market cannot continue to blossom, which should in turn continue to flow through to strong consumer spending and economic growth.

Regardless of our short-term outlook, however, we continue to emphasize the need for a balanced, risk tolerance-appropriate portfolio that can weather short-term fluctuations in pursuit of your longer-term goals. Selling based on headlines or negative shocks remains a great way to miss out on the inevitable recoveries, and all-in or all-out calls are always too extreme. As always, the ideal approach for a long-term investor is to set a diversified, risk-appropriate portfolio and to maintain a focus on the big picture.

A brief history of the federal income tax, from the Civil War to the 16th Amendment, as well as what may lie ahead.

Federal Income Tax: How Did We Get Here?

April 16, 2019 was an important day for many of us. But do you know why? It was Tax Freedom Day — the day when the average American theoretically earned enough to pay his or her tax obligations for the year. According to the Tax Foundation, Americans will pay $3.4 trillion in federal taxes in 2019, more than they spend on food, clothing, and housing combined.* But it wasn't always this way. In fact, income taxes are a fairly new development in the overall history of America. So how did we get to this point?

In the Beginning...

The United States was founded, in part, on the premise that colonists didn't want to pay taxes without representation, which led to the famous tossing of tea into the Boston Harbor and the American Revolution. However, not long after the colonies gained their freedom from England, Congress passed the Stamp Act of 1797, which essentially was our nation's first estate tax. Otherwise, from the early 1790s to 1802, the U.S. government was supported by taxes on such items as spirits (alcohol, not the ghostly kind), sugar, tobacco, and corporate bonds.

Wars played a big part in the history of taxation in this country. To fund the War of 1812, Congress taxed sales of gold, silverware, jewelry, and watches. In 1817, tariffs on imported goods provided the main source of revenue to run the government.

With the onset of the Civil War, Congress enacted the nation's first income tax law, the Revenue Act of 1861, which included a flat tax of 3% on annual incomes exceeding $800 to help pay for the costs of the war. That tax law was repealed and replaced by the Revenue Act of 1862, which established the Office of the Commissioner of Internal Revenue (forerunner to the Internal Revenue Service), levied excise taxes on most goods and services, and replaced the flat tax with a progressive tax.

The 16th Amendment

However, it was not until 1913 with the adoption of the 16th Amendment to the Constitution, that the income tax became a permanent fixture in the American tax system. Congress now had the authority to tax income of both individuals and corporations. It didn't take the IRS long to start inundating us with forms, beginning in 1914 with the introduction of the first income tax form, the dreaded Form 1040. Enactment of the Revenue Act of 1916 introduced tax rates and income scales.

Tax Rates

Here's a sobering fact: In 1913, the top federal income tax bracket was 7% on all income over $500,000, and the lowest tax bracket was 1%. During the Great Depression, Congress raised the highest tax bracket to 63%. Wars can be expensive, as evidenced by the jump in the highest tax rate to 94% during World War II. In 2018, the highest income tax rate was lowered to 37%.

Trying to Get it Right

Over the years, there have been frequent attempts to reform the tax law in some manner. We've seen the adoption of the alternative minimum tax, Social Security tax, taxes on cigarettes and alcohol, gasoline taxes, aviation taxes, property taxes, telecommunication taxes, not to mention state and local taxes. To quote Will Rogers, "The difference between death and taxes is death doesn't get worse every time Congress meets."

Tax laws are always changing and will likely remain a political hot potato. Only time will tell what changes are ahead, but there is no doubt that through taxation, what the government giveth, it inevitably taketh back again.

**Tax Freedom Day 2019 was April 16, as calculated by the Tax Foundation, taxfoundation.org.*

America's Social Security program faces looming demographic challenges in the years ahead. What can be done about it, and what effect could the program's current status have on your benefits?

Social Security: Shoring Up America's Safety Net

Ever since a legal secretary named Ida May Fuller received the first Social Security retirement check in 1940, Americans have been counting on Social Security to provide much-needed retirement income. For many older Americans, Social Security is their main source of guaranteed retirement income — income that continues throughout their lifetimes and is indexed for inflation every year (in 2019, the cost-of-living adjustment, or COLA, was 2.8%).

Social Security provides more than just retirement income, though. It also provides disability and survivor insurance benefits. About 62 million people — more than one in six U.S. residents — collected some type of Social Security benefit in 2018, with approximately 80% of these recipients receiving Social Security retirement or survivor benefits.[1]

How Social Security Works

Social Security is a pay-as-you-go system, which means that payments from current workers (in the form of payroll taxes) fund benefits for current beneficiaries. The payroll tax rate for Social Security is 12.4%, with 6.2% paid by the employee and 6.2% paid by the employer (self-employed individuals pay the entire 12.4%). These payroll taxes are deposited into the Old-Age and Survivors Insurance (OASI) trust fund (for retirement and survivor benefits) and the Disability Insurance (DI) trust fund (for disability payments).

Because of demographic and economic factors, including higher retirement rates and lower birth rates, there will be fewer workers per beneficiary over the long term, worsening the strain on the trust funds. This year, the trustees of Social Security reported that the OASI trust fund is projected to run out in 2034. After that, payroll tax revenue alone would be sufficient to pay 77% of scheduled benefits.

Ideas for Reform

There has been little national consensus by policymakers on how to deal with Social Security's looming demographic challenges. Meaningful reform will require broad bipartisan support, and the trustees have urged Congress to address Social Security's challenges sooner rather than later, so that solutions will be less drastic and can be implemented gradually, lessening the impact on the public.

Some Social Security reform proposals on the table include:

- Raising the current Social Security payroll tax rate — according to the 2019 trustees report, an immediate and permanent payroll tax increase to 15.1% (up from the current 12.4%) would be necessary to address the long-range revenue shortfall (16.05% if the increase started in 2035)
- Raising or eliminating the ceiling on wages currently subject to Social Security payroll taxes ($132,900 in 2019)
- Raising the full retirement age beyond the currently scheduled age of 67 (for anyone born in 1960 or later)
- Reducing future benefits—to address the long-term revenue shortfall, the trustees have noted that scheduled benefits would have to be immediately and permanently reduced by about 17% for all current and future beneficiaries, or by approximately 20% if reductions were applied only to those who initially become eligible for benefits in 2019 or later
- Changing the formula that is used to calculate benefits
- Changing the formula that is used to calculate the annual cost-of-living adjustment for benefits

Understand Your Retirement Benefits

The amount you'll receive from Social Security is based on the number of years you've worked, the amount you've earned over your lifetime, and the age when you file for benefits. Your benefit is calculated using a formula that takes into account your 35 highest earnings years, but you don't need to work for that long to qualify for retirement benefits. Generally, you need to have earned a minimum of 40 work credits, which is about 10 years of work in a job covered by Social Security. If you haven't worked long enough to qualify on your own, you may qualify for spousal benefits based on your spouse's work record. A spousal benefit claimed at your full retirement age is generally equal to 50% of the primary worker's full benefit.

You can get an estimate of your future Social Security retirement benefits by visiting the Social Security website at ssa.gov and using the Retirement Estimator tool or by viewing your Social Security Statement. Your personalized statement contains a detailed record of your earnings history, as well as estimates of the retirement, survivor, and disability benefits you can expect at different ages. To view your statement online, you'll first need to register. If you haven't registered online, you'll receive your Social Security Statement in the mail every year if you are age 60 or older and not yet receiving benefits.

[1] *Top Ten Facts About Social Security, Center on Budget and Policy Priorities, August 14, 2018*

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How Can I Teach My High School Student the Importance of Financial Literacy?

Even though your child is just in high school, he or she may still have to deal with certain financial challenges. Whether this involves saving for an important purchase like a car or learning how to use a credit card responsibly, it's important for your high schooler to have a basic understanding of financial literacy concepts in order to manage his or her finances more effectively.

While financial literacy offerings in schools have increased in popularity, a recent study reported that only 17 states require high school students to take a personal finance course before they graduate.[1] Here are some ways you can teach high school students the importance of financial literacy.

Advocate Saving. Encourage your children to set aside a portion of any money they receive from an allowance, gift, or job. Be sure to talk about goals that require a financial commitment, such as a car, college, and travel. As an added incentive, consider matching the funds they save for a worthy purpose.

Show Them the Numbers. Use an online calculator to demonstrate the concept of long-term investing and the power of compound interest. Your children may be surprised to see how fast invested funds can accumulate, especially when you match or contribute an additional amount each month.

Let Them Practice. Let older teens become responsible for paying certain expenses (e.g., clothing and entertainment). The possibility of running out of their own money might make them think more carefully about their spending habits and choices. It may also encourage them to budget their money more effectively.

Cover the Basics. By the time your children graduate from high school, they should at least understand the basic concepts of financial literacy. This includes saving, investing, using credit responsibility, debt management, and protection planning with insurance.

[1] Survey of the States, Council for Economic Education, 2018

Should Parents "Go for Broke" on Youth Sports?

Many parents encourage their kids to play organized sports because they believe the experience will be good for their physical and mental well-being. Athletic participation often provides an opportunity to instill discipline and develop social skills that could have a positive impact on their children's futures.

But kids play has morphed into big business. In 2018, the size of the U.S. youth sports market was estimated to be about $17 billion.[1]

The costs can really add up at more competitive levels, when payments for professional instruction, specialty equipment, and travel kick into high gear. On average, families with children who competed on elite teams spent an average of $3,167 per player in 2018, up from $1,976 in 2013.[2]

Lofty hopes and dreams might inspire some parents to overspend on youth sports. In fact, surveys suggest that many parents are willing to make big financial sacrifices to cover athletic costs, possibly even taking on credit card debt or delaying retirement.[3] Unfortunately, some parents may have unrealistic expectations, such as those who are confident their children will become professional athletes, despite the very long odds against it.

Parents who assume that investing in athletics will pay off with college scholarships are also likely to end up disappointed. Only about 2% of high school athletes benefit from athletic awards, and few of them are "full rides." Coaches often have more roster spots to fill than available scholarships, so many athletes receive partial awards that may cover only a small fraction of tuition costs.[4]

Although most parents have good intentions, there may be some unhealthy side effects. According to a 2016 research study, young athletes whose families devoted a large portion of their household income to sports felt more pressure to succeed and were less likely to enjoy the experience.[5] And even if their kids love to play, parents should attempt to keep the costs in an affordable range so that other important financial goals (such as saving for college and retirement) are not neglected.

[1] WinterGreen Research, 2018

[2-4] *The Wall Street Journal,* April 21, 2019

[5] *Family Relations,* April 2016