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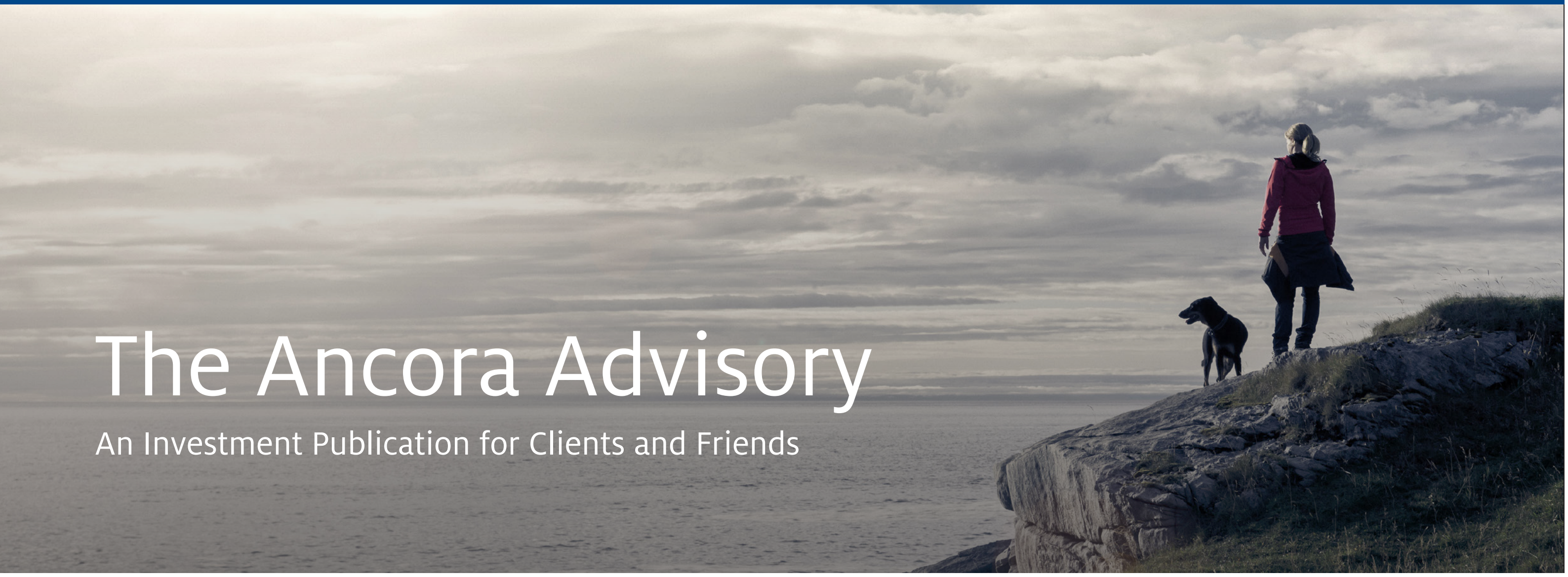
Second Quarter 2019



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U.S.-China Trade Conflict: Long-Term Market Disruption or Short-Term Noise?

John Micklitsch, CFA CAIA
Chief Investment Officer

The step backward in U.S.-China trade talks has unsettled markets. This has caused fundamental and technical disruptions short-term, but longer-term, fundamentals probably will be ok given the stakes for both parties. Below are a few data points and perspectives, as well as a revisit of the temporary versus permanent risk concept investors can resort to during periods of increased volatility that might be helpful in the current environment.

- The S&P 500 Index was recently down approximately 5.6% from highs due largely to the breakdown in trade talks between the U.S. and China. Small cap stocks, as measured by the Russell 2000 Index, are off roughly 7.7% from their highs. Both indices are still up sharply for the year. Clearly, the trade issue has grabbed investors' attention once again. In a flight to safety, the 10-yr U.S. Treasury yield has fallen from 2.53% to 2.25%. Valuation on the S&P 500 at current prices is approximately 15.9x forward earnings with a forward dividend yield of roughly 2.0%.
- Recall that, on average, the S&P 500 experiences a decline of 10-12% about every year with the market still finishing in positive territory for the full year roughly 75% of the time. The wall of worry items that cause the declines are usually different and they always feel significant and unique to the moment, but businesses, the economy and policies adapt, which protects against derailment of the long-term, upward trajectory of markets when given enough time.
- Estimates project that sustained tariffs could cost the U.S. economy 0.4-0.5% of real GDP growth as buyers at all points along the supply chain adjust. Tariffs artificially increase costs, slowing down the rate of consumption (and therefore the velocity of money), which causes a headwind for GDP. For China, the disruption costs are estimated closer to 1.0-1.5% in lost growth. China, however, is starting from a place of higher real growth versus the U.S. Nevertheless, China could see its GDP growth fall from the 6.0-6.5% level down to the 5.0-5.5% level. The U.S. could see 2.50-2.75% real GDP growth slip closer to the 2.0-2.25% level under a protracted conflict.
- Most bear markets (declines of 20% or more) are associated with a recession and, while the figures noted above would represent a

slowdown in the U.S. economy, they are not indicative of a recession at this point, in our opinion.

- Because the U.S. imports more from China than China imports from the U.S. and the U.S. is the bigger economy, the U.S. is thought to hold leverage in the negotiations and some would argue the Administration is simply pressing its advantage now. On the other hand, China's greatest point of leverage is time, as the 2020 election cycle looms and the Administration would most assuredly like the issue off the table well before then. Sensing this, the Chinese may be trying to extend the negotiation window to try to get a better deal. Time will tell who is bluffing. The next time it appears that Presidents Trump and Xi could meet face-to-face is June 28-29 at the G20 Summit in Japan.
- A more ominous consideration for a quick resolution is if trade talks broke down because hard line members of China's Communist Party have convinced President Xi that any deal is tantamount to 200 more years of humiliation at the hands of the West and that no deal is the best deal. With a population of 1.4 billion and a rising middle class, China needs access to the U.S. markets to create jobs and maintain political stability. That makes the no-deal route a challenge. Another bigger-picture consideration is that this is an emerging battle over global Internet/technology leadership itself and that, given the importance of advanced technology initiatives such as 5G, this dispute could usher in what some are calling a new technology "cold war" and a gradual shift from a G20 led world to a G2 led world focused on U.S. and Chinese policy.
- The U.S. remains one of the most open and least-tariffed economies in the world. In some sense, that goes with being the leader of the free world. These talks, therefore, are probably more a recognition that China, as the world's second largest economy, is all grown up now (and then some) and no longer needs a tilted economic playing field like other emerging trading partners or less-stable economies. Although the Chinese instinctively may sense the shift as well, a desire to preserve the status quo combined with their ability culturally to "save face" under the current negotiation framework is limited and may be contributing to the difficulty of the talks.
- In terms of investment strategy, most successful, long-term investors tend to think of periods of volatility as buying opportunities at some point, especially as you get deeper into the pullback/correction.
- While both sides appear to have retreated to neutral corners, the market continues to handicap that a resolution or further "stand-down" is possible, which would make the current impasse temporary if it played out that way. Even if it is not temporary, economic moderation is not the same as heading for a recession. Businesses and consumers adjust to economic conditions as does policy, including perhaps the FED's willingness to lower interest rates to support the economy. Temporarily, however, investors' desire for a higher margin of safety may spike until the new normal sets in, after which markets and individual companies can begin to rebuild their momentum. When you are living it, temporary can feel like a long time, but in the context of a long-term financial plan, it is not. ◊

How Vulnerable are U.S. Treasuries in a Trade War?

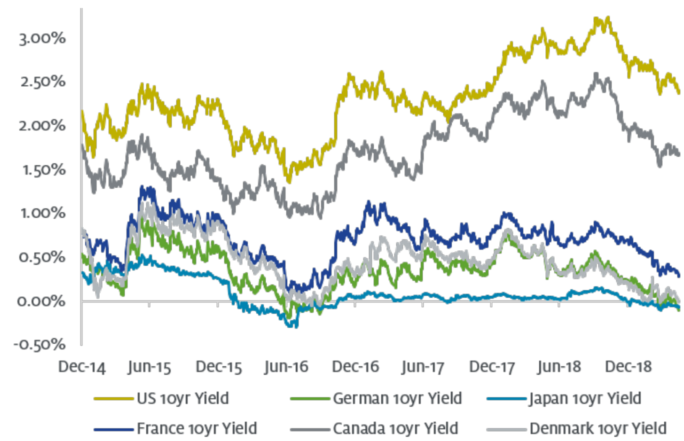
Kevin Gale
Managing Director, Fixed Income

At the present time, the United States has $22 trillion of outstanding government debt. Over each of the next five years, the national deficit is expected to be around $1 trillion annually. Additional deficits and existing government debt maturities make it very important that investors maintain demand for U.S. Treasuries.

Since the financial crisis in 2008, outside of the Federal Reserve which owns $2.46 trillion of U.S. Treasuries, China has become the largest single holder of U.S. Treasury securities at $1.13 trillion. As the trade war between the U.S. and China continues, speculation persists that China could sell most or even all of its Treasury holdings in retaliation for the U.S. tariffs.

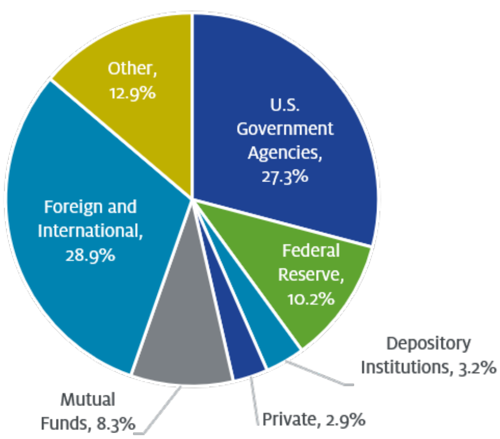
We believe that China dumping its Treasury holdings would be a last resort measure. Over the years, China has accumulated over $3 trillion of foreign currency reserves that need to remain safe. The safest and most liquid investments for these reserves are in developed country government bonds. Yields on U.S. Treasuries are the highest of any developed country, offering China the biggest return on these investments.

Developed Country 10-Yr Debt Yields



Source: Bloomberg

U.S. Treasury Owners



Source: Federal Reserve Bank of St. Louis

Initial reaction to the thought of China selling its U.S. Treasuries would lead us to believe that Treasury yields would spike on the news. While this is certainly a possibility, it is also very reasonable to conclude that U.S. Treasury yields could then ultimately actually fall even after an initial knee-jerk spike. The reason for a decline in yields would be increased concerns that the trade war between the U.S. and China could drag on for longer than anticipated, potentially leading to a slowdown in global growth or even a global recession.

The good news is even if China were to stop purchasing U.S. Treasuries and reduce its holdings, we believe there will be enough demand by other investors to pick up the slack. Of the $22 trillion of outstanding U.S. Treasuries, $5.8 trillion, or 27%, is intragovernmental debt, owned by U.S. federal agencies such as Social Security, Federal Retirement Funds and Medicare. The remaining $16 trillion of debt is owned by public holders including foreign investors and governments (40%), pensions and local governments (10%), the Federal Reserve (16%) and mutual funds/banks (18%).

In the unlikely scenario that investors decide not to pick up the slack from China's reduced holdings, we believe there is a very high likelihood that the Federal Reserve would step in and resume purchasing U.S. Treasuries to combat a significant spike in yields. Every day the trade war drags on, the likelihood increases that China will sell U.S. Treasuries in retaliation. While there is certainly reason to be concerned over this tactic, overall, we believe the impact on yields would be minimal. We see no reason to panic over this threat and would not look to significantly reduce duration in bond portfolios as a result. ◊

How Reading Shareholder Letters Can Make You a More Successful Investor and Business Person

John Micklitsch, CFA CAIA
Chief Investment Officer

Every year, several public company CEO shareholder letters go beyond updates about their company and tackle issues related to the overall economy, governance, business management and long-term trends. In some regard, these letters are mini-MBA courses from some of the best business minds in the world. As a result, each year we endeavor to offer you what we believe are some of the most salient points from several that we enjoy reading. Here goes.

Berkshire Hathaway Inc. 2018 Shareholder Letter, Warren Buffett - Chairman & CEO

The granddaddy of all shareholder letters, Warren Buffett's annual shareholder letter is likely the most anticipated annual letter of its kind. In many regards, Buffett created the highly educational format that today's most thought-provoking letters utilize. He built the template and has perfected it as a means of communication. In 2018 he continued to emphasize perhaps the most important tenant of successful investing; focus on the long-term quality of the business (as a business owner would) and tune out short-term noise.

Buffett also practices a management technique whereby he praises individuals publicly by name yet takes personal responsibility for most of Berkshire's shortcomings in a given year. This example of leadership not only builds tremendous loyalty but is also good business. If you had a choice in terms of who you could sell your business to, would this type of leadership approach tip the scales in Berkshire's favor? You bet it would - and Buffett is a master at building an environment conducive to getting that all important "first call" when there is a deal to be had.

This year, Buffett also emphasizes the importance of retained earnings. This is a concept that is applicable to both corporations and individuals. Corporations have retained earnings when there is a profit that they decide to keep (rather than pay out to shareholders). Individuals have retained earnings when they spend less than they make. What you do with retained earnings is equally important for both companies and individuals. Retained earnings, invested wisely, become the foundation for the future financial fortress that both businesses and individuals seek.

JPMorgan Chase & Co. 2018 Shareholder Letter, Jamie Dimon - Chairman & CEO

Chairman and CEO Jamie Dimon breaks up the JP Morgan shareholder letter into three parts:

1. JP Morgan Chase Principles and Strategies: In this section, Dimon explains to the company's various constituents (its shareholders, employees, customers and communities served) how the company is run via seven overarching principles and strategies. Transparency and communication build trust which creates long-term political capital with its constituents that the company can rely on if it ever needs to. This section also establishes a cultural road-map for employees. Jamie Dimon can't possibly be in every situation that requires a decision or commitment from JP Morgan, but the Principles and Strategies section can help guide the day-to-day employee decision making process to ensure the best possible chance for positive long-term outcomes.

2. Comments on Current Critical Issues: In this section, Dimon demonstrates thought leadership on various current topics including the strength of the banking system, privacy policy, cyber security concerns and the need to balance free markets with thoughtful regulation. With all of these, Dimon acknowledges there will be unknown risks and is realistic about their outcomes, but one can re-visit the decision-making framework he has forged in the Principles and Strategies section to formulate how the company will handle whatever comes its way. Give a person a fish and you feed them for a day. Teach them how to fish and you feed them for a lifetime.

3. Public Policy: In this section, Dimon identifies no less than 11 issues facing public policy decision makers. While he argues the American Dream is still very much alive and reiterates the economic power of capitalism, he stresses the need for public/private cooperation, less partisanship, inclusiveness and continued investment in the business tax system, infrastructure and education as keys to effective public policy. This thought leadership undoubtedly gives Jamie Dimon, and in turn JP Morgan Chase, a seat at the table when public policy makers look to the private sector for guidance.

Dimon's annual shareholder letter has become a textbook for leadership in Corporate America.

Amazon.com, Inc. 2018 Shareholder Letter, Jeff Bezos - Founder & CEO

Jeff Bezos, famous for emphasizing the importance of maintaining a "Day One" culture at Amazon, ends each shareholder letter with a copy of the company's first shareholder letter from back in 1997. 21 years later, many of the same guiding principles are still in place and can be seen in the corporate culture today. For example, back in 1997, Bezos wrote of the importance of long-termism when it comes to maintaining and extending market share, on how it treats customers, how it reinvests in the business, its hiring practices, its treatment of employees and its use of data for decision making.

In fact, Bezos' ability to focus all of Amazon's constituents on long-term opportunities is probably its greatest advantage because it has allowed Amazon to reinvest in the business at rates other companies could only dream of. Bezos has a section in the 2018 letter called Intuition, Curiosity and the Power of Wandering, which recalls the famous quote, "Not all who wander are lost." For Bezos, that meant creating a culture of "builders – people who are curious, explorers. They like to invent. Even when they're experts, they are 'fresh' with a beginner's mind". He links the creation of Amazon Web Services (AWS), which has become one of the world's largest cloud computing platforms and one of Amazon's crown jewels, with that same curious spirit. In 2002, when AWS was formed, nobody was looking for an AWS type of service, but the company was curious enough to ask the question and $25 billion a year in sales later, that curiosity and explorer's spirit has paid off handsomely.

In closing, there are so many good examples of leadership and management wisdom in annual shareholder letters and we could review many more for you. But several consistent themes we believe you will find in most of the good ones is a focus on long-term thinking, the formation of a set of guiding principles that establish a cultural "true north" for the organization and finally a willingness to take calculated risk through thoughtful and careful reinvestment of corporate earnings (or personal savings in the case of individuals) for future growth. These three pillars of organizational management are a great place to start in charting your own path towards personal and financial success. ◊

2018 Ohio Residency Tax Law Changes: What You Need to Know

Howard Essner, JD
General Counsel, Family Wealth & Retirement Plan Advisor

Late in 2018, Ohio's legislature made some changes to rules regarding when someone can claim residency in another state while still maintaining a home in Ohio. These rules provide a "bright line" test that should provide assurance that the State cannot challenge non-residency for someone who meets these 5 tests and who files the appropriate tax forms. The stated purpose of the changes was to avoid the confusion created by conflicting rulings from the Ohio Department of Taxation, and therefore is welcome news.

Starting with years after January 1, 2018, anyone who meets these five tests for a calendar year is presumed not to be a resident of Ohio.

1. The person owned at least one residence in another state for the entire year for which he or she did not claim depreciation under Section 167 (i.e., not a rental property or other business use of the property).

2. The person has no more than 212 "contact periods" in Ohio. The definition of a "contact period" remains the same as prior law and is defined as any two consecutive days in which the person is away from his or her principal out-of-state residence overnight and spent any part (no matter how minimal) of two consecutive days in Ohio.

3. The person did not have a valid Ohio driver's license or State ID for the entire year.

4. The person did not claim or receive a real property tax reduction-based residency (e.g., a homestead property exemption or the owner-occupied tax reduction) for the year.

5. The person did not receive in-state tuition in any Ohio college based on a residence in Ohio for the year.

Under the new rules, anyone claiming non-residency must file an Ohio Form IT NRS every year in which he or she maintains a residence in Ohio. This form replaces the old Ohio Affidavit of Non-Residency, which is no longer used. The IT NRS is due by October 15 of the year following the close of any year in which non-residency is claimed. The form can be filed jointly, but if only one spouse is claiming non-resident status, that person can file the form individually.

A few notes about the new rules:

› The requirement that someone not receive an Ohio homestead property tax reduction is very important. Not only will the receipt of this exemption cause the failure of the test, but it could lead to a loss of a similar exemption in the person's home state (along with interest and penalties). Some states, including Florida, are very aggressive in their enforcement of these rules.

> Ohio's new residency rules generally don't apply to any taxable year in which the taxpayer permanently moves in or out of Ohio. In this case, part-year resident allocations continue to apply.
> The State can only challenge a claim of non-residency if it can show that any of the five criteria have not been met or the individual fails to file the proper form. However, if the State challenges the number of contact periods, the person must prove the time in and away from Ohio by the preponderance of evidence. This means that it is still very important to keep accurate records of your travel in and out of the State.
> The test for in-state tuition applies only to the individual claiming non-residency status, but not to his or her dependents, who can get the in-state tuition based on their own residency status.

If you are thinking about establishing a domicile or residency in another state, or have any questions about this article, Ancora can help with the decision-making process. Please contact your relationship manager for further discussion. ◊

As always, don't hesitate to contact your Ancora advisor or relationship team if you have any questions or would like to learn more about these topics. Visit our website at www.ancora.net to read past newsletters and find other news and insights from the investment professionals at Ancora.