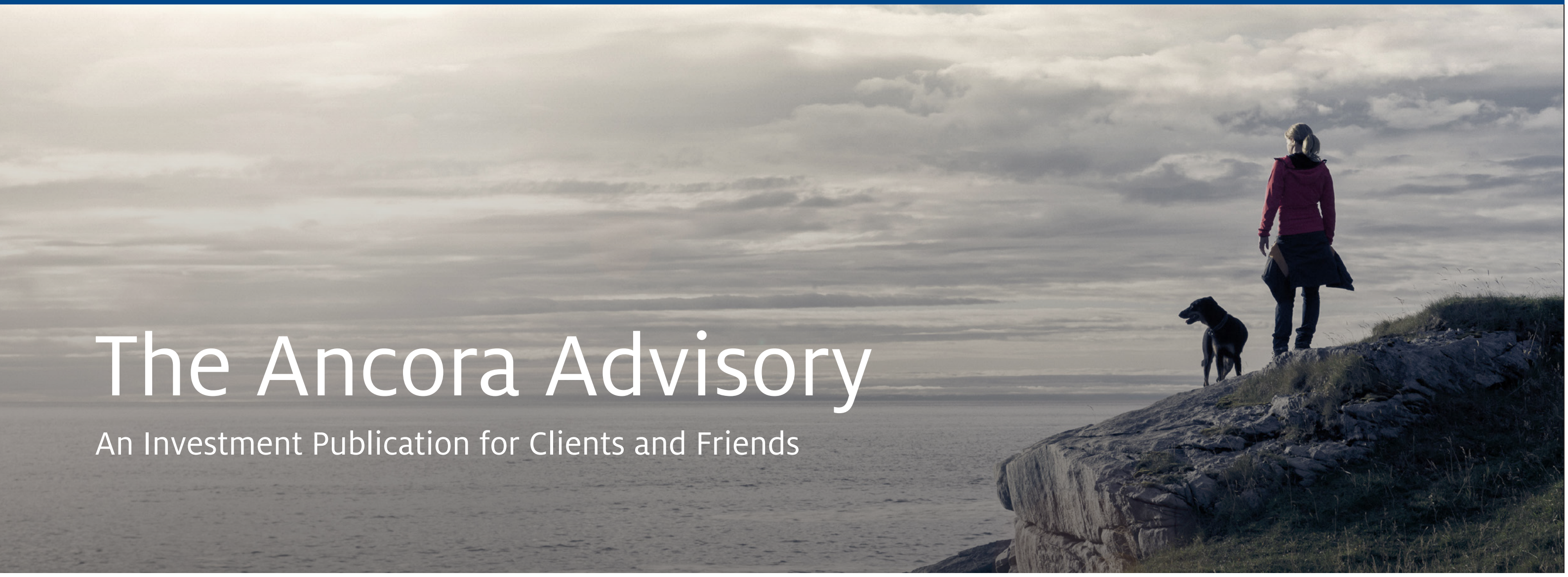
Third Quarter 2019



The Ancora Advisory

An Investment Publication for Clients and Friends

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A Review & Game Plan for Today's Wall of Worry

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The trade conflict between the U.S. and China recently entered a new and potentially escalating phase. The volley of tariffs back and forth could lead to higher prices for consumers, greater uncertainty for corporations and the potential for a slowdown in the global economy. Since the announcement of the latest round of tariffs, economists have reduced U.S. 3Q19 and 4Q19 GDP estimates down to 1.9% and 1.8% respectively, which is below the previous 2.0%+ trend. For its part, China is experiencing an equal or greater amount of pain as a result of the tariffs and stands to lose 1.0% of growth from a sustained trade conflict.

Estimates for the global economy point to a 0.6% hit to growth from a sustained trade war, which could bring downside to the World Bank's estimate of global GDP growth of 2.6% for 2019 and 2.8% by 2021. It is important to note, however, that potential deceleration is different than recession (defined as two consecutive quarters of negative year-over-year GDP growth) and that relief could come suddenly from any sort of breakthrough in negotiations. We believe such a breakthrough becomes more likely the closer we get to the 2020 presidential election. In the meantime, trade uncertainty will likely become the new normal for the markets.

Sensing some deceleration in the economy, the Federal Reserve (the FED) reduced interest rates by 25 basis points (bps) on July 31, which was the first rate cut since 2008. Furthermore, the FED appears ready to do more if necessary. In fact, almost all central banks across the globe are now easing, which puts further pressure on the FED to "keep up". Bond investors are now pricing in a 100% probability of a 25 bp rate cut and a 30% probability of a 50 bp rate cut at the September 18th Federal Open Market Committee (FOMC) meeting.

For perspective on where benchmark interest rates are, on the day of the rate cut in July, the yield on the 10-year Treasury note closed at 2.01%. On August 1st, the unexpected tariff announcement lead to a significant flight to quality, pushing the 10-year Treasury note yield down to 1.89%. The flight to quality, in addition to an influx of foreign capital fleeing negative yields, has continued since, pushing the yield on the 10-yr Treasury note down to as low as 1.43% on September 3rd, its lowest yield since July of 2016.

Of developed nations around the globe, U.S. bond yields remain attractive despite the significantly lower yields. The yield on the 10-year German note is -0.71%, the Japanese 10-year note is yielding -0.29% and the French 10-year note is yielding -0.40%. Over $15 trillion of global debt (approximately 33% of all outstanding global debt) now trades with a negative real yield. When adjusted for inflation, over half of all outstanding global debt now trades with a negative yield. This makes U.S. bonds attractive by comparison, which draws in foreign capital, pushing bond prices higher and sending our rates lower. Therefore, the capital flight into U.S. bonds could lead to a false signal in terms of what the recent drop in interest rates is telling us about the domestic economy. However, the decrease in rates cannot totally be dismissed.

U.S. 10-Year Treasury Note Yield

Source: Bloomberg as of August 31, 2019

On the positive side, despite the flight to quality and the increased volatility in equities, the corporate bond market has acted in an orderly fashion. Investment grade corporate credit spreads have widened by 19 bps since the July 31st FOMC meeting to 136 bps. For perspective, in 2019, Investment Grade credit spreads have traded in a range of 117 bps to 177 bps. High yield spreads have behaved similarly, widening 23 bps during the same time period to 394 bps. High yield spreads have traded in a range of 303 bps to 537 bps in 2019. Bottom line, while rates have fallen in an absolute sense, credit spreads are not blowing out disproportionately, which is encouraging in terms of foreshadowing the overall health of the economy and continued liquidity in the bond markets.

In terms of equities, the recent moves in the stock market appear to be a reaction to geo-politics and the uncertainty that trade, growing populism and low interest rates are creating in terms of future global economic conditions. As both the U.S. and China dig in, the likelihood of the "trade cold war" becoming the new normal increases, until either political or economic pressure caves to one side's demands. The good news for long-term focused shareholders is that well managed companies, as they have in the past, will adjust supply chains to the new paradigm, creating fresh opportunities from the disruption. This would allow investor sentiment to stabilize and the market to build on itself once again.

In the meantime, the American consumer, who drives roughly two thirds of the domestic economy, remains resilient as evidenced by strong retail sales, low unemployment, strong household debt service ratios and personal consumption expenditure readings. Furthermore, lower valuations in and of themselves often lead to the "green shoots" of any market recovery. While sentiment can shift with a single tweet, long-term business values typically do not and, eventually, the market figures that out. Lastly, liquidity remains high as evidenced by strong money supply levels, meaning there is a lot of money still on the sidelines ready to buy the dips in this unloved bull market. The compulsion to buy equities becomes even stronger in the current low interest rate environment for investors seeking positive real rates of return for their long-term objectives. In addition to all of that, we are always just a tweet away from a break in the trade impasse or some other release valve for the current trade tension that can change investor sentiment back to a more sustainably positive trend.

In closing, the reaction by the bond market to the growing trade conflict and its impact on the global economy has been significant and is therefore worth noting. However, there are a variety of influences, mainly political, at work and the long-term, negative impact on businesses may be overstated. In addition, according to Guggenheim, since 1945, the average 5-10% S&P 500 sell off takes approximately one month to recover from. The average 10-20% correction takes five months to recover. Moreover, according to J.P.

Morgan, the average intra-year decline in the S&P 500 since 1980 is 13.9%, yet stocks manage to finish in positive territory for the full year approximately 75% of the time and generate positive returns with even higher degrees of confidence over longer periods of time.

Simply put, volatility caused by periodic uncertainty is the price equity investors must pay for higher expected long-term returns. There is little getting around this truth for those seeking long-term growth from equities. Therefore, the best blueprint for this or any environment remains, in our opinion, to diversify with an eye towards fading portfolio risk as your time horizon shortens, invest in quality assets and strategies that can endure whatever the economy throws at them and focus on time in the market as opposed to trying to time markets. As has been said before, investing, at its core, is simple, but it is not easy. ◊

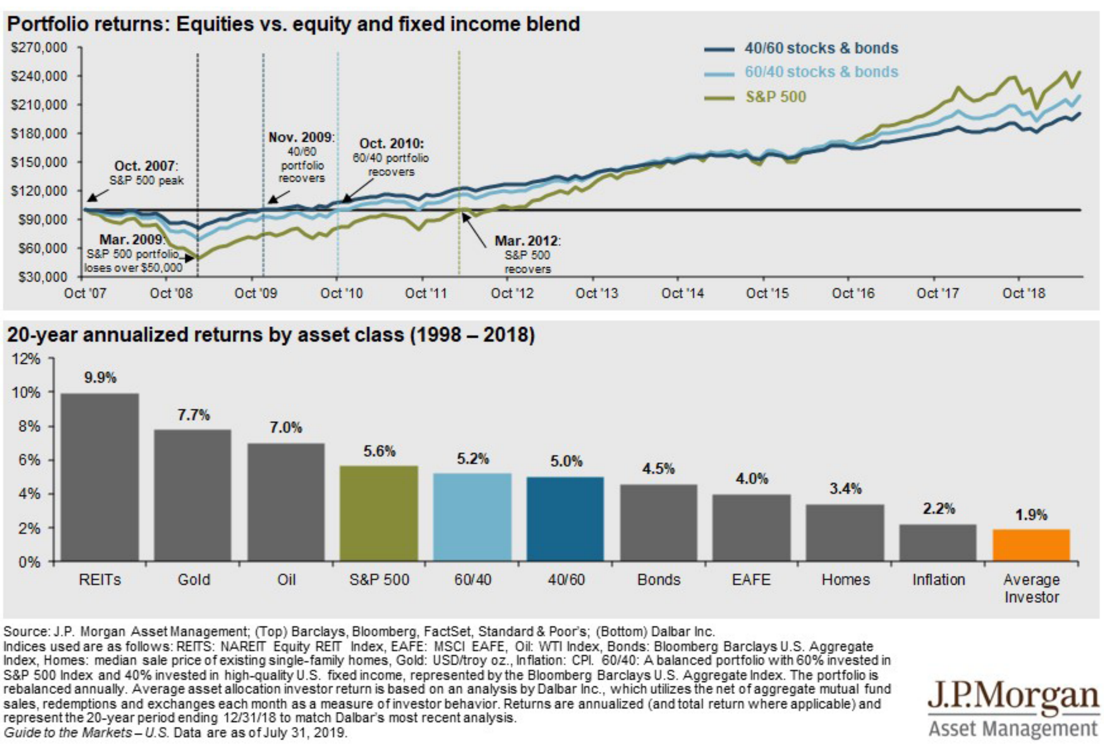
What is the Best Portfolio for You?

Michael Santelli, CFA
Director, Portfolio Manager

"The best portfolio isn't the one with the highest returns. The best portfolio is the one that clients can actually live with." -Barry Ritholtz

Recently the stock market has experienced heightened volatility. When people use the word "volatility" in this way, it usually means downside volatility. Everyone loves upside volatility, but it is the downside volatility that can cause investors to make poor long-term decisions. For validation, refer to the 20-year returns chart below from J.P. Morgan. The "average investor's" returns from 1998-2018 are less than any of the asset classes or balanced portfolios shown on the chart. This is because investors collectively can make the wrong decisions in the face of downside volatility. They associate safety and security with a rising market and fear and despair with a falling market. As a result, they buy after the stock market has risen and sell after the stock market has fallen; buying high and selling low. Taken as a group, investors chase what has worked in the recent past and avoid what has not. This approach, as evidenced below, can lead to sub-optimal long-term results.

Diversification and the Average Investor



Slide courtesy of J.P. Morgan Asset Management, as published in *Guide to the Markets*® U.S. 3Q 2019 slide 64.

Part of the value of a financial advisor is to reverse this decision-making pattern and to help clients determine how much risk they are willing, able and need to take in their portfolio to achieve their long-term goals. Then, to coach them on the benefits of redirecting their short-term instincts when volatility hits in order to remain invested for the long-term. Helping clients move from the "average investor" to the "60/40" balanced portfolio returns, as shown in the table above, can make a significant difference over an investing lifetime. At Ancora, we seek to understand each client individually so that we can build a portfolio they can live with through thick and thin, thereby increasing the probability of reaching their long-term goals. ◊

Commodities Q&A: A Review of the Current Commodity Market Environment

Paul Caruso
Director, Commodity Investments

Q: Paul, how do you approach investing in commodities?

A: There is roughly $400 billion invested globally in commodities futures markets. Strategies may include:

- Passive, long-only exposure to indices such as the Goldman Sachs Commodity Index
- Exchange Traded Funds (ETFs) that track an underlying commodity such as GLD (gold) or USO (oil)
- Mutual fund products that track a basket of commodities
- Risk premia strategies that utilize volatility and curve structure to add alpha
- Limited partnerships that are typically actively managed strategies

When I consider the current environment, which is best characterized by divergent returns, I think the latter offers the most potential.

Q: How do you see commodities fitting into an investor's portfolio?

A: Commodities are an uncorrelated asset class, so I view an allocation to the sector as a way for an investor to diversify a portfolio, generate returns and protect against inflation in the longer-term. An allocation to commodities or a commodity strategy should be viewed as part of an individual's overall alternative investment allocation bucket. A pure commodity strategy that is using underlying futures and options, that goes both long and short, will track more closely to other alternative strategies, such as equity hedge fund vehicles, than it will a real assets allocation, which is typically overweight real estate and more long-only oriented.

Q: How has the U.S.-China trade war impacted the commodity markets?

A: The biggest impact has been a disruption to supply chains, which has produced market inefficiencies. For example, due to the trade war, U.S. soybean exports to China have fallen 70% year-over-year. China is currently purchasing the vast majority of its soybean import needs from South America at a huge premium. However, this exchange sends the wrong signals. Its telling South America to expand production despite the U.S. holding record inventories. If markets could operate freely, the lowest cost supplier, in this case the U.S., would see an increase in exports allowing its balance sheet to improve while pressuring South American premiums and signaling that current production is adequate and expansion isn't necessary.

This same type of scenario is playing out in several industries, not just agriculture. The concern going forward is whether supply chains have been altered forever and if domestic producers should cease, or at the very least reduce, capital investments. Decisions being made now, with the currently available information, could have major ramifications for years to come. Unfortunately, nobody wins as markets become paralyzed and decisions are made under irrational circumstances, which can create opportunities for long-short oriented strategies.

Q: What effect will a lower interest rate environment have on commodities?

A: The biggest effect thus far has been to encourage a massive inflow of capital into precious metals. Gold, silver and, to a lesser extent, platinum are all top performers over the past 12 months. According to the most recent quarterly report from the World Gold Council, Central Bank demand for gold increased to a three-year high and was up 8% year-over-year. With nearly $15 trillion of government bonds trading at negative yields around the world, the reallocation of capital into precious metals will likely continue.

Q: Where do you see the biggest opportunities in commodities?

A: I think we will continue to see a divergent return profile within commodities. The reality is that some markets are oversupplied due to the trade war, while others are seeing renewed demand outstripping supply. I think precious metals will continue to outperform and that livestock markets will experience upward pricing pressure stemming from China's protein shortage. I view energies as mostly range-bound. OPEC is making necessary cuts, which should provide a floor, but with the U.S. producing record amounts, the upside is capped as well. Overall, stable energy prices are a positive for the U.S. economy. Soybeans and soybean meal are dealing with excess inventories while soybean oil is tight due to biofuel mandates. These are just some opportunities, but the point is that a balanced portfolio of long and short exposures allows investors to take advantage of the widest opportunity set in the current market.

Q: What are some overarching themes in commodities?

A: The trade war will continue to be an overriding theme. Another major theme is African Swine Fever, which has decimated China's hog herd, contributing to a protein shortage there. To put this in perspective, China's hog herd is more than 10-times larger than the U.S.'s. Their meat shortage could result in a multi-year bull move for livestock markets (if the trade war ends). As previously mentioned, the low interest rate environment will likely continue to be a big theme in commodities as well, with precious metals benefitting the most. Lastly, weak currencies from commodity producing countries such as Brazil, Argentina, Russia and Australia, should continue to push (distorted) expansion outside of the U.S. within agricultural markets.

Q: You have been involved in the commodity markets for 17 years, what excites you about them and why have you made a career of this?

A: My internships while attending college were with commodity related companies. I should mention, I didn't seek commodity related roles, but rather they were the only roles that I found opportunities in, so in a way the industry chose me. However, I am very fortunate to have discovered this field because I find it to be very conducive to my mindset and global macro interests. As a result, I quickly realized that I wanted to make a career in commodities. The markets are very dynamic, constantly evolving and there are so many nuances to them. Commodities can be impacted by market specific fundamentals, macro events, politics, currencies, capital flows, weather, etc. Some inputs are more predictable than others, but the constant change challenges and excites me. I have enjoyed making a career of analyzing the markets and determining where there is a dislocation or inefficiency that, over time, supply and demand factors and economic theory will correct. ◊

Non-Qualified Deferred Compensation Plans Q&A: What Are They and How Can They Help Your Business?

John Bartels
Managing Director, Retirement Plans & Insurance Services

Q: John, briefly explain what a Non-Qualified Deferred Compensation (NQDC) Plan is and why business owners would be interested in one?

A: A Non-Qualified Deferred Compensation plan (sometimes called "Top Hat Plans") is sponsored by an employer to provide additional retirement savings to recruit and retain its key employees. A NQDC must be unfunded. That is, the employee receives nothing more than the employer's promise to pay benefits in the future (although the employer may decide to invest in an asset designed to match its future liability, as discussed below). This type of plan is not covered by ERISA and generally is easier to administer, having no discrimination testing, no minimum contributions and no Form 5500 filings. NQDC plans allow business owners to match or make contributions for their employees and defer the payout to a future date. The flexibility of the plans comes with one trade off; the employee's claim to future benefits, including any of his or her own compensation deferred into the plan, could be wiped out or reduced in a bankruptcy or insolvency.

NQDC plans generally fall into two categories:

- Asset based, where the employer purchases an asset designed to match its future liability. Any employee deferrals and employer contributions are "invested" in this asset. The employer can give the employee the right to control how this asset is invested, similar to how a 401(k) plan would look. Any employer contributions can be tied to a custom vesting schedule. It is important to remember, however, that the asset is an employer asset and the employees in the plan have no specific rights in this asset. To match their liability, employers typically use cash on the company's balance sheet, mutual funds / ETFs, or corporate owned life insurance (COLI), which can provide additional tax benefits to the employer.
- No-asset, where the employer simply accrues a liability to record the future benefits to be paid. Compensation can still be deferred and employer benefits can be promised. However, the employer does not have any asset on its balance sheet designed to match this liability. This form is generally not recommended or preferred by employees.

Q: What are the primary benefits of establishing a Non-Qualified Deferred Compensation Plan?

A: NQDC plans can help business owners attract and recruit top talent in a competitive, benefit-seeking environment where 401(k) profit sharing plans may not meet employee retirement goals. Providing these types of important retirement benefits may help retain talent and encourage company loyalty by helping employees meet their retirement goals. Companies can also put in place performance-based initiatives to reward employees while retaining "golden handcuffs" and providing a tool for mutual success.

NQDC plans are generally more flexible, even allowing an employee to defer up to 100% of their salary. They can provide employees with an ownership experience, while allowing for different timing on distributions and tax planning opportunities.

Q: How is a Non-Qualified Deferred Compensation Plan different than a 401(k) Plan?

A: 401(k) plans are protected under ERISA and have strict testing and filing requirements. This means 401(k) assets are invested in segregated accounts protected from company creditors. NQDC plans can step in and fill the gaps where key employees may be limited on contribution levels to their 401(k) plan. NQDC plans have no limits on contribution levels, can be distributed prior to age 59 ½ and provide employees, in some cases, a choice as to when to take distributions. 401(k)s are capped at IRS stated levels, and have rules around accessing funds prior to age 59 ½, which generally comes with an IRS imposed 10% early withdrawal penalty.

Q: Is it burdensome to establish and maintain a Non-Qualified Deferred Compensation Plan? What is involved?

A: Generally, NQDC plans are easier to administer, have lower costs, and require no testing compared to 401(k) plans. They can mimic 401(k) plans with most platforms and allow employees to change investment choices to match their specific retirement goals. Employees contributing to NQDC plans must make an irrevocable election decision to defer a specific percentage of their compensation from 0%-100%.

Q: Have there been any changes in approach to designing a Non-Qualified Deferred Compensation Plan in recent years that are worth sharing?

A: Corporate owned life insurance (COLI) was much more attractive a few years back due to the higher tax rates on corporations. With COLI, the business enjoys tax deferral when employees change their investment choices. There are no unwanted capital gains on corporate assets in COLI. However, due to lower corporate tax rates as a result of the 2018 calendar year tax law changes, companies should also look at mutual fund and ETF funding to compare the best method for funding future payouts.

Q: If you already have a Non-Qualified Deferred Compensation Plan, what are some best practices for reviewing and making potential improvements?

A: Investment choices, corporate owned insurance products and overall fees should all be part of a thorough review. With existing plans on the books, there may be ways to reduce fee "drag" and unwanted consequences. Also, life expectancy tables have increased. Meaning, life insurance policies purchased greater than 10 years ago may be able to be redesigned to allow for more efficient deferral of assets as life expectancy and insurance costs have become more competitive.

Q: How can Ancora help businesses and business owners with questions about Non-Qualified Deferred Compensation Plans?

A: Ancora has a very experienced team of professionals to help customize, review and design NQDC plans to match ownership's goals. We can review integration and gaps with existing 401(k) plans. If you are a C Corporation, there are potentially very attractive tax benefits to explore with NQDC plans which we would be happy to discuss. ◊

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.

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