



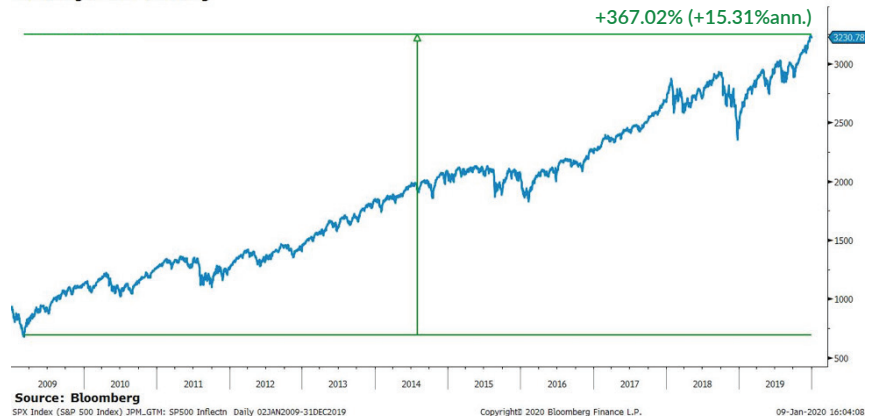
Quarterly Client Update

Headwinds Subside, Markets Reach New Highs

As 2019 came to an end with the major stock indices at or near their all-time highs, it's worth reflecting on just how far we have come in this historic decade. Since the S&P 500 bottomed at a level of 676 on March 9, 2009, it has rallied an eye-popping 367.02% to close 2019 at a level of 3,230.78, during what is now the longest period of economic expansion in U.S.

history. It wasn't entirely smooth sailing toward the finish line, however. 2019 was plagued with constant fears and headwinds: negative political pressures (U.S.-China trade, Trump's global tariff threats, unresolved Brexit, and unrest in Hong Kong, Chile, and France), weaker corporate earnings, slowing global growth, and for good measure, the first inverted yield curve since 2007. Yet on the back of de-escalating U.S.-China trade tensions and an accommodative Federal Reserve, the market delivered strong fourth quarter results. The

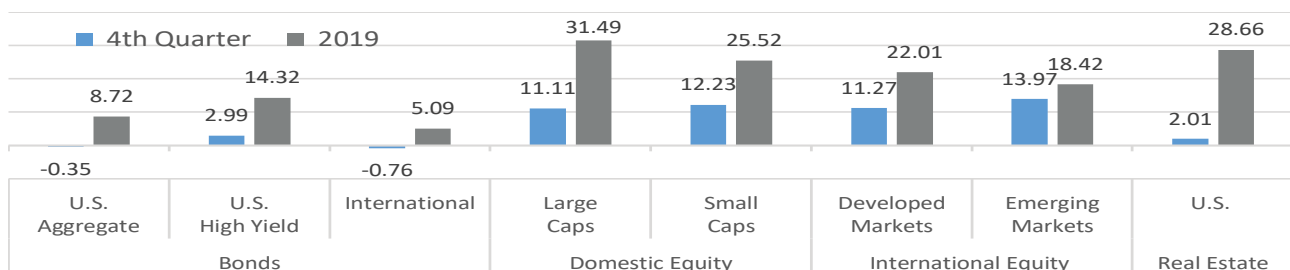
S&P 500 - A Decade Later
S&P 500 gain since bottoming



NASDAQ led the way, posting a return of 12.17%, while the S&P 500 was up 9.07% in the final three months. For the year, these indexes would provide investors with a return of 35.23% and 31.49%, respectively. Small cap equities also posted impressive gains with the Russell 2000 climbing 9.94% in the quarter and finishing the year up 25.52%.

International markets overcame similar recessionary fears along with Brexit uncertainty to participate in the rally, with the MSCI EAFE and MSCI Emerging Market indexes rising 8.21% and 11.93% in the fourth quarter, respectively, along with full-year numbers of 22.66% and 18.90%.

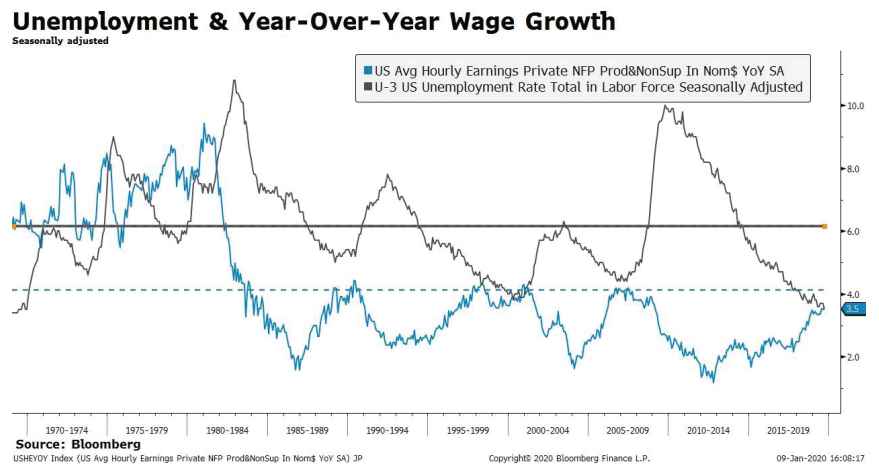
Bonds might be one of the largest surprises in 2019. Typically, when equities rise, so do interest rates, sending the prices of bonds lower. However, earlier this year we witnessed yields fall to lows not experienced since 2016, with the 10-year U.S. Treasury yield dipping below 1.50% in the third quarter before rising in the fourth quarter to end the year at 1.92%. Despite the modest late-year recovery in rates, bonds were still able to eke out a positive gain of 0.18% in the fourth quarter, bringing the calendar year return to 8.72% on the Bloomberg Barclays U.S. Aggregate Bond Index.



Have no fear, the Fed is here...

The Federal Reserve is tasked with two main responsibilities, controlling growth and inflation. After pursuing tighter monetary policy with interest rate increases throughout 2018 (contributing to a major market sell-off), the Fed reversed course in early 2019, stating they would likely pursue no further increases and return to a more “data dependent” approach. While the equity markets celebrated the U-turn, broader interest rates continued to slide, indicating the bond market and stock market were in conflict on the short-term outlook of the economy. As recessionary fears swelled, the Fed was forced into action, and in July, joined the other global central banks by cutting interest rates (by .25%) for the first time since 2008. Two subsequent cuts were made in the following months for an aggregate reduction of .75%. December’s communication from the Fed indicates rates will be on hold “for a time”, as the FOMC believes they enforced adequate measures over the second half of 2019.

A primary catalyst for the loose monetary policy has been surprisingly low inflation, which has been welcomed with open arms by businesses, equities, and consumers. Historically, wage growth and inflation have gone hand-in-hand, but advancements in technology and a slowly growing workforce population have kept a lid on inflation. Should wage growth continue to trend upwards and there is a material trade deal between the U.S. and China – leading to an uptick in business investment, we could finally start to witness inflation approach the Fed’s elusive 2% target. Given recent geopolitical tensions in the Middle East, we would not be surprised to see transitory spikes in headline inflation, as oil prices rise, but look for core inflation (ex-energy) to remain relatively steady. We will be watching this closely, however, as any shock upward could cause the Fed to feel the need to raise rates and bring fear back into equity markets.



Progress with China eases trade tensions

Markets had endured nearly two years of back and forth negotiating, tariffs, and increasing tension with China. The fourth quarter brought welcome respite, however, as the tentative agreement from an October 10-11 meeting between the U.S. and China became a “Phase One” deal on December 13. The U.S. agreed not to enforce scheduled 15% tariffs on \$160 billion of consumer goods, and cut the September 1 tariffs on \$120 billion of Chinese goods in half from 15% to 7.5%. The 25% tariff on the remaining \$250 billion of goods would remain enforced, with further reductions being linked to progress in future trade negotiations. China agreed to increase purchases of U.S. goods and services to \$200 billion over the next two years, suspend retaliatory tariffs for December 15, implement intellectual property safeguards, and instill a tariff exclusion process. Of particular note, is of the \$200 billion in purchase, China will import \$40-\$50 billion in agricultural products in each of the next two years.

While the market has been clearly welcoming of this “Phase 1” deal, and we find the fourth quarter progress encouraging, we feel investors should know the contention between the United States is far over. While a signing party is supposedly scheduled for January 15, 2020, as of the writing of this piece, the “Phase 1” deal has not been formalized. The progress is encouraging, but we don’t expect comprehensive resolution in the foreseeable future, and as such, the U.S.-China trade soap opera will continue to garner headlines, posing

ongoing risks for the global economy. The uncertainty surrounding the trade war is not only impacting U.S. corporate profits, but has brought business investment and capital expenditures to a halt. Our economic growth has been sustained, for the time being, by the strength of the U.S. consumer and continued expansion in the service sector. We will be closely monitoring corporate earnings calls in the coming weeks, looking for green shoots in planned business investment as we move forward. In our opinion, a wildcard here is president Trump – \$50 billion of agricultural goods would equate to nearly double China’s purchases in 2017 (pre-trade war). Many analysts believe China will have a very difficult time reaching this figure; if that’s the case, how will Trump respond if China fails to meet this amount?

Geopolitical Risks, Impeachment Proceedings and Upcoming Elections

Perhaps the only thing markets hate more than uncertainty is surprises. Recent events in the Middle East stirred up fears of a broader conflict with Iran, and while it appears that neither side wants a war, events in the Middle East warrant close monitoring. If the Fed doesn’t kill a business cycle, geopolitics are the next likely suspect. If you’ll recall in our last quarter’s update, we noted that the last three recessions (1990, 2001, and 2008) were all preceded by a shock in oil prices. As evidenced by a sharp spike in oil futures after Iran’s retaliation on the U.S. base, any escalation in tensions could have a dramatic impact on commodity prices.

A cynical person might wonder about the curious timing of the escalation with Iran coinciding with the peak of impeachment proceedings, as democrats attempt to call more witnesses in the trial that will ultimately take place in the House. Though we do not believe there is any connection between the two events, the prospect of war with a major foreign power certainly did draw the attention of the average U.S. citizen away from a topic that has seemed to drag on needlessly with a predictable outcome. It’s unlikely that the President will be convicted in the Republican-controlled Senate, but bombshell testimony from John Bolton could change that landscape, or perhaps impact Trump’s re-election chances.

It’s too early to predict exactly what will happen in the 2020 presidential and congressional elections, but the market seems to be pricing in a split congress and either Trump or one of the more moderate (Biden, Bloomberg) Democratic candidates to win the white house. A material shift, such as one of the more left-leaning candidates (Sanders, Warren) winning the white house and full democratic control of congress, would likely send shock waves through the markets as significant policy changes would be expected. As we learned in 2016, anything is possible, especially with such a large field of candidates in the non-incumbent party seeking election—stay tuned!

Implications

2019 saw capital markets persistently climb the wall of worry. With many of the headwinds diminishing, we are cautiously optimistic that risk-assets such as stocks will deliver the best performance in 2020. Inflation is negligible, interest rates remain low, corporate profits look poised for a rebound, and U.S.-China trade negotiations appear to be progressing. The S&P 500 grew by more than 31% last year, mostly through multiple expansions, and little through the production of earnings. As we progress through 2020, we would expect corporate earnings to rebound in the high single digits, supporting the current price levels and perhaps some modest growth. While stocks may indeed perform well this year, we believe we are in store for a year filled with more volatility than the one we’re leaving behind. As we mentioned last quarter, we are fearful of this low interest rate environment. We anticipate rates will probably remain range bound with the 10-Year floating between 1.5% and 2.25%, which often leads to risk-taking. More specifically, as we stated last quarter, “our fear is the unintended consequences of the Fed’s actions...more importantly, we fear that investors, particularly risk averse investors, who lack the ability and/or willingness to take additional risk, yet need income, will start to

stretch. When investors chase yield in a lower rate regime, they often move down in credit quality or increase their exposure to high-yielding, interest rate sensitive equities, like REITs and Utilities. This yield seeking behavior often leads to portfolios over-leveraged with risk. Should a downturn occur, the unintended consequences of lower rates and higher risk profiles will have greater negative repercussions. We strongly caution against this type of behavior. It's times like this where focus on quality is imperative."

After years like 2019, it's easy for investors to become complacent. However, these are the moments that give us pause, as we reassess current portfolio positioning; looking for opportunities to rebalance back to long-term strategic target, maintaining a disciplined approach with a focus on diversification. Most importantly, however, we look for opportunities to ensure the portfolios that we manage match the objectives and risk tolerance of the clients we have the privilege to serve. We appreciate your business and ongoing trust, and invite you to reach out to your advisor should you have any questions, or to schedule your next review.



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