Dear Client:

In what promises to be an eventful 2019…
Here are 10 big trends and stories to watch.

1) The U.S. economy will keep growing. But the pace is clearly starting to slacken as the boost from last year’s tax cuts starts to fade and the slowing global economy weighs on the U.S. Figure on GDP growth of 2.5% or so…OK, but a noticeable step down from 2018’s 2.9% rate. And the economy could flag by year-end. Don’t be surprised if growth in the fourth quarter slips below 2%. With so few workers to hire, firms will be hard-pressed to increase their output much unless they can figure out how to get more efficient with their existing workforces…a challenge lately. (Look for the jobless rate to fall to a slender 3.4%.)

2) The Federal Reserve will raise rates twice over the course of 2019, taking the bank prime rate to 6% by Dec. Long-term rates are a different story, though. They may rise in the middle of the year before pulling back by the end of 2019 to near 3%, not much higher than now. Investors who are worried about an economic slowdown or recession in 2020 or 2021…a reasonable concern, in our opinion…will buy up Treasuries as a safe haven. That’ll keep yields fairly low. Rate hikes and slowing growth will keep inflation muted at 2.3% in 2019.

3) Fed Chairman Jerome Powell isn’t going anywhere, despite rumblings that President Donald Trump is unhappy with the Fed’s rate hikes and would like to replace him. White House officials know that axing Powell would send markets into turmoil. They’ve been busy lately signaling that Trump won’t try to oust him. There’ll be several new faces at the Fed, but no real change in its policy.

4) The stock market will remain jumpy, and gains will be hard to come by. With corporate earnings set to grow by just 7%, after 23% last year, stock investors will have less reason to bid up shares. And they’ll have plenty of cause for anxiety, from uncertainty on the trade front to the risk of a messy divorce between Britain and the European Union. Meanwhile, the rise of computerized trading could result in amplified market rallies and routs. Late Dec.’s volatility provided an early preview. Markets may claw a bit higher in 2019. But the downside risks are growing.

5) 2019 will be a mixed bag for the housing market. Sales of new homes should grow by a modest 2% as builders react to slowing home demand. However, sales of existing homes figure to dip…rising prices and mortgage rates are bad news for would-be buyers, who are finding themselves increasingly priced out of the market. Expect inventories to stay lean and home prices to rise 3%, versus 2018’s 5.2%.
6) Look for another mass Republican exodus from Capitol Hill this Congress. The 115th Congress set a record for GOP retirements and resignations from the House. Now in the minority, members have even less incentive to stick around. GOP elation over taking full control of Washington in 2017 quickly turned into public infighting. Republicans’ inability to reach internal consensus stalled action on every major issue, save tax cuts, prompting many to seek other offices. Discomfort with President Trump drove many moderates to early retirement. Those dynamics won’t change before 2021. Traditional Republicans will leave the Senate, Tenn.’s Lamar Alexander being the first.

7) Trump will find more allies among remaining and new GOP lawmakers. The number of his critics has dramatically decreased, some replaced by vocal supporters, particularly in the Senate. Many newcomers embraced him on the campaign trail. The House’s new top Republican is a staunch Trump ally, unlike his predecessor, empowering Trump loyalists whom ex-Speaker Paul Ryan sidelined as much as possible. Though fewer in number, Republicans will be more unified this Congress.

8) Trump will keep his own counsel even more as he replaces top officials willing to counter him with ones who share his positions, especially on trade and defense. Despite the protests of his national security team, Trump ordered the withdrawal of all U.S. troops stationed in Syria and half of those in Afghanistan. It’s possible that others the president listens to will talk him down...Sen. Lindsey Graham (R-SC) is encouraging Trump to at least delay the announced withdrawal. And the Pentagon could slow-walk orders with which the military brass and civilian leaders disagree. But Trump read even the midterm results as license to defy most conventional wisdom.

9) 2019 could see an all-mobile financial service provider become a bank. The Office of the Comptroller of the Currency started taking applications last summer for national bank charters intended for financial technology, or fintech, companies. But states are suing to block the OCC. In the meantime, a Silicon Valley start-up, Varo Money, has applied for a regular bank charter. It must clear two more hurdles before becoming the first app-based bank: Federal Deposit Insurance Corp. coverage and acceptance into the Federal Reserve system, the latter being the biggest barrier.

Two other mobile-based firms have sought state-based industrial bank charters: Lender SoFi and payment processor Square applied to Utah, though SoFi withdrew. Both would accept deposits. (The special OCC charter is open to nondepository firms.) The U.S. has granted only 11 new banking charters of any kind since 2009. If any of the fintechs succeed, it could ignite bank expansion after years of contraction.

10) Smart speakers will become hackers’ top targets. The virtual assistants, led by Amazon, have invaded American living rooms. At about two-thirds market share, the e-commerce giant’s Alexa device is most common. In 2018, 74 million Americans used some type of web-connected voice gizmo as an alarm clock, stock ticker or radio. The devices’ ubiquity and access to other systems make them attractive bait. Their newness also means they undoubtedly have unknown exploitable weaknesses. Attackers will try to steal data. But they also want to hijack other smart-home gadgets, which they can use to launch denial-of-service attacks on any website, for example. Hackers flood an official site with traffic until it crashes or has to be taken offline. They then demand ransom in exchange for backing off. Criminals will write malware to target smart-home tech, using Alexa as a gateway into any wired device in a household. Manufacturers will race to plug holes, eradicate bugs and shore up defenses.

Smartphones will also come under attack. Hackers will try to pick the locks on smart homes through them. Expect mobile phishing...fake social media messages, e-mails and texts luring people into sharing their home network and device passwords, letting hackers turn off everything from home security alarm systems to thermostats.

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President Trump’s trade war with China will continue to hold the spotlight. However, there’s still a way for tensions to wind down. Costs are mounting for both sides, giving plenty of incentive to compromise by the March 1 deadline for striking a deal. If negotiations fail, a 10% tariff on $200 billion of Chinese goods jumps to 25%, along with a U.S. threat to target an additional $267 billion of goods.

China is likely to offer just enough concessions for Trump to declare victory… adding protections for intellectual property and buying more U.S. goods, for example. Still, expect heated back-and-forth to punctuate the early months of 2019.

Even if China and the U.S. end up finding a way to end their trade war… The two nations will maintain a fraught relationship. The White House and both parties in Congress are united in believing that Beijing is a strategic rival that needs to be countered. Flash points range from Chinese economic espionage to island building in the South China Sea. Turning down the heat remains unlikely. The recent detention of two Canadian citizens is a sign of trouble to come. The move came after Canada’s arrest of a Chinese tech executive, at U.S. request. She was accused of violating U.S. sanctions on Iran. More hardball tactics could follow.

Global meat demand is increasing, especially for beef. And even the outlook for dairy will improve. Still, the spate of farm bankruptcies and asset sell-offs will continue.

The U.S. agricultural trade surplus will narrow in 2019, the USDA says. Officials predict that the U.S. will export $14.5 billion more in agricultural products than it imports next year, the lowest surplus since 2007. Unlike overall trade in goods and services, the U.S. consistently runs a strong surplus in agricultural commodities. It’s no surprise that the blame goes to the ongoing trade war with China, which is expected to cause a $7.3-billion decline in exports to the lucrative market under current conditions. A trade truce could ease some of the blow, of course. But U.S. farmers would still struggle to regain lost market share taken by others.
The Environmental Protection Agency will spend a lot of time in court in 2019 as it proceeds with President Trump’s deregulatory agenda. The legal drama will start in earnest in March, when the EPA finalizes its rollback of fuel economy rules written under President Obama. The Waters of the United States rule, another reg from the Obama era that businesses detest, is also in for a pro-business makeover.

New EPA leadership hopes to avoid problems that bedeviled deregulation in 2018, such as unfriendly judges and procedural mistakes. The new administrator, Andrew Wheeler, has more experience in government and less personal baggage than predecessor Scott Pruitt, who left office under a cloud of scandal last year. But environmental groups say the real issue is that EPA is failing to follow through on its statutory duties to keep the air and water clean and to protect public health.

Investors are losing their appetite for leveraged loans, which have soared from a $5-billion market 20 years ago to $1 trillion today. Generally defined as credit extended to already heavily indebted firms, leveraged loans are often used to finance mergers and acquisitions and refinance existing debt. Financial regulators have begun flagging the dangers of such loans, which come with fewer protections for lenders than other forms of debt. If the economy stumbles, many leveraged loans could default and leave the investors who backed them with significant losses.

Mutual funds that invest in leveraged loans are seeing heavy redemptions as investors lose confidence in them. The pullback means less access to financing for companies with weaker credit...another challenge at a time of rising interest rates.

Life insurers are entering 2019 with healthier capital levels, putting them in good financial shape to withstand even a severe market downturn. Many insurers are bulking up on less-liquid but higher-yielding assets to ensure adequate income to cover future claims. Meanwhile, demand for their product keeps ticking higher. In 2017...the most recent year for which data are available...life insurance sales hit $3.1 trillion in coverage, up more than 5% from the year before. About 60% of Americans have life insurance, a figure that should rise as the population ages.

Apartment landlords can expect solid rent increases as 2019 unfolds. But the pace of gains is likely to slow a touch because of ample new supply that will hit the market over the course of the year. Thus, many hot local markets that saw rents rise more than 5% last year stand to cool off a bit. Average rent growth will end up closer to 4% than 2018’s 4.7% rate. A few metro areas should outperform, though, such as Seattle and Tacoma, Wash.; Sacramento, Calif.; and Memphis, Tenn.

Wish you could fly to your destinations faster? You may be in luck. New jets under development now are intended to re-create the supersonic air travel of the old Concorde service with far lower fares. Boom Supersonic, Spike Aerospace and a joint venture between Aerion, GE Aviation and Lockheed Martin aspire to deliver supersonic passenger jets in the next decade. A flight from the East Coast to Europe could be two hours quicker, for instance. From the West Coast to Africa or the Middle East...a third faster, even with a refueling stop. Boom Supersonic says that it can offer round-trip transatlantic fares for $5,000...a fraction of the Concorde’s.

One key to the supersonic industry’s success: Quieting the jets’ sonic booms. Supersonic flight over the U.S. is currently banned, but lawmakers have told regulators to ease aviation noise regulations so that manufacturers can test quieter engines.

Yours very truly,

Jan. 4, 2019

THE KIPLINGER WASHINGTON EDITORS

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Lower Your Investment Return Expectations

The next decade will deliver only modest investment gains, which means you might need to rejigger your portfolio. We think large-company stocks will gain a below-average 6% annually over the next 10 years. You might increase your stock returns by investing abroad—especially in emerging markets, if you can tolerate the risk. Foreign currencies have fallen against the U.S. dollar, but if they rebound, they could put some extra octane into your portfolio as returns earned abroad translate into more dollars here. As for bonds, the 10-year yield is unlikely to rise above 4%, up from 2.7% as of December 31. Just don’t give up on bonds. You’ll want them in your portfolio if there’s a recession and a bear market in stocks. A 3% return from cash over the next 10 years wouldn’t be unusual. If the next decade produces lower-than-average returns on stocks and bonds, your best bet is to save more. KPFM

How Big an Umbrella?

Umbrella insurance—also known as excess personal liability insurance—sits on top of your automobile, homeowners and watercraft liability coverage. In the event of injury or accident, your auto or home insurer will pay for damages up to the liability limits of your coverage. But if damages exceed those limits, your umbrella policy will pay a judgment or settlement if you’re found at fault, or for your defense even if you’re not found at fault. Umbrella insurance costs about $150 a year for each $1 million of coverage up to $5 million. A car accident is the most likely scenario in which a loss would trigger excess liability coverage, but other risk factors include owning a condo, employing domestic workers, or owning a swimming pool, trampoline, dog, boat, RV or snowmobile. You are also more vulnerable to a lawsuit if you’re active on social media or serve on the board of your homeowners or condo association. To estimate the right level of coverage for you, see kiplinger.com/links/plup. KPFM

How Long to Keep Tax Records and Returns

Generally, you should keep federal tax returns at least three years. But don’t automatically throw out all returns and records after three years. You may need to keep state tax returns longer. You should also hold on to records that help establish your adjusted basis in real estate until at least three years after you dispose of the property. The same goes for securities transactions. And if you’ve made nondeductible contributions to IRAs or after-tax pay-ins to 401(k)s, you should keep records until three years after the accounts are depleted. KTL

Countdown to Retirement

Whether you are 10 years, five years or one year away from retirement, you’ll want to prepare by making some important financial moves. Ten years before retirement, have your financial adviser run projections to see if you are on course to meet your target date, or compare results from several online retirement calculators (including the one at kiplinger.com/links/retirementcalculator). Your income from Social Security, investments, pensions and annuities will need to replace about 75% to 80% of your current gross income. To crunch your own numbers, add up your sources of guaranteed annual income in retirement and subtract it from your estimated annual expenses. The result is how much you’ll need to pull from your portfolio each year for living costs.

Five years away, review your Social Security earnings history to make sure you’re receiving credit for every year you worked. Getting your benefits estimate will also help you determine how much more you need to save. For more steps to follow when retirement is on the horizon, see kiplinger.com/links/countdown. KPFM
**State Tax Map for Retirees**

Whether you are contemplating relocating after you retire or staying where you are, you’ll want to know how the state where you might live taxes retirees. Kiplinger has a handy online tool to help with this—an updated state-by-state guide to taxes with detailed information on how each of the 50 states and the District of Columbia tax retirees. For example, you’ll see which states give special breaks on retirement income and which ones provide property tax breaks for seniors. Alaska, Wyoming, South Dakota, Mississippi, and Florida top the list as the five most tax-friendly states for retirees. See kiplinger.com/letterlinks/2018map to view the retiree tax map and compare states. **KTL**

**A Lucrative Social Security Move on Its Way Out**

If you are turning full retirement age in 2019—that’s 66—see if you can take advantage of a valuable Social Security strategy that lets you restrict an application to spousal benefits only, giving you some Social Security income now while allowing your own retirement benefit to grow 8% a year until age 70. To restrict an application to spousal benefits only, you must have been born before January 2, 1954, and be at least full retirement age. Your spouse must have already claimed his or her benefit. If you don’t qualify, you can still maximize Social Security benefits by coordinating claims with your spouse. For instance, the lower earner could take his or her benefit first, while the higher earner allows his or her benefit to grow until turning age 70. **KRR**

**The Best High-Yield Bond Funds**

There is much evidence that, except in credit crunches and recessions, high-yield corporate debt is a reliable income producer. Bonds rated single-B and double-B rarely default. You do have to be patient: Over the past 10 years, the typical high-yield mutual fund was more than twice as volatile as the Bloomberg Barclays U.S. Aggregate Bond index. We prefer funds with more bonds rated BB (or Ba, by Moody’s) and B and 15% or less in CCC/Caa assets; a low allocation to energy-producer debt; and active managers dedicated to high-yield bond ideas. Spread your money around to several funds that meet our criteria. For example, Fidelity Capital & Income (symbol FAGIX, 4.5% yield, 5.2% three-year return) has about one-fifth of its assets in stocks, while Hotchkis & Wiley High Yield (HWHAX, 7.2% yield, 6.4% three-year return) has two comangers who are deans of the category. **KII**

**Watch Out for Deferred Interest**

If you opened a retail credit card with a deferred-interest plan to trim holiday expenses, be sure to pay down your balance well before the no-interest term expires. The reason: If any amount remains after the deferred-interest period expires, or you are more than 60 days late in making a minimum payment before the period ends, you can be charged interest retroactively on the average daily balance from the original purchase date. If you are racking up interest charges on your regular credit card, consider transferring your balance to a new card that charges no interest on transfers for a set period of time. For the next holiday season, consider using a general-purpose rewards card. **KPFM**