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Ted Truscott: Q&A on financial markets

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The end of the bull market, the biggest risk financial markets are ignoring (hint: North Korea) and a book recommendation.

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On a recent conference call with financial advisors, Ted Truscott discussed some of the hot issues of 2018. Read the advisors' top-of-mind concerns, and see Ted's responses.

Q: How long do you think the bull market will last?

Ted: That's the big question, isn't it? To best help our clients, my job is to be greedy when others are fearful (take advantage of opportunities that others are missing) and fearful when others are greedy (exercise caution when others are too exuberant). My interpretation of the current market environment is that there's a lot to suggest that the bull market can continue, but we need to be aware of what could happen to derail it. In our annual publication, Looking ahead: Insights for 2018, our thought leaders across asset classes emphasized that we still see good opportunities and reasons to stay invested, but we're also keeping an eye on the risks.

In addition to the tax reform that already passed, Trump has a broad deregulatory agenda — and a good amount of it can be accomplished by his executive order. We're also experiencing global synchronized growth, which helps companies' earnings. This is all good news for the bull market to continue.

But we also need to identify the risks we should be fearful of. Most immediately, I'm surprised that the financial markets haven't had a stronger reaction to geopolitical risk. And there's the longer term issue: interest rates only have one place to go — up. We're getting off the quantitative easing ride in the U.S., and Europe will follow at some point in the future.

Q: Can you talk more about what geopolitical risks you're most concerned about?

Ted: The Olympics are coming up in South Korea, which may put a spotlight back on Mr. Kim Jong-un. I don't think we should take the North Korean situation lightly, and frankly, I'm concerned about it. The politics playing out in Saudi Arabia are also very interesting. There's no doubt that Crown Prince Mohammad bin Salman has made a lot of enemies in the process of reforming the economy and society, and the events that follow could affect not just the Middle East, but also the price of oil. Venezuela, one of the largest holders of crude oil, is also in bad shape. Around the world, there's a plethora of potential geopolitical risks that financial markets don't seem to care about, probably because nothing catastrophic to financial markets has actually happened as a result of any of these situations.

Geopolitical risk is hard to figure out and even harder to predict, so we need to make sure we're consistently talking to our clients about it. It does affect markets, sometimes to a lesser or greater degree. This printable cheat sheet shows Chief Investment Officer Colin Moore's three criteria to assess the effect a geopolitical event is likely to have on the financial markets and whether that effect will dissipate quickly or linger.

Q: What is a not-so-obvious risk that investors should keep an eye on?

Ted: The structure of the yield curve. A normal yield curve is upward sloping — bonds with a longer maturity have a higher yield. If the yield curve inverts, it's the fixed-income market's way of warning that there's a potential slowdown or recession coming. We've never experienced an end to quantitative easing because we've never had it before! At least not to the same degree in any memory I have. So, how the Fed goes about ending quantitative easing — and the effect it will have on the yield curve — will be a huge thing to keep an eye on going forward. In this video, Senior Interest Rate Analyst Ed Al-Hussainy discusses what to expect from the end of Fed Chair Janet Yellen's term.

Q: What will be the effects of tax reform?

Ted: Tax reform will increase the gap between the U.S. government's spending and revenue collection. Economic growth is a great way to solve deficits, which is one reason why a lot of faith has been put into potentially higher economic growth. But the real question is whether we will get enough additional economic oomph to offset the larger deficits that tax reform creates. The U.S. can sustain a deficit for a while. But as the deficit grows larger, its percentage of GDP becomes greater. This is even more problematic if interest rates increase and raise the interest payments on the deficit.

Over the long run, it will be interesting to see what happens when people across tax brackets figure out that they didn't actually get a tax cut. Offsetting that

disappointment, we can confidently say that major corporations have received a tax cut. In the short run, it's a confidence booster, and I think the markets have responded accordingly. This blog post highlights six ways tax reform could affect investors.

Q: What do you think about floating rate loans, Treasuries, convertible securities and emerging market debt?

Ted: That's a long list. **Floating-rate loans** are a great way to deal with rising interest rates. You're at the top of the capital structure food chain in the event of a bankruptcy (meaning you have an earlier claim on the assets), and the coupon on floating-rate loans will increase as rates do. So the biggest risk is credit risk rather than interest rate risk.

I'm not a huge fan of global or domestic **Treasuries** right now because interest rates are going up, which makes them less attractive. The attractiveness of **convertible securities** really depends on the individual security, so I would highly recommend considering a diversified product to invest in them — at the end of the day, the value of any convertible bond is based on the terms of that particular security.

Finally, **emerging markets debt**. I'm bullish for all things emerging markets given the growth prospects in emerging economies. But you have to be careful of local currency risk and picking the best opportunities from all of the emerging market debt possibilities out there. In short, a diversified product backed up with bond-specific research may be a prudent way to access emerging market debt.

Q: Have you read any good books recently?

Ted: I recently read *Capitalism without capital: The rise of the intangible economy* by Jonathan Haskel and Stian Westlake. It discusses the increasing role of intangible assets in the economy. A lot of these intangible assets are simply ideas or patented methods, and a lot of that stuff doesn't show up on a balance sheet the same way the tangible assets of a steel company traditionally would have. The result is that the price-to-revenue and price-to-book metrics may not be as good at indicating a company's value as they once were. The challenge of measuring this rise in intangible assets, and the effect it has on markets and society, is really interesting. And as a former security analyst, I find the challenge of valuing companies with intangible assets even more interesting to follow.

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