Quarterly Insights

January 2018

EDGING FORWARD

The dichotomy between the political and economic environment is striking. Depending upon whom you listen to, our political affairs are either influenced by Russian collusion and hacking or run by the deep state of imbedded, left wing politicos. It is certainly a lot to absorb but, in reality, it has not stopped the U.S. economy from achieving some remarkable benchmarks. Strengthening employment data, strong corporate earnings, and a world characterized by low interest rates and modest inflation have given the investment markets a strong growth base. And now, Congress has passed a much anticipated tax bill. What looks good in short run, however, may be setting the stage for future problems.

The signature provisions of the tax code reform are oriented more towards corporations than individuals. In addition to cutting the corporate tax rate from 35% to 21%, the bill provides incentives for corporations to repatriate foreign earnings. The complexity of corporate tax reform goes beyond anyone's ability to provide a simple understanding of how this works. Suffice to say, corporations will pay less in taxes and they will have an incentive to invest in the U.S. That, at least, is the Republican spin.

The housing lobby screamed with dismay at the new tax bill but it seems unlikely to have much impact. Sales of both new and previously owned homes jumped in November while optimism among builders is at an 18 year high. Still, home prices have risen faster than income and wage growth and home ownership is stuck at 62% - a 50 year low. Clearly, the 2006 housing market crash damaged the myth that residential housing prices can only go up and Millennials are less inclined to be buyers. Rising prices may well reflect a lack of supply rather than higher demand as new construction remains 40% below its peak more than a decade ago .

The impact of tax reform on the U.S. economy is uncertain but it comes at a time when the economy is picking up steam. The U.S. economy, subdued for almost a decade, has still outpaced the world's developed countries. Fueled by an aggressive Fed policy stance, which was later adopted by Europe and Japan, the U.S. stabilized during the Obama years and then began to accelerate after President Trump's election. The U.S. economy has surprisingly achieved 3% plus growth, 4.1% unemployment, and 2.2% inflation. Tax reform is expected to boost consumer activity by targeting tax cuts to middle income groups. In fact, the limitation on deductions will be more than offset by both a higher standard deduction and modestly lower rates. High income earners will see little benefit here while those in high tax states will actually pay more.

In response to upside economic momentum, the Federal Reserve has been quietly but steadily reversing policy by nudging short-term interest rates higher. The current Fed Funds rate stands at 1.25% and most Fed watchers predict at least three hikes in 2018 as growth heats up. Famed economist Milton Friedman believed that time lags in monetary policy are long and variable. Rate hikes at this point are pre-emptive and directed towards keeping future inflation under control. We expect incoming Fed Chairman Jerome Powell, who is known as a pragmatist, to continue the Fed's slow yet deliberate policy tightening. If the Fed raises rates too quickly growth might be reined in; however, if they move too slowly they risk allowing inflation to run faster than wanted.

Higher interest rates in the U.S., as well as a flow of corporate profits repatriated under the new law, should strengthen the U.S. dollar in further 2018. Corporations which had been deferring taxes on earnings will need to convert those assets back into U.S. dollars. It's been estimated that there is $1 trillion in earnings held overseas which could materially increase demand for dollars. A strong dollar makes U.S. companies less competitive on world markets. Offsetting this , however, is the fact that central banks globally are beginning to normalize their policies by ending stimulus and raising rates. Foreign investors may soon find a more compelling interest rate in their own currencies as well as better investment opportunities at home.

One of the curiosities of our world and perhaps a sign of elevating excess is the Bitcoin phenomenon. We have had a few inquiries on how to invest and, while we are glad to pass that information along, we won't be adding Bitcoin positions to our portfolios any time soon. Bitcoin, the limited supply digital currency, was designed to facilitate peer-to-peer transactions outside of the traditional banking system. Developed by a still unknown person or group, it was designed to protect real purchasing power from Central Bank's printing of fiat currencies by having a hard limit of 21 million Bitcoins in circulation.

In an ironic twist of events, that same concept of limited supply has attracted the attention of speculators who have driven the price higher in a self-perpetuating cycle. The extreme volatility in the Bitcoin's price has, in fact, vastly limited its utility as a transactional currency. An inherent feature in any useful currency is it's relative stability in purchasing power. And, at least for the time being, Bitcoin still needs to be converted to a traditional currency for most spending and investment purposes. The 30% one day drop in value in December scared the speculators but also highlighted the limitation of Bitcoin as a legitimate alternative to the U.S. dollar.

Schroders Global Investor Study, which surveys 22,100 people globally about their expectations of annual returns, revealed that the average investor expects to earn 10.2% annually over the next five years. On the high end Millennials expect an 11.7% return while the over 65-crowd expects 8.1%. Both these are well ahead of the S&P's 20-year average return of 7.23%. We do not think it is unusual to see a shift to higher risk taking as markets push higher.

We are encouraged by the economic progress both at home and abroad, but remain disciplined in our approach of maintaining a balance in portfolios to manage unanticipated risks. We look forward to, hopefully, another productive year in 2018.—Jerry McQueen & Todd Fungard

SUMMARY OF THE TAX CUTS AND JOBS ACT

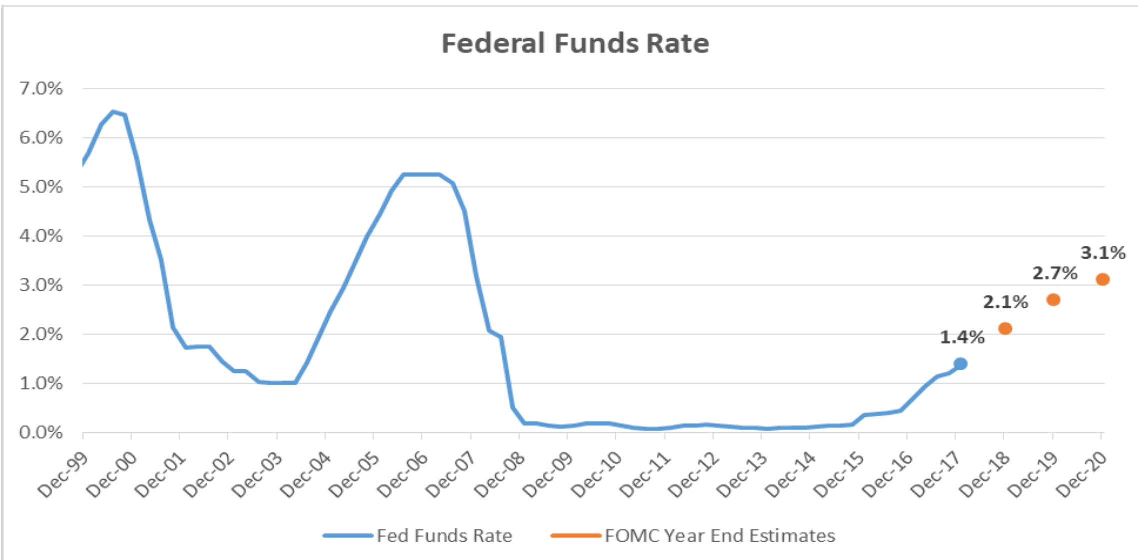
On December 22, 2017, President Donald Trump signed into law H.R. 1, known as the Tax Cuts and Jobs Act (TCJA). This major piece of legislation makes widespread changes to the Internal Revenue Code that will impact every taxpayer. Corporate tax reforms are now permanent. Tax provisions related to individuals are generally written as temporary modifications to the tax code and will be subject to a sunset provision at the end of 2025.

The following is a summary of some relevant changes to the individual tax code. This is not intended to be an in-depth all-inclusive outline. If you have any questions or would like more information, please feel free to contact us to discuss how the new tax legislation impacts your personal situation for 2018.

- 7 ordinary income tax brackets remain and most are decreased by a few percentage points (10, 12, 22, 24, 32, 35, and a top rate of 37%).
- The tax on dividends and capital gains remains at 0%, 15%, 20% and 23.8%. Taxpayers whose income is predominately dividend and capital gains will see little benefit from lower rates.
- The 3.8% tax on investment income for joint taxpayers with income above $250,000 remains unchanged; $200,000 for single taxpayers.
- Personal Exemptions, which had been limited under the old law, are now eliminated.
- The standard deduction for joint filers is increased to $24,000; $12,000 for singles.
- Most common deductions remain, though they are more limited. Most notable is the limitation on deductible taxes – a $10,000 maximum deduction cap for married filing jointly applies to state and local income taxes and property taxes combined; $5,000 for single and married taxpayers filing separately.
- The combination of limited deductions and an increased standard deduction means that many people will no longer itemize deductions.
- The individual AMT was not repealed but the base exemption was increased to $109,400 for joint taxpayers and the phase out threshold was increased to $1 million. Because of these changes the AMT is essentially eliminated for all but a small group of taxpayers.
- The estate tax exemption amount for 2018 has been doubled to $11.2 million for individuals; $22.4 million for couples. Both portability and step-up basis remain, as does the top 40% tax rate on gifts and estates, and the other existing rules on generation-skipping taxes.
- The 2018 annual gift exclusion amount increases to $15,000 per beneficiary per donor.
- 529 plans can now be used for private elementary and secondary school expenses (for up to $10,000 in distributions per student each year). This provision includes public, private, or religious schools.
- There is modification to the Kiddie Tax. This is a provision which taxes a child's unearned income. Under the new law, this income will be subject to higher trust rates instead of parent's tax rates.
- A wide range of families will benefit from a greatly expanded Child Tax Credit with drastically higher income phase outs.
- Pass-through business owners (i.e. partnerships, LLCs, S corporations) may receive a 20% deduction of qualified business income, subject to a number of limitations and qualifications. - Mike Peters

INTEREST RATES

After nearly 8.5 years the Federal Funds interest rate rose above 1% in 2017. It ended the year at 1.38%, a level that was last seen prior to the Global Financial Crisis in 2008. Higher short-term interest rates should offer savers a better rate of return. The Fed has been gradually raising short term interest rates to preemptively stave off expected inflationary pressures from the growing economy. In contrast, longer-term rates stayed relatively flat in 2017. The 10 year US Treasury note ended the year at 2.40%, slightly lower than the 2.45% level where it began at the start of the year. Looking ahead over the next 3 years the Federal Open Market Committee (FOMC) expects higher Federal funds rates at the end of each year as seen in the chart below. We welcome the changes as our short duration positioning within fixed income should allow us to reinvest at higher rates moving forward. - Todd Fungard



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