Mench Financial, Inc.
Market Thoughts
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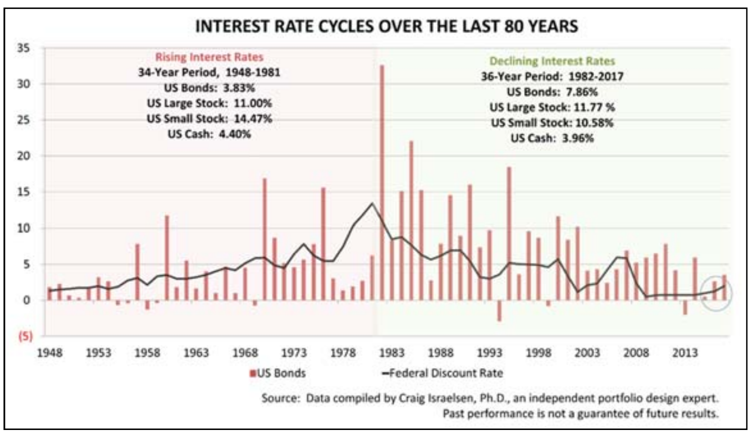
The Interest Rate Inflection Point And Your Portfolio

Interest rates are on the rise, and that means bond prices will decline. Here's a summary of financial history since World War II demonstrating how long interest rate cycles last and how it is likely to affect you.

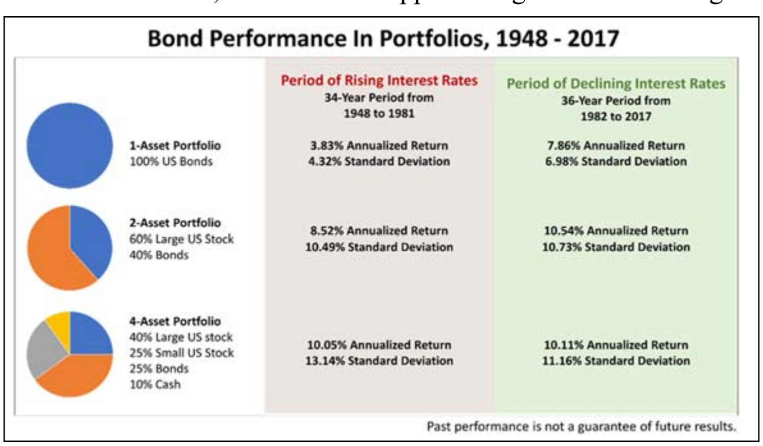


From the end of World War II to 1981, interest rates rose, as is shown in the black line in the chart. Of course, when interest rates rise, bonds prices fall because bonds paying less than the new, higher rate are less desirable and their prices adjust downward. Thus, from 1948 to 1981, the average annual return on bonds was just 3.83% annually.

Now look at what happened since the declining rate cycle began in 1982 through the end of 2017. As interest rates moved lower, the prices of bonds climbed. Bonds returned an annual average of 7.86%, for this 36-year period. Which brings us to where we are today.

Interest rates started moving up about two years ago, which means bond holdings declined in value. The Federal Reserve, which controls short-term rates — the black line — will continue to push rates higher for many years, if history is a guide. In fact, amid the strengthening economy, the Fed says it expects to ratchet rates higher again and again in 2018.

For investors who, over three decades, have grown accustomed to bonds appreciating at a rate rivalling



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Good Riddance To The Alternative Minimum Tax

Perhaps the most despised federal levy is the alternative minimum tax, which Congress passed in 1969 to prevent the loophole-savvy ultra-wealthy from shortchanging Uncle Sam.

Over the years, AMT's reach expanded to include households with more than $200,000 in AGI (adjusted gross income) annually and two-earner couples with children in high-tax states.

Under the new tax law, starting in 2018, the AMT's damage radius is reduced considerably. This alternative tax calculation still requires some individuals to calculate their tax bill twice — under regular rules and then the AMT's, and pay the higher sum. In 2018, though, a fraction of tax-filers will fall into the clutches of the dreaded AMT.

With the tax code rewritten, only about 200,000 tax filers are expected to be required to pay the AMT in 2018, way down from the 5.25 million, according to the Tax Policy Center.

Congress increased income exempt from the AMT calculation. This expands to $109,400 for joint filers, up from $84,500, and to $70,300 for individuals, up from $54,300.

The happy outcome is that the changes permit many more households making more than $200,000 to bid the AMT a not-so-fond farewell.

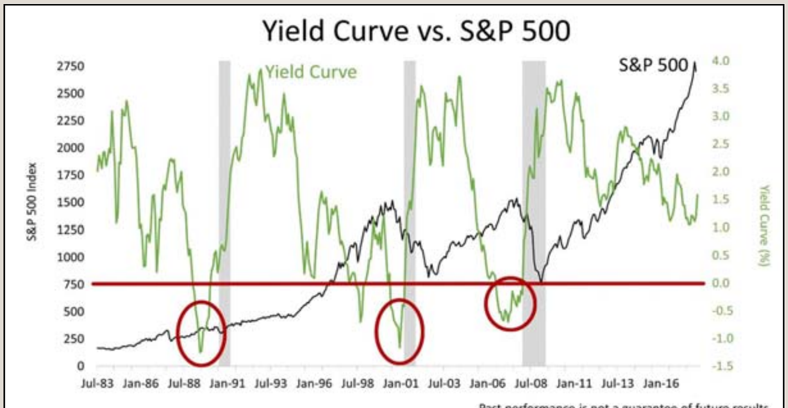
T.S.M.

Understanding Economic Fundamentals

Past performance is not a guarantee of future results.
Sources: National Bureau of Economic Research, Federal Reserve; Standard & Poor's; through February 22, 2018.

At 105-months-old, this is the second-longest economic cycle in post-World War II America. For the last couple of years, a new phase of the expansion marked by rising interest rates began. Shifting fundamentals underpinning the economy can cause jitters in investment markets or spark changes in sentiment. In fact, the most recent correction — a loss of about 12% — was caused by fears of rising interest rates and inflation. So, let's set the record straight.

While no one can predict the stock market's near-term ups and downs, what we do know is that history shows rising rates are not bad for stocks. Actually, rising bond yields have often coincided with bull markets in stocks. The red arrows point to five periods since the 1990s when the yield on the 10-year U.S. Treasury bond rose sharply and stock prices rose at the same time.



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Sources: National Bureau of Economic Research, Federal Reserve; Standard & Poor's; through February 22, 2018.

A more reliable economic and financial indicator is the yield curve — the difference between long-term bond yields and short-term interest rates. When the difference between the yield on 10-year U.S. Treasury Bond and the 30-Day U.S. Treasury Bill is more than zero, an expansion could continue just fine. However, when the yield curve is inverted — when a 30-Day Treasury yields more than a 10-year Treasury — that has been bad for the economy and stocks. Before each of the last three recessions, the yield curve went into negative territory.

Currently, the yield curve isn't near inversion. It's not signaling an end to the eight-and-a-half-year expansion and bull market. This 105-month old economic expansion is approaching the length of the longest expansion, the 120-month cycle in the 1990s, and it's still got legs. Of course, indicators are not a guarantee and must be considered in the context of history and your personal situation. But the yield curve is key to watch as this expansion nears the 120-month longest-ever cycle in the 1990s. Please let us know if you'd like to receive our email newsletter about wealth management. ●

Giving More To Loved Ones – Tax-Free

While it may be better to give than to receive, as the adage contends, both givers and receivers should be happy with the new tax law. The annual amount you can give someone tax-free has been raised to $15,000, from $14,000 in 2017.

Exempting $15,000 annually from gift tax, over time, transfers a lot of wealth to those you care about during your lifetime, while avoiding the tender mercies of the tax man, and married couples can have double the fun.

Take the example of a husband and wife with three married children and six grandchildren. The husband can give $15,000 each to his married children and the same amount to their spouses, and also $15,000 to the half-dozen grandchildren — totaling $180,000 — and his wife can do the same for the same 12 beneficiaries. The grand total is $360,000 per year. No federal tax will be levied on these transfers of your wealth to family as well as friends.

In addition, you can give more than the annual exemption caps for college savings. The Tax Cuts and Jobs Act (TCJA) permits bunching five years of $15,000 annual gifts into one year, by plugging it into a 529 college savings plan for a child or grandchild. That's $75,000 in total. Assets in 529 savings plans grow tax-free, if used to pay qualified education expenses.

Gifts made during your lifetime reduce your exemption from tax on your estate. The TCJA more than doubled the estate tax exemption in 2018 from $5.5 million to $11.2 million for individuals, and from $11 million to $22.4 million for couples. All of these new levels will increase with inflation, though the formula annually adjusting inflation is less generous than before.

Lifetime gifts can be made directly

New Ways To Influence The Next Generation

The Tax Cuts And Jobs Act of 2018 (TCJA) gives you more good reasons to help your children, grandchildren, great nieces and nephews. Any amount you give to a 529 account that's used to pay for qualified expenses for college as well as private or religious schooling before college is deductible. With tax reform eliminating all or a large chunk of state income-tax deductions for many individuals in 2018, giving to a 529 lightens your state income-tax load while perhaps changing a life of a family member or friend and influencing their values.

If a child in your family is affected by autism, ADHD, opioids, or any other modern maladies, you have new ways to benefit from the privilege of helping children with special needs.

The average annual the rate of college inflation was double the overall inflation rate for the past decade, according to College Board data, and 529 assets hit $279 billion in 2016, according to College Savings Plan Network — up almost 160% from 10 years earlier, as parents tried to keep pace with rising college costs.

Enacted two decades ago, Section 529 plans have become popular because contributions grow tax-free and withdrawals for tuition, books, room and board are also tax-free. No limits are imposed on contributions, but your 529 may not exceed the estimated cost of a beneficiary's education expenses.

Many states let you deduct 529 contributions from state income tax, and some also allow deductions made to out-of-state 529 plans. Almost all states offer 529s and permit out-of-state residents to invest. Here's how the new tax overhaul encourages 529 savings:

Savings on state income tax lowers federal liability. To the horror of high-tax states, federal deductions for state income, property and sales tax were limited for 2018, and annually through 2026, with a $10,000 limitation. Still, 41 states have an income tax and New Hampshire and Tennessee tax dividends and other investment income, and about three dozen states allow deductions for 529 contributions. Your gifts to 529s lower your income subject to federal as well as state income tax, easing the pain of losing the federal deduction for state and local taxes.

Paying for private school tuition. 529s to pay for kindergarten through 12th grade are now permitted, but you must check to see if your state allows you to deduct 529s used to pay for private schools.

Consider financial aid. A 529 might hurt a child's chances for financial aid at private high school. However, 529s do not penalize an applicant for Federal Student Aid (FAFSA) for college.

Children with special needs. This bolsters a federal tax break for those who become blind or disabled before age 26. It also covers education for modern maladies, like ADHD and autism. Enacted in 2014, ABLE accounts make gifts to individuals with special needs eligible for tax-free growth in 529 accounts. The 529 accounts are not figured into eligibility for Medicaid, Social Security income or Supplement Security Income (SSI) payments.

Deduct up to $15,000 a year by giving to an ABLE account from a 529. Spouses get twice as much benefit. Withdrawals are tax-free for qualified expenses, like employment training, housing, fighting autism, ADHD and overcoming disabilities.

If you have the privilege to be able to help the next generation and want to finance religious school, military training, or help a child with special needs, this is a loophole for you. Please let us know if we can assist you with making this happen. ●

or through trusts. With a trust, you place the gift of cash, securities, or other assets in an entity set up to make transfer of wealth after you die. The assets in the trust avoid probate court, and makes the transfer faster, less costly, less likely to be contested, and generally more sure-footed. Trusts can influence the values of your progeny by requiring the money you leave to be spent for religious, philosophical, or any variety of educational activities.

A trust also shields assets left to your heirs from lawsuits and business creditors. Should your grandchild get divorced, the trust money is shielded.

The friendlier tax treatment of transfers under the TCJA affects your estate plan and how your assets will be spent after you are gone, but it also may change your plan for gifting during your lifetime. Giving assets during your lifetime can be satisfying because you can witness your impact and influence on the future of your family. ●

Commodities Stink But Serve A Purpose

Commodities are supposed to buffer a portfolio from inflation, but years of low inflation have made commodities laggards in a broadly diversified portfolio. We're here to remind you why commodities still belong in a portfolio, even though they've been stinkers for years.

Over the past 20 years, in a portfolio with 12 distinct types of securities, commodities delivered just a 3.48% average annual return. Only cash was worse, at 20.9%. Meanwhile, U.S. stocks delivered an average return annually over the 20-years two or three times that of commodities. Stocks and commodities are negatively correlated. When one zigs, the other tends to zag.

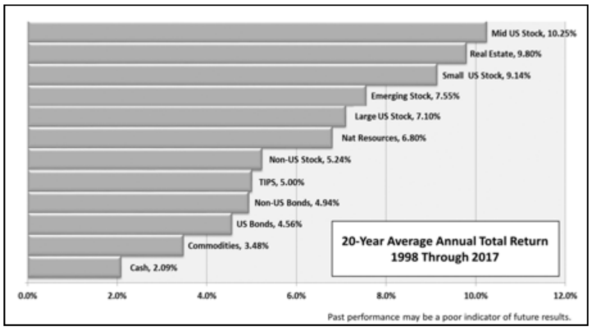
Of course, for short spells commodities performed well, usually because of a rise in the price of oil. In 2014, for example, oil topped $100 a barrel before plunging in 2016 to $28, and it recently hovered at around $60. Its price made shares of commodities-related companies behave totally different from the broad U.S. stock market. For perspective, the table shows how core asset classes performed since 1970, when accurate performance statistics on an index of a commodities company shares was first tracked. The 48 years have been defined by two cycles of inflation. The first 24 years were high inflation years, while the second 24 years were characterized by low inflation.

48-Year Average Annual Returns On Core Assets And Inflation

		Large US Stock	Small US Stock	Non-US Stock	US Bonds	US Cash	Real Estate	Commodities
Low-Inflation Era 24 Years Below-Median CPI	Avg. Nominal Return	13.08	13.76	10.91	6.39	2.45	12.58	(1.97)
	Avg. Real Return	10.80	11.44	8.67	4.27	0.41	10.30	(4.03)
High-Inflation Era 24 Years Above-Median CPI	Avg. Nominal Return	10.82	12.61	11.33	9.03	7.39	14.26	21.98
	Avg. Real Return	4.70	6.26	5.21	3.00	1.33	7.86	15.13

Past performance may be a poor indicator of future results.

Commodities, before adjusting for inflation, averaged an annual loss of 1.97% in the 24 low inflation years, while their "real" adjusted for inflation return, after subtracting the rate of inflation based on the Consumer Price Index, lost an average of 4.03%.



In the low-inflation time, stocks were the winners, with large stocks notching a nominal 10.8% average annual return. Even cash, at a 0.41% real return, averages a higher return than commodities.

However, in the high-inflation period, it's commodities that were the champs, gaining 15.13% after inflation — three time as much as large and small-cap U.S. stocks. Bonds and cash suffered the most, with 3% and 1.35% respectively.

No one is expecting a high inflation period like the one in the 1970s anytime soon. However, the cycle of low inflation changed in 2018, as the economy grew and signs of a tightening in the labor market began to appear. The Federal Reserve, the nation's central bank, says it expects the inflation rate to rise to 2% in the second half of 2018 and is planning on raising interest rates several times. With the risk of higher inflation growing at this point in the economic cycle, commodities remain important in a diversified portfolio, even though they have been stinkers for a long time. ●

Interest Rate Inflection Point

(Continued from page 1)

stocks, the future seems likely to be very different, which especially affects the demographic bubble of baby-boomer retirees, who have long favored bonds for producing reliable income.

To understand the effect the new rising rate cycle might have on your portfolio in the years ahead, this table gives you the key facts.

The 11% annual return on stocks and the return of about 4% on Treasury Bills stayed approximately the same through both the rising and falling interest rate cycles. However, the 3.8% average annual return bonds in the rising rate cycle from 1948 to 1981 was less than half the 7.86% annually averaged on bonds during the 1982 to 2017 period. This poses a new kind of risk that many investors have never experienced before.

During the rising rate cycle, when the average annual return on bonds was a measly 3.83%, stocks and 90-day Treasury Bills averaged about the same annual return as they did in the falling rate cycle. The performance of stocks, bonds, and cash over this period demonstrates why diversification and a strategic approach are so important to long-term investing.

Shorter maturity bonds — due in three- to seven-years, as opposed to 10, 20, or 30 — are less susceptible to interest rate risk than longer maturity bonds with more years to run paying your interest before returning your principal.

These illustrations do not reflect the impact of inflation, which adds another dimension and requires a separate discussion. The takeaway here is that rates may be at the start in a new long-term cycle and clients can rely on our advice on the best way to manage this risk. Please do not hesitate to contact us with questions. ●

Large-cap US equity represented by the S&P 500 Index. Small-cap US equity represented by the Ibbotson Small Companies Index from 1970-1978, and the Russell 2000 Index starting in 1979. Non-US equity represented by the MSCI EAFE Index. Real estate represented by the NAREIT Index from 1970-1977 and the Dow Jones US Select REIT Index starting in 1978. Commodities represented by the Goldman Sachs Commodities Index (GSCI). As of February 6, 2007, the GSCI became the S&P GSCI Commodity Index. U.S. Aggregate Bonds represented by the Ibbotson Intermediate Term Bond Index from 1970-75 and the Barclays Capital Aggregate Bond index starting in 1976. Cash represented by 3-month Treasury Bills.