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Market Thoughts

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Third Quarter 2018

Fed Shatters Conventional Economic Wisdom

Conventional economic wisdom holds that the record-low unemployment rate will cause employers to bid up wages, which then will be passed through to consumers in the form of higher prices, triggering rising inflation. However, conventional wisdom is being shattered.

Just as civilization came to understand that the world is not flat, the world just recently realized that the framework for understanding the relationship between inflation and employment, The Phillips Curve, was wrong.

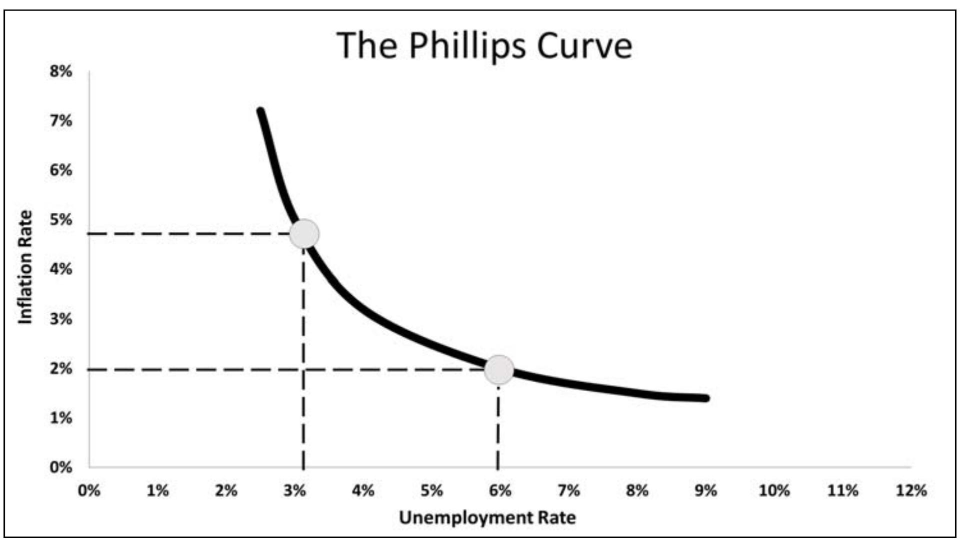
While civilization generally progresses at glacial speed, this is a breakthrough in the world's understanding of economics and it has modern-world consequences.

William Phillips, a professor of economics at the London School of Economics in the 1950s, explained the inverse relationship between unemployment and wages in 1958. When the economy grows the unemployment rate declines, driving wages and spurring higher inflation.

By the late 1960s, the Phillips Curve was the primary framework for forecasting inflation among central banks across the world. Now, however, in a departure from conventional economic wisdom, the Phillips Curve is being rethought by the U.S. Federal Reserve.

Jerome Powell, the chairman of the U.S. central bank, does not expect a sharp rise in inflation, even though unemployment has hit a record-low and wages are on the rise. He believes the inverse correlation between employment and wage inflation isn't as strong as it used to be, and he sets U.S. interest-rate policy.

If the Fed relied on the Phillips Curve, Mr. Powell would likely be trying to head off inflation right now by raising rates more aggressively to slow down the economy.



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This First Year Under The New Law Requires Planning

The new federal tax code affects the return you'll file in Spring 2019.

The standard deduction, the amount you can subtract from your taxable income if you don't itemize, nearly doubles from $12,700 for joint-filers to $24,000, and from $6,350 for singles to $12,000. That's big.

Fewer than half of those who itemized their 2017 return are expected to itemize in 2018. If you have never used the standard deduction before, preparing your return will be much simpler. A joint-filer with more than $24,000 of itemized deductions will still want to itemize.

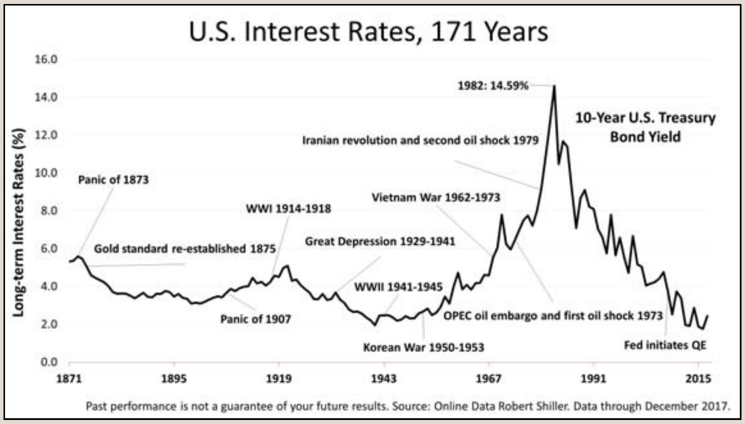
If you are still going to be itemizing in 2018, medical expense deductions will be more generous. For tax years 2017 and 2018, medical outlays in excess of 7.5% of adjusted gross income are deductible. However, Congress is considering extending the 7.5% threshold on medical expenses or making it permanent. Stay tuned.

The Alternative Minimum Tax — a despised set of parallel tax rules — will zap fewer Americans in 2018. The AMT started in 1982 as an effort to close loopholes, but it gradually affected more individuals and, in the 1990s, Congress stiffened the AMT rate. Under the AMT, the standard deduction and deductions for state and local income taxes are lost. The AMT exemption is much higher under the new law. Starting in 2019, the threshold income level subject to AMT rises to 10%.

This is an unusual period of adjusting to the new tax law and it requires professional care. Please contact us with your questions.

T.S.M.

Everything You've Learned About Interest Rates May Be Wrong



In the long arc of financial history, Americans are coming off a 50-year aberration and returning to normal interest rates.

The last 50 years represent an aberration of U.S. financial history in the context of the last 171 years. In the long arc of financial history, lessons learned over a lifetime may be wrong.

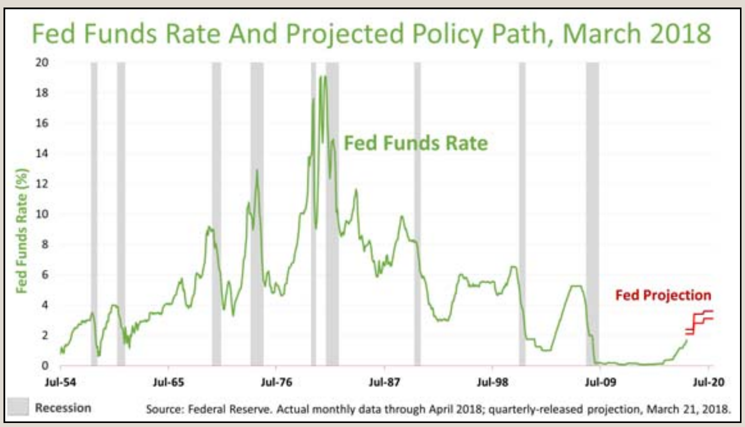
Though double-digit rates are a fear investors have dealt with for five decades, history indicates it is unlikely to occur in our future anytime soon. Beginning in the late 1960s, a 25-year period of rising intertest rates was followed by a 25-year period of declining rates, completing only in recent months a 50-year cycle highly unlikely to repeat itself anytime soon.

The yield on a 10-year U.S. Treasury bond, in the grand sweep of history, averaged about 4% annually. That's normal. Mortgage rates of the 70s, 80s, or 90s were abnormal.

The "new normal" ironically is the old normal. No wonder the financial press is confused.

In late March, when the 10-year T-bond yield topped 3% for the first time since 2014, it sparked a spate of headlines about the risk of rising rates. Such fears may be misplaced, using the 171-year history as a guide.

The new normal may be a 2% inflation rate and a 10-year bond yield of 4%. Headlines evoking fears that a 3% yield on 10-year T-Bonds portends 1980s'- or 1990s'-style inflation and a rise in interest rates are unlikely in the years ahead.



The Fed is expecting the 10-year Treasury bond to revert to the long-term mean of about 4% in 2020. Once a quarter, the Fed releases its interest rate policy, plan, and projection. Based on the Fed's plan and forecast, the Fed Funds Rate is targeted to hit 3% in January 2020. The Fed could be wrong, but it's not wildly wrong and it's what you should expect. Despite your life experience and widely-held notions, interest rates over the next decade probably won't be anything like what you've experienced before.

To be clear, your experience in fixed-income investing has been framed by an outlook based on aberrantly high rates. A reversion to the 100-plus year mean Fed Funds Rate is expected by the Fed. Thus, investing based on your experience isn't enough now; understanding the future of interest rates requires historical perspective. As a financial professional, our experience in investing is informed by the long arc of history. ●

10 Years After The Great Recession

Ten years ago, the economy was bleak. The U.S. was in a recession. The subprime mortgage crisis was undermining Bear Stearns, Lehman Brothers, Countrywide Financial, AIG, and other major financial institutions; General Motors looked like it might go out of business. Then, in a story for the ages, the nation bounced back and led the world out from The Great Recession.

Over the last 10 years, a dollar in America's 500 largest public companies grew to $2.48. From the stock market's low point on March 9, 2009, a dollar appreciated in value 4.75 times, to $4.72 – a 372% return!

For the past decade, what makes America exceptional was in plain sight but difficult to see in the moment. It's never easy to see why U.S. stocks would gain in value. The current period is no different.

Share prices plunged 10.2% in early February, on inflation jitters, and again in March, on fears of a trade war. In April, *The Wall Street Journal* warned of a long period of weakness

A Guide To The New Rules On Tax Deductions In 2018

Uncle Sam giveth, and Uncle Sam taketh away. The new federal tax code, which went into effect in 2018 and affects the return you'll file in spring 2019, lowers taxes by expanding some deductions, but restricts or outright eliminates others.

Deductions lower your taxable income so you pay less tax. Here's how deducting items from your income were expanded, restricted, or eliminated.

EXPANDED DEDUCTIONS

Standard deduction. The standard deduction is the amount you can subtract from your taxable income if you don't itemize — that is, individually deduct items like mortgage interest, charitable donations, and car loans. Nearly doubling the standard deduction to $24,000 for joint filers and $12,000 for singles pushes it up from $12,700 and $6,350, respectively. Fewer than half of taxpayers who itemized their 2017 return are expected to itemize their 2018 return. If you file using the standard deduction, preparing your return will be much simpler. If the standard deduction is less than the total of your itemized deductions, you'll still want to file by itemizing, subject to the rules below.

Medical expenses. If you itemize deductions, medical expense deductions will be more generous. For tax years 2017 and 2018, medical outlays in excess of 7.5% of your adjusted gross income are deductible. Starting in 2019, the threshold rises to the previous level of 10%. Congress is widely expected to consider extending the 7.5% threshold or making it permanent.

Alternative minimum tax. This very unpopular parallel tax system has been reined in and will zap fewer Americans in 2018. The AMT started in 1982 as an effort to reduce loopholes open to ultra-high-income earners, but its net gradually spread and it affected more individuals. In the 1990s, Congress hiked the AMT tax rate, stiffening its cost. Under the AMT, the standard deduction and deductions for state and local income taxes are lost. With the new law, your exemption — the amount you can subtract from your AMT liability — is much larger. Previously, $54,300 was exempt for a single-filer and $84,500 for a married couple filing jointly. Respectively, the exemptions increased by almost a third, to $70,300 and $109,400.

Child tax credit. This actually is not a deduction against your income. It's a credit on your tax bill. A credit reduces your tax bill dollar for dollar. The credit for children under age 17 was raised to $2,000 from $1,000.

RESTRICTED DEDUCTIONS

State and local taxes. Lawmakers placed a $10,000 cap per return on deductions for state and local taxes (SALT). Till now, the amount you could deduct for SALT levies was unlimited. If you live in a place with high state and local taxes and home prices, you're hit hard. If you earn more than $100,000 in adjusted gross income and live in California, Connecticut, Maryland, New Jersey, New York or Oregon, you're very likely to see a material hike in your annual federal tax liability for at least the next decade.

Mortgage interest. You can continue to deduct this interest for first and second homes. The change: For mortgages dated after Dec. 14, 2017, only the interest on the first $750,000 of debt is deductible. Before that date, the $1 million ceiling still applies. In places where home prices and, thus, mortgages, are low, that is not as much of a concern. In high-price locales, it is.

Home equity interest. You no longer can deduct interest paid on home equity loans, unless it is used to improve the dwelling. Many people use such loans, which are secured by their homes, to pay for college tuition or new cars. If a home equity loan and the mortgage totals more than $750,000, the amount over that limit can't be deducted.

ELIMINATED DEDUCTIONS

Personal exemption. Exemptions, which lowered your income by $4,050 per person — usually family members — are gone. For some families with children over 17, who can't take advantage of the expanded tax credit, the elimination of the personal exemption will be a net loss.

Alimony. For divorce and separation agreements made after 2018, alimony payments will no longer be deductible. The deduction is helpful to a paying ex-spouse who is short on funds.

Casualty and theft losses. If your house burned down or a crook took your wallet, you could deduct the loss not covered by insurance to the extent it exceeded 10% of your income. Under the new law, only casualty losses suffered in a natural disaster declared by the president are deductible.

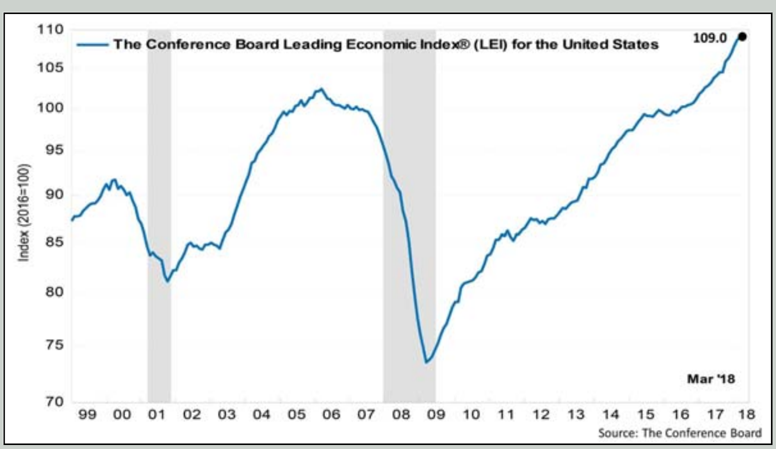
Job expenses. Continuing education, medical tests and licensing fees previously were write-offs. Not anymore.

Moving expenses. Before, you could deduct these if you moved to start a new job and it was a good distance (that varies by circumstances, but typically meant 50 miles away) from your old home. Now, that is gone, unless you are in the military.

Tax prep. Depending on the complexity of the return, these fees can amount to more than $500. Uncle Sam no longer will let you deduct them, though. ●

and cracks in global growth. Things looked bleak.

We're here to remind you that U.S. leading economic indicators released in April continued a long surge far beyond the highest point of the last expansion. This key forward-looking composite of 10 indicators points to solid growth for the rest of 2018. Despite the headlines, increased market volatility, and a weak first quarter return on stocks, very strong economic fundamentals remain in place. We're here to help you manage your portfolio for the long run. ●



Ten Things About 10-Year U.S. Stock Market Performance

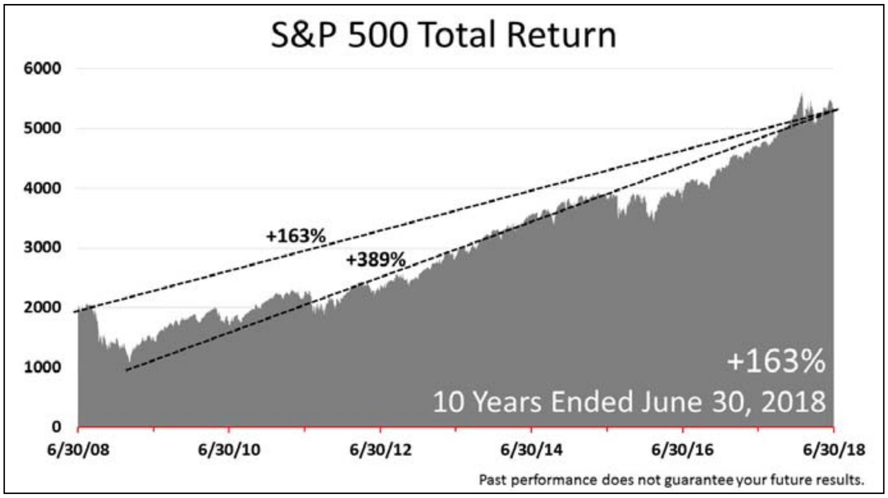
Although a picture is said to be worth a thousand words, out of respect for your time, here are 290 words about this chart of U.S. stock market performance over an amazing decade.

1. Over the 10-year period ended June 30, 2018, the S&P 500 total return index gained +163%, an average annual return of 16.3%, compared to the average annually since 1926 of 10%.

2. From the financial crisis bottom on March 9, 2009, the S&P 500 total return index through June 2018 gained +389% — an average return in those nine years of 43.2%.

3. In the nine-year bull run, stocks "corrected" — market-speak for a decline of 10% to 20% — four times, and each double-digit setback came in the last five years.

4. An investor with perfect timing predicted the March 9, 2009 low during the bottom of the 40% drop in prices in the bear market of 2008-9, which no one could, and then held for the next nine years, despite four corrections.



5. An investor with the worst possible timing, who put their retirement nest egg in stocks at market peak a decade ago, just before values plunged by 40%, in the decade, averaged a return of 16.3% annually.

6. The Great Recession decline of 40% was one of the worst bear markets in modern U.S. history.

7. Those within five years of retiring are at the greatest risk to bad timing and can be mitigated by strategically allocating assets, which is crucial to pre-retirees.

8. America's 500 largest publicly held companies more than fulfilled their role as the engine of growth in a broadly diversified retirement portfolio.

9. Understanding 10 years of stock market performance requires knowing statistics, but mostly depends on knowing the history of domestic and global financial assets, along with economic fundamentals driving growth.

10. No one can predict the end of a bear or bull market or the stock market's next big move. ●

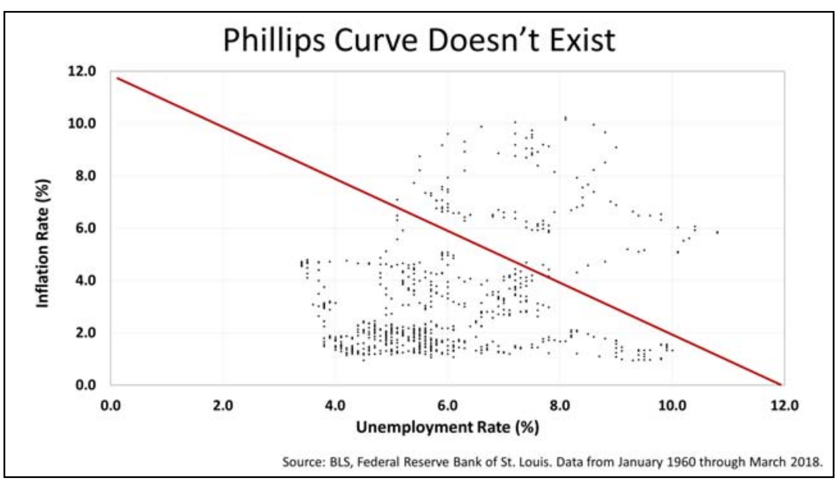
Fed Shatters Economic Wisdom

(Continued from page 1)

Inflation recently surged to the Fed's target rate of 2% and the unemployment rate dropped to a record low of 3.9%. In addition, the Index of Leading Economic Indicators, a forward looking composite measuring growth literally 10 ways monthly, rose again in April continuing an uptrend and suggesting solid growth continuing through the second half of 2018.

Mr. Powell, who became Fed chair in February 2018, has moved decisively in defiance of conventional wisdom, highlighting humanity's improved understanding of financial economics.

This chart from independent economist Fritz Meyer, whose research we license to share with you regularly, shows the inverse relationship of inflation and unemployment since 1960.



If the Phillips Curve were an accurate forecasting tool, each of the black dots would line up on top of the red line. When Professor Phillips came up with his theory in 1958 it was prophetic, but a half-century later we know so much more.

We're here to help you plan your future based on facts, analysis, and humanity's growing understanding of financial economics. ●