ANDERSON
FINANCIAL STRATEGIES

Quarterly Playbook

1st Quarter 2018

Current Financial Planning and Investment Themes

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If the world were perfect, it wouldn't be. – Yogi Berra

As we look at how things stand going into the beginning of 2018, it's hard not to be optimistic. The US economy seems to be firing on all cylinders, securities markets have positive momentum for the most part, and even global environments are measurably improving. However, we are still a ways away from euphoria and there is still the potential for negative surprise in the form of monetary policy and geopolitical challenges…

US Economics

With the US economy already accelerating to highway speeds, the passage of the *"Tax Cuts and Jobs Act of 2017"* was like adding a turbocharger to the mix. However, year-long expectations of tax reform most likely were the high octane fuel that led to the high performance of the 2nd, 3rd, and 4th quarters of 2017. The 3rd and final estimate came in at 3.2% for the third quarter and expectations for the 4th quarter are similar. The Fed tightened upward their projections to 2.4%-2.6% from 2.2%-2.7%. Our feeling is that the final number will be closer to 2.6%-2.7%. Furthermore, there is no reason to doubt that quarterly GDP growth will slow, so we are projecting the annualized 2018 GDP growth rate to be above 3%, which would be the first time this will have occurred since 2005. For more evidence of economic strength, we can look to the employment numbers. The most recent U-3 (official) unemployment rate ticked down to a seasonally adjusted rate of 4.1% from 4.2% in September. The Federal Reserve is forecasting this rate to drop even lower to a remarkable 3.6%-4.0% range for 2018. Likewise, the U-6 (broader definition including part-time) rate fell to 8.1% from 8.3% as of September. Unfortunately, the Labor Participation rate ticked down a couple of points, back to 62.7% as of December vs. 63.0% back in September. Our hope is that this number increases toward 65% over the next few years. Overall, the economy is in very good shape and tax reform should further solidify and accelerate that standing.

**Summary of Economic Projections to be released with the FOMC minutes December 13, 2017

US Equity Markets

The US Equity markets are motoring along quite nicely and are not looking to need a pit-stop anytime soon. Although there is a mix of excitement and skepticism about how far and how fast the markets have come in the past 14 months, there are also plenty of justifications. While it is true that most categories of stocks have P/E ratios higher than their 15-year averages, the denominator "E" or earnings component of the equation is expected to grow meaningfully due to tax reform and economic strength. Other supportive factors include relatively high dividend yields, earnings yield spreads that continue to be positive, and corporate cash levels close to 30% of current assets according to JPMorgan Research. It is our belief that the US stock markets will have a healthy year with above average returns across small and large market caps, just not as good as 2017. This is a natural part of markets pricing assets in anticipation of where fundamentals will be.

US Fixed Income

The pressure is increasing on bond yields, especially on shorter maturity bonds. As a reminder, when bond yields are increasing, this means that bond prices are decreasing. With all treasury bonds from 2 to 30 years only having yields between 2-3%, it doesn't take a big downward price move to eat up the income and cause flat to negative total returns, which is what we expect for government bonds in general for 2018. However, moving over to corporate bonds and even high yield corporate bonds, the income production should overpower any pricing pressures in our view. Most global bonds, however are still yielding much lower than US bonds, which provides some downward resistance to sharp rises in yields. All in all, fixed income should continue its muted positive total return status into 2018.

International Markets

International environments are still continuing to shine; especially emerging market equities which were the highest performing asset class in 2017 with returns in the upper 30+%. Other more developed international equity benchmarks weren't far behind. These trends are also expected to continue as we see synchronized global growth. Both Europe and Japan, however, are still progressing through their recovery and have a significant way to go.

Real Estate
Real Estate in general should see some benefits from improving economic growth and a higher degree of cash flow due to the new tax law. However, even though it seems like REITs have been trying to play catch-up, there are still reasons they might not get there due to factors such as increasing interest rates. REITs are experiencing a high degree of sensitivity to the increase in interest rates and are only producing returns around average, whereas most other *risk assets* are producing above average returns. Although we believe there are strong fundamentals in this asset class, the most likely environment is more continued average returns in 2018 in our view.

Legislative
Well, after almost a year of not being able to get much done, Washington finished off the year with a bang! We were not expecting a tax bill to be passed until early 2018, but the Congress, incentivized by the need to retain the standing balance of power, negotiated hard and pushed through the first major tax reform bill in 27 years. This is significantly positive for markets and the economy, and many companies have already adjusted various items accordingly such as employee bonuses, increased 401k matching contributions, increasing minimum starting wages, and raising earnings outlooks. As the theory goes, the increased growth in GDP will bring in more tax revenues to offset the rate cuts, we shall see… Moving forward, the 2018 legislative menu includes trying to pass a budget, dealing with DACA and other immigration issues, and dealing with entitlement spending reforms. At this point we do not anticipate another attempt to pass a healthcare reform bill until after the "mid-term" elections are passed. They may surprise us, but we expect 2018 to be a little quieter….

Interest Rates & the Fed
We were wrong, as we believed that the Fed would not raise interest rates again in December, but yet they did. Furthermore, they went against data that showed they have not yet met their objective of a minimum 2% inflation. In my opinion, this was a mistake. However, this isn't the end of the world. They probably wanted to get a rate hike in before the new Fed chair, Jerome Powell, took over. This would allow them to have an easy, hold steady first half of 2018. At present, the yield curve is getting very flat, which can signal trouble. The reason is, if the yield curve inverts, this causes banks to restrict credit, the life blood of an economy, and cause a recession. As we have mentioned before, there is a growing body of economists that blame the Fed for most US recessions due to raising interest rates too quickly. This is a primary risk for 2018 that we will want to keep our eyes on. Despite what the media and the Fed's own predictions might tell you, our view is that only two rate hikes in 2018 are likely appropriate.

Financial Planning Corner: Summary of New Tax Law Changes (Tax Cuts and Jobs Act of 2017)

Individual, Trust, and Estate Tax Rates and Brackets

Changes

- For individuals, the new law provides for the same number of tax brackets, but with lower rates and different income thresholds. See the following charts for income thresholds associated with each bracket.

Marginal Tax Rate	Single	Married Filing Jointly	Head of Household	Married Filing Separately
10%	$0-$9,525	$0-$19,050	$0-$13,600	$0-$9,525
12%	$9,525-$38,700	$19,050-$77,400	$13,600-$51,800	$9,525-$38,700
22%	$38,700-$82,500	$77,400-$165,000	$51,800-$82,500	$38,700-$82,500
24%	$82,500-$157,500	$165,000-$315,000	$82,500-$157,500	$82,500-$157,500
32%	$157,500-$200,000	$315,000-$400,000	$157,500-$200,000	$157,500-$200,000
35%	$200,000-$500,000	$400,000-$600,000	$200,000-$500,000	$200,000-$300,000
37%	Over $500,000	Over $600,000	Over $500,000	Over $300,000

- The tax rates for trusts and estates have also decreased and now consist of only four brackets. New rates: 10%, 24%, 35%, and 37%. Old rates: 15%, 25%, 28%, 33%, and 39.6%.

Standard Deduction and Personal Exemptions

- Personal Exemptions have been eliminated
- However, the Standard deduction has been increased, even doubled in some cases.

Tax Filing Status	Previous Standard Deduction (Set to take effect in 2018)	New Standard Deduction
Single	$6,500	$12,000
Married Filing Jointly	$13,000	$24,000
Married Filing Separately	$6,500	$12,000
Head of Household	$9,350	$18,000

Qualified Dividends and Capital Gains

Long-Term Capital Gains Rate	Single Taxpayers	Married Filing Jointly	Head of Household	Married Filing Separately
0%	Up to $38,600	Up to $51,700	Up to $38,600	Up to $77,200
15%	$38,600-$425,800	$77,200-$479,000	$51,700-$452,400	$38,600-$239,500
20%	Over $425,800	Over $479,000	Over $452,400	Over $239,500

Estate, Gift, and Generation-Skipping Taxes

• The new law doubles the "applicable exclusion" to $11,200,000 per person, effective in 2018.

• This exclusion will continue to be inflation-adjusted in future years.

Business Income and Deductions

• The tax rate for C corporations is reduced to a flat rate of 21%.

• Corporate AMT is eliminated.

• There is now a new deduction for 20% of qualified business income of S corporations, partnerships, and sole proprietorships.

- In general, this special deduction is allowed against business profits, and does not apply to wages earned by the business owner.
- The amount of the deduction generally cannot exceed 50% of wages paid by the business, however, capital-intensive businesses may qualify for an alternative limitation based on the value of capital assets.
- This deduction is not available for businesses that provide services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, investment or brokerage services, or any business where the principal asset is the reputation or skill of one or more of its employees.
- Owners with taxable income below $315,000 (if married filing jointly) or $157,500 (if single) are still permitted to take this deduction, without regard to the limit for wages or specified services businesses.

• Taxpayers are also able to deduct 20% of income received as qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income.

• 100% expensing of qualified business property is allowed for five years then gradually phases-out.

• Increased limits for expensing are allowed under Section 179 and certain real property improvements are added as qualifying property.

Other notable changes:

- Congress did not repeal existing Medicare taxes (the 0.9% additional payroll tax, or the 3.8% tax on net investment income) that apply to higher-income taxpayers. These apply when adjusted gross income (AGI) exceeds $250,000 (joint) or $200,000 (single).
- The deduction for state and local taxes is significantly changed. This deduction will be capped at $10,000 for the sum of state and local property taxes and income taxes (or sales tax in lieu of income tax). Property taxes paid in carrying on a trade or business will not be subject to this $10,000 cap.
- Mortgage interest deduction limit on qualified acquisition debt is reduced from $1,000,000 to $750,000. This means interest is deductible on loan balances up to $750,000 used to buy, build, or improve your primary home or one second home. This reduction applies only to debt incurred on or after December 15, 2017.
- Mortgage interest deduction is eliminated for interest paid on home equity debt. This is debt used for something other than to buy, build, or improve your home.
- Cash contributions to charitable organizations may now offset up to 60% of your AGI (up from 50%).
- Deductions for investment expenses, tax prep fees, and unreimbursed employee expenses are eliminated.
- Medical expenses exceeding 7.5% of your AGI are deductible (down from 10%). This reduced limit applies only for 2017 and 2018.
- The phase-out of itemized deductions for higher-income taxpayers is eliminated.
- The child credit increases from $1,000 to $2000. The income level at which the credit begins to phase out also increases allowing more taxpayers to benefit.
- Alimony payments for divorce agreements entered into and/or modified after December 31, 2018 will no longer be deductible by the payer and will not be considered income to the recipient.
- The Alternative Minimum Tax exemption is increased allowing more taxpayers to escape AMT.
- The rule allowing a contribution to one type of IRA to be re-characterized as if made to another type of IRA is modified to exclude Roth IRA conversions. Normal IRA contributions may still be re-characterized.
- Qualified distributions from a 529 plan now include up to $10,000 annually for grades K-12.

Our firm is not a tax or legal advisor. Although this summary is not intended to replace discussions with your tax advisor, it may help you to comprehend the tax implications of your investments and plan efficiently going forward.