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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.

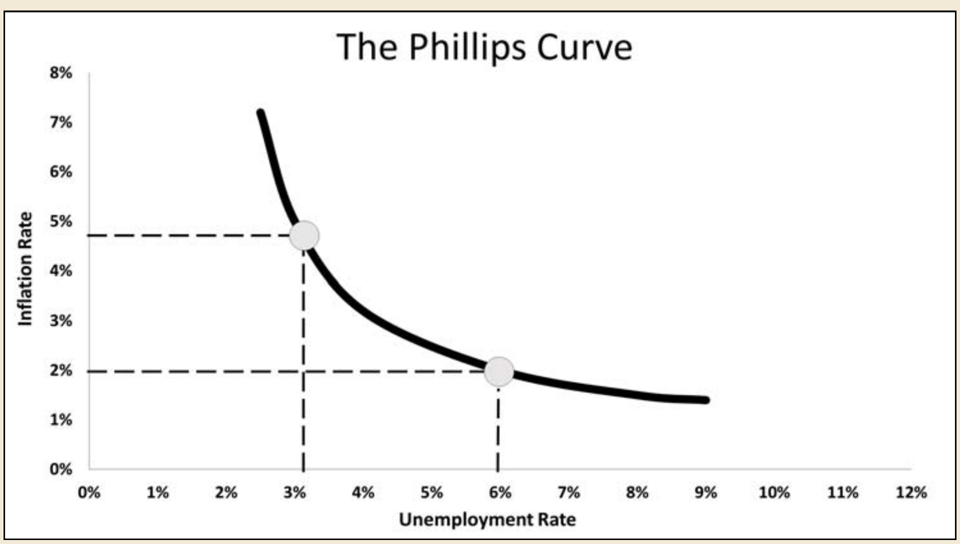
While civilization generally progresses at glacial speed, this is a breakthrough in the world's understanding of economics and it has modern-world consequences.

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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Life Is Fragile, So, Please, Value Each Day As Priceless

If you spend your professional life giving financial advice, you learn to appreciate every day.

As financial advisors, the fragility of life unfolds before us every day. At any moment, a client might call amid a family crisis or death.

This is not the kind of thing to bring up at a cocktail party, but this is part of the day-to-day work of a financial professional: a 17-year-old killed in a car crash; a 65-year-old mother of two grown children succumbing to cancer in her husband's arms; and a litany of unspeakable family tragedies happening in slow motion. This is the most important work in the practice of a financial professional.

The specialized knowledge about financial planning that we bring is often thought of only amid a family crisis, and that is what we're here for. It is a privilege not taken lightly.

Your trust motivates the relentless pursuit of your best interest and that is the way we operate. But the main point here, in these 190 words, is not about business; it's that we all should be thankful for every moment of every day and value it pricelessly.

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 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. ●

New Deduction Rules For Business Owners

If you are a small business owner, Washington, D.C. has changed tax rules to lower your burden but the new rules are fairly complex. Many small businesses, and some that aren't so small, are "pass-through companies," tax-jargon that means the entity's net income isn't taxed at the corporate level but flows straight to their owners' personal returns. That income is taxed at personal income tax rates, as opposed to corporate rates that are generally lower.

The new tax law, though, has a valuable deduction that evens things out for pass-throughs, although the accounting gymnastics make this anything other than simple. "The size of the deduction varies, depending on the nature of the business activity and the total income of its owner," says Howard Gleckman, a senior fellow at the Tax Policy Center. "It may also depend on how much the business pays its employees and how much property it owns."

Under the new tax law, the top personal rate drops to 37% from 39.6%, with similar reductions in brackets below the highest level. Yet most U.S. businesses are classified as C corporations, which means these companies are taxed separately from their owners. The new tax law lowers the federal tax for C corps to 21% from 35%.

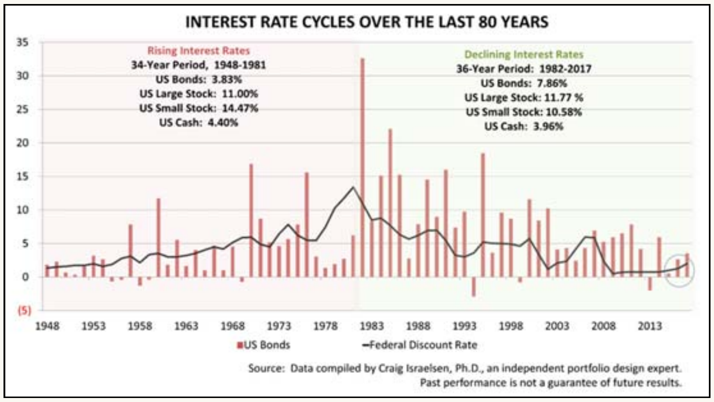
To balance out the difference, Congress allowed pass-throughs — limited liability companies (LLCs), S corps, partnerships and the like — a 20% deduction on their net income. The effect, for those in the top tax bracket, is to lower an owner's rate to 29.6% from 37%. True, 29.6% is higher than 21%, but owners of C corps, meaning shareholders, pay a tax on dividends they receive, usually 15%. So that comes closer to parity with the pass-throughs.

To prevent those part-time jobs from being deemed as pass-through entities, lawmakers limited the new rules. So, you can't suddenly claim you are a

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.

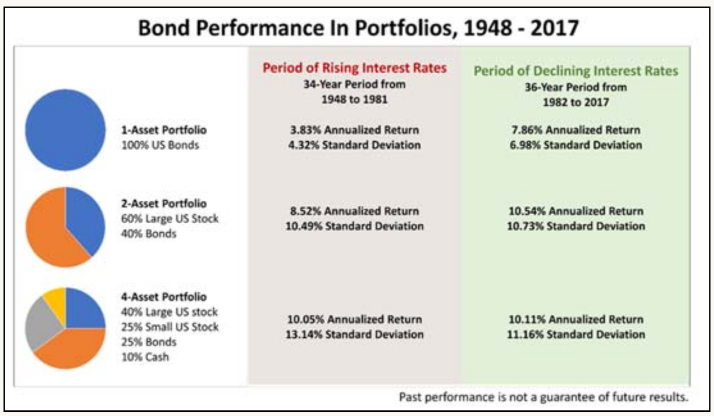
From the end of World War II to 1981, interest rates rose, as is shown in the black line in the chart. Of course, when interest rates rise, bonds prices fall because bonds paying less than the new, higher rate are less desirable and their prices adjust downward. Thus, from 1948 to 1981, the average annual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

consultant and create a sole proprietorship with the intent of grabbing a tax break.

Owners of service businesses — doctors, lawyers, and consultants — are limited in what they can deduct. Service businesses, according to the tax law, may count as their principal asset the "reputation or skill" of the owners and employees, while manufacturers may not.

In addition, Congress inserted income limits on the deductions that affect all pass-throughs, whether or not they're a service business. The 20% deduction is confined to income of $157,500 for single-filers and $315,000 for married couples. For service businesses, the deduction is phased out progressively in excess of those levels and eliminated entirely when total taxable income is $207,500 for singles or $415,000 for couples filing jointly.

For other types of businesses, the deductions over those thresholds are limited to the greater of 50% of paid wages or 25% of wages plus 2.5% of the business' tangible depreciable property.

The pass-through rules are a big boon for real estate operators, whose properties usually each are LLCs. Further, if every property in a real estate owner's portfolio, say an office building or a shopping mall, is worth a large amount, the deductions can be sizable. For example, on a shopping mall worth $5 million, 2.5% of its value is $125,000. That's quite a deduction. ●

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Fed Shatters Economic Wisdom

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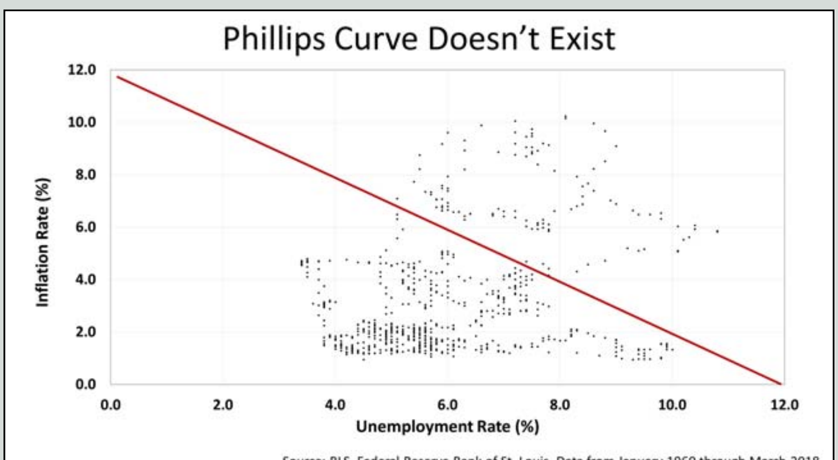
Inflation recently surged to the Fed's target rate of 2% and the unemployment rate dropped to a record low of 3.9%. In addition, the Index of Leading Economic Indicators, a forward looking composite measuring growth literally 10 ways monthly, rose again in April continuing an uptrend and suggesting solid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