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2017: Strong Markets, Good Economy

The changing of the White House guard was felt even before the inauguration on January 20th. President Trump's agenda, built on a repeal-and-replace mentality, focused on revamping nearly everything established prior to his term. There have been successes and failures in forcing change, but the year ended with one clear political victory: tax reform. Before we dive into the specifics of the new law, let's recap a bit more of the past year and offer up some thoughts on the year ahead.

2017 saw the the economic recovery continue at a moderate pace, with some signs of improvement. By all measures, optimism has taken hold: the bulls are in charge, and the bears are doubting their own position. Stocks fluctuate up and down in the natural course of things, but in 2017, investors felt no pain. The biggest "correction" in 2017 was a paltry 3% pullback. But investors would be wise not to grow accustomed to this past year's results. This level of unfettered market gains has its limits: the average annual pullback in the current cycle has been 12%.

According to early Federal Reserve estimates, the US economy grew 2.8% in 2017. Unemployment now sits at 4.1%, just shy of the 40-year record low of 3.8%, enjoyed in the go-go '90s. Some economists predict we will match that record within the next 24 months. Wages grew at a modest 2.4%, but a pickup in home sales suggests optimism for the year ahead. Manufacturing growth saw an uptick in the fourth quarter, and corporate profits rose for the full year.

Tax reform will take immediate effect in 2018, and could temporarily boost GDP to just over 3%. Lower individual tax rates will translate into higher paystubs for most workers, and those extra dollars will support continued spending on goods and services. Some companies have announced their tax savings will be used to raise wages, but history suggests corporate America will use the bulk of the tax windfall to increase dividends, buy back stock, or pay down debt. Paying off debt may be the wisest corporate decision, as debt has grown steadily over the past few years and will face expensive refinancing costs with higher rates. Rates are forecast to rise by 0.75% in 2018, but could go further if inflation heats up. Because of the risk of excessive inflation, it's unusual for a large stimulus package such as tax reform to be announced nine years into an economic recovery. The Federal Reserve is pleased with what they're seeing so far, with inflation close to their 2% target.

Index	*12/31/2017*	*YTD*
Dow Industrials	**24,719.22**	**25.1%**
S&P 500 Index	**2,673.61**	**19.4%**
Russell 2000	**1,535.51**	**13.1%**
MSCI EAFE	**2,050.85**	**21.8%**
Global Bond Index	**484.70**	**7.4%**
10-Year Treasury yld	**2.4%**	

As recently as 2015, the Federal Reserve was keeping interest rates at absolute zero: today, US rates are a full 1.5% higher. So far, the Fed has made a smooth start in normalizing interest rates, keeping inflation below or near target. A new Fed chair takes the helm in 2018, but expect the same slow and stable policy with Jerome Powell as with Janet Yellen. Expectations are for the Fed to raise interest rates to 2% or slightly higher by the end of the year. This is good news for savers, as money markets, CDs, and bonds will start paying more.

Bond investors have so far survived the initial phase of rising interest rates, with interest received offsetting lower valuations. Bond prices will continue to fluctuate, but bond investors should anticipate continued steady income and net positive returns in the years ahead.

The stock market, over time, is the best means of profiting from the broad advance of the economy and from productivity gains. But

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Quotes:

The ability to distinguish between volatility and loss is the first casualty of a bear market.
Nick Murray

The stock market is a giant distraction from the business of investing.
Jack Bogle

Don't save what's left after spending ... spend what's left after saving.
Warren Buffet

If you look at what you have in life, you'll always have more. If you look at what you don't have in life, you'll never have enough.
Oprah Winfrey

Money doesn't do much when it's standing still. It's when it's moving around that it really works.
Terry Pratchett

The stock market is designed to transfer money from the active to the patient.
Warren Buffet

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Safety in Numbers: One Phish, Two Phish

Cyber-crooks constantly develop new tactics, as new software blocks the old attacks, as users learn the old tricks, and as the ever-changing digital world offers new openings.

In the last few years, Microsoft in particular made a major shift from a set of programs on your computer to cloud-based 'software as a service'. Hundreds of other companies have added mobile platforms and apps to their offerings. For some users, this means convenience and connectivity – and for hackers, it means a new front for attacks.

Most of us know, by now, the look of a 'phishing' email, but the newest versions are getting harder to spot. When a misspelled email from a bank you don't use hits your inbox, it's easy to spot the risk and delete it. But will you be equally suspicious of an email from a service you do use, warning you that your account might be compromised? How about a notice from your cloud-based email platform, asking you to review quarantined items? Or a UPS tracking email for a shipment you don't remember ordering?

All of these have passed through my own mailbox in the last few months, each one sporting a clickable link leading – somewhere.

Nowhere good.

2017 In Review

(cont'd from page 1)

we've all experienced, too recently, the potential for stocks to disappoint in the short run. We can't ignore that current US market valuations are a bit rich. We're continuing to exercise caution in our exposure, diversifying into better valuations in international markets, and maintaining bond exposure as a hedge against the next correction. It's unlikely that 2018 will be as calm and steady for stocks as 2017 was.

The Tax Bill

The 2017 Tax Cuts and Jobs Act makes major changes to our tax system. While not the largest tax cut ever, it is significant and will have implications for all of us. Since this article cannot be comprehensive, we will highlight the provisions that will have the most impact on our clients.

The top marginal tax rate has dropped from 39.6% to 37% and tax brackets have been restructured, eliminating the marriage penalty for couples who earn less than $400,000. However, future annual increases in the new brackets are not likely to keep up with inflation. As income rises, individuals will creep into higher brackets sooner than expected. The personal exemption has been eliminated, but the standard deduction is nearly doubled, to $12,000 for individuals and $24,000 for joint returns. Although the personal Alternative Minimum Tax (AMT) has not been repealed, a higher exemption will reduce the number of individuals affected. Because the bill is not "revenue neutral", tax-cut provisions for individuals will expire in 2025 unless renewed. Tax cuts for corporations are permanent.

Deductions for state and local taxes will be capped at $10,000, hitting clients living in areas with high income and property taxes. The mortgage interest deduction will be limited for new loans to mortgages under $750,000, and home equity loan interest is no longer deductible at all. The deductible limit for medical expenses has been retroactively dropped from 10% of adjusted gross income (AGI) to 7.5% for most taxpayers, but for the 2017 and 2018 filing years only. Additionally, the law repeals the individual insurance mandate.

For families, the child-care tax credit has been expanded to offset the loss of personal exemptions. Funds in 529 educational savings accounts, formerly restricted to college expenses, can now be used for private K-12 schooling tuition.

Estate taxes for many of our clients will now be a non-issue. The tax remains, but will only apply to the small subset of individuals with estates over $11.2 million, or $22.4 million for married couples.

The tax bill drops the US corporate tax rate to 21%, previously at 35% and considered the highest in the developed world. On paper, this change makes the US more competitive for business. In practice, the actual tax savings to US corporations will be less than advertised, as most already enjoyed effective rates much lower than 35%. The largest US corporations will also get a one-time windfall, paying just 15.5% tax on offshore funds repatriated back to the US.

Another major change is to the taxation of "pass-through" corporations, such as LLCs, partnerships, and S Corporations, the preferred structure for many small and middle-sized businesses, where profits are taxed on the owners' personal returns. Owners of this type of businesses will be able to deduct up to 20% of their corporate profits earned, with some rules and limits to preclude abuse. A further exception will cause certain high-income-earning "personal service" corporations, such as medical and legal firms, accountants, and financial services entities, to continue to be taxed at individual rates.

We have concerns about the bill: after accounting for potential acceleration in economic growth, various projections still have the bill adding approximately $1.5 trillion to our already $20 trillion national debt. Tax reform is a boost to the economy, but previous rounds of tax cuts suggest it will be difficult for this bill to pay for itself.

While the bill had some good intentions, it was rushed and contains many flaws: most Americans will benefit from this tax reform, some more than others, but there will be long-term costs from the government's lost revenue, and a high probability of unintended consequences as the IRS tries to interpret the law. With so many provisions changing, we encourage you to consult your tax professional on how it will affect you.

Have a wonderful and happy new year. And if you can, contact your HR and update your 401k contributions. The new contribution limits are up $500, to $18,500 ($24,500 if you're over 50).