January 2018 Client Letter

By now, you have probably read more than one discussion about the changes in the tax code but a couple of points and then a list of the major changes. We are still early in the process of fully understanding these changes and updates are expected in the future.

"The legislation will result in substantive tax reform for corporations, with the elimination of the corporate alternative minimum tax (AMT) and consolidation down to a single 21% tax rate (from 35%), all of which are permanent," Michael Kitces, a respected authority on tax issues, wrote on Kitces.com.

"However," he added, "When it comes to individuals, the new legislation is more of a series of cuts and tweaks, which arguably introduce more tax planning complexity for many, and will be subject to another infamous sunset provision after the year 2025."

Sharpen your pencils – the new tax code and tax planning

Over 80% of Americans will get a tax cut next year, while just 5% of taxpayers are expected to pay more (Tax Policy Center, *Washington Post*). In most cases, cuts are expected to be modest; however, much will depend on individual circumstances. We would like to touch on the high points. It's not all-inclusive and not a deep dive, but given many of your questions lately, we believe an overview is in order.

So, let's get started. (Sources for this review include Kitces.com and the Tax Policy Center.) This applies to tax year 2018.

1. The 10% bracket remains unchanged, while the 15% bracket declines to 12%, the 25% to 22%, the 28% to 24%, the 33% to 32%, the 35% holds steady, and the 39.6% slips to 37%. The thresholds are modestly adjusted above the new 22% bracket.

2. The standard deduction nearly doubles to $12,000 for single filers and $24,000 for married filers, reducing the incentive to itemize and simplifying for some taxpayers.

3. The $4,150 personal exemption is eliminated, and the $1,000 child tax credit doubles to $2,000. In general, rules for charitable contributions remain unchanged.

   By itself, the combination of points one, two, and three will provide modest tax relief for most families. But we must caution, it depends on your individual circumstances.

4. Those in high-tax states could see the biggest hit, as there will be a $10,000 cap on state, local and property tax deductions.

5. For investors, the preferential treatment for long-term capital gains and dividends remains intact, as is generally the case for retirement accounts.

   One important change – the new law repeals rules that allow for recharacterizations of Roth conversions back into traditional IRAs. Once you convert into a Roth, there's no going back.

6. The 3.8% Medicare surtax on investment income for high-income taxpayers was retained. Since the levy entered the tax code, we have crafted strategies that reduce its bite; however, the tax survived tax reform and is likely to remain a permanent feature of the tax code going forward.

7. The AMT for individuals was not repealed, but exemptions have been widened.

8. The estate tax survived, but the exemption will double from $5.6 million to $11.2 million, and $11.2 million to $22.4 million for couples.

9. The new tax bill also repeals the Obamacare mandate that requires all individuals to obtain health insurance. It becomes effective 2019.

   Finally, it's important to point out that many of the more popular changes in the tax code for individuals will sunset in 2025. While many may eventually be made permanent, as we saw with the Bush tax cuts of 2001 and 2003, there's no guarantee this will happen again.

10. And for businesses: Given that the 21% corporate tax rate applies only to C-corps, there will be a 20% deduction for pass-through entities, such as S-corps, partnerships, and LLCs. I believe this will be a welcome benefit for many business owners, but complex rules may limit the pass-through for some entities.

Final thoughts

I fully expect that the rewrite of the tax code will produce unintended benefits and unexpected consequences. From an economic standpoint, Congress and the president hope to unleash the "animal spirits" that have been lethargic for much of the economic expansion. They hope that changes, especially as they relate to business, will encourage firms to open new plants, expand in the U.S., and level the playing field with the global community.

The $64 million-dollar question – will it work? About 90% of economists surveyed by the *Wall Street Journal* expect a modest boost to growth in 2018 and 2019, but after that, opinions diverge.

If tax incentives boost productivity, it could lift long-run GDP potential, which would yield a significant benefit. If the economic benefits end after a two-year sugar high, it will likely be deemed a failure.

At a minimum, the lower tax rate increases longer-run after-tax earnings, which played a big role in the late-year stock market rally. It could also boost corporate stock buybacks and dividends going forward, which would create an added tailwind for stocks.

A peek at 2018

During our years serving as financial planners for clients, we've been inundated with articles and soothsayers that offer up specific roadmaps for stocks. Based on history, none have been consistently right. We prefer more of an evidenced based approach so let’s use math to guide us as we enter 2018.

The S&P 500 Index advanced 21.83% in 2017. That figure includes reinvested dividends, So, does a sharp upward advance in one year set the stage for a pullback in the following year? We recognize that the following examples are a little heavy on numbers, but please stick with us. I believe you’ll find the evidenced-based approach to be quite enlightening.

Since 1950, the S&P 500 has risen at least 20% (including reinvested dividends) 24 times (excluding 2017). In the year that followed, the S&P 500 finished higher (all examples include reinvested dividends) 19 times. The S&P 500 rose 79.2% of the time in the year that followed a 20% or greater advance, with an average gain of 18.1%. (Here is the link to the Http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html raw data)

When the S&P 500 has declined following a 20%+ advance, the average drop has been 6.5%.

The biggest take away from this data is that when the market has upward momentum it tends to continue upward. It also tells us that stocks have an inherent upward bias over the longer term.

What will impact stock prices in 2018?

As we have said in our newsletters and in our meetings with you over the long term, it’s always about the fundamentals, i.e., economic growth which results in profit growth and the level of interest rates. Last year continued with low inflation and what are historically low interest rates which helped the stock market.

The momentum generated by a growing U.S. and global economy is likely to carry over into the new year. As of this date, S&P earnings are forecasted to rise as much as 14% for next year. The odds of a recession which could produce a longer term downward bias in the market appear to be very low.

Having said all this and used all these numbers what does that mean? Basically, the market is in an upward bias pattern supported by strong economic growth worldwide, low inflation, low interest rates and higher projected earnings. How high prices go in 2018 is impossible to predict with any certainty but odds are for higher prices by the end of 2018.

Unexpected events can create short-term emotional responses in the market that are best avoided by long-term investors. The market moves on a shorter-term basis based on events and uncertainty that are immediately reflected in prices but long term the bias is still positive. The market last year enjoyed very little volatility with the biggest drop in the S&P at just 2.8% according to the St. Louis Federal Reserve and LPL Research. This was the smallest decline (correction) since 1995.

Can we expect more of the same for 2018? Again, that very difficult to predict but volatility is a part of the investment markets and will not be going away anytime soon. The movements in the market today come in short durations. Based on the availability of 24 hour a day news, the market adjusts to all known data very quickly.

Our job is to assist you in achieving your goals. During our meetings and conversations, we spend a considerable amount of time making sure your portfolios are in alignment with your goals. Keeping you aligned is why we rebalance your portfolio when necessary to maintain your asset allocation versus your stated goals.

We are honored that you have selected us to help with your financial planning and investment management.

We look forward to seeing you all during the coming months. If you should have any questions, before our next meeting, please call us.

Sincerely
Quintin and Ginny
January 23, 2018