MARKET TALK

WESTVIEW INVESTMENT ADVISORS

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Enjoy the Ride but Watch the Road *By Roy W. Sokolowski*

Inside this issue:

Special points of interest:

- ***Lindsay will be out on Maternity Leave starting at the end of November!*** *Lindsay and her husband Jack are looking forward to welcoming a little girl to their growing family sometime around Thanksgiving! She will be available via email and phone starting January 1st and will return to the office March 1st.*
- ***Required Minimum Distribution:*** *We are in the process of completing RMD requests. The status of your 2018 RMD is enclosed in your quarterly statements from WestView.*
- ***Markets/Office Closed****: Thanksgiving - November 22nd & 23rd, Christmas—December 25th & 26th, New Years Day—January 1st*

Roy W. Sokolowski, President

I have read that people generally think that a contrary or negative opinion sounds "smarter" than a positive or optimistic viewpoint. I've found that to be true in general and due to my cynical nature, I must confess that a contrarian viewpoint generally piques my interest more acutely as well. So, it is at the risk of some personal intellectual capital that I must tell you, truth be told, that the US markets have just concluded a very solid third quarter and first nine months of 2018. The US economy is very strong and firing on nearly all cylinders and almost everyone in the economy is benefiting. Frankly, in my estimation, the various equity and interest rate markets are reacting the way they should be, given the circumstances. Sometimes we need to just sit back and enjoy a good quarter.

As you know, my goal throughout the years in these notes is to attempt to pass on what I thought was important, overlooked, or perhaps just interesting. As I thought about the good news this quarter I realized that I could shed very little insight into a market and an economy that seemed, even if briefly, in synch with one another. Perhaps that's a personal insight – don't overthink a bull market. I did, however, note some interesting items along the way this quarter; so rather than dissecting last quarter too much, I'd like to just share the good numbers and then pass along (in no particular order) some of the items I noticed along the way.

Despite a notoriously bad reputation and a bit of a September slowdown, Q3 turned in a very solid performance and added to a positive trend this year. The S&P 500 added +7.71% in Q3, and the Dow Industrials an even more positive +9.63%. Large stocks on the US exchange (the S&P and Dow) were really the story because a September swoon in the S&P Small Cap 600 of -3.17% reduced smaller stock performance to "only" +4.71% for Q3. Foreign markets both large and emerging continued their mostly downward ways and closed Q3 with the EAFE at -3.76% for the year and the emerging markets at -9.54% year-to-date. Likewise, Federal Reserve rate hikes continue to depress the US bond market as the Barclays US Aggregate Bond Index remains negative at -1.9% YTD.

Some notes along the way:

- As you might have noticed above, the performance differential between the US equity markets and the rest of the world is striking. At Q3 close the differential was 14.3 percentage points between the S&P and the EAFE and fully 20.1 percentage points between the S&P and the emerging markets YTD. The world's capital seems to be flowing our way for now, but divergences tend to revert to the mean over time and I do wonder how this will play out.

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Provisions you may have missed in the Tax Cuts and Jobs Act *by Pat Sokolowski*

Pat Sokolowski, Vice President

The Tax Cuts and Jobs Act (TCJA) was signed into law on 12/22/2017. The 186 pages of reform were so broad that even as financial professionals we are still trying to grasp all the impacts to our clients. Although much has been made of the lower marginal tax rates, higher standard deduction, and limitations on SALT (State and Local Tax) deductions, there are several items that we found interesting and wanted to point them out to you. Here are some of the lesser publicized provisions in the TCJA:

1. **Repeal of the Pease Limitation**. IRC Section 68, also known as the Pease Limitation, limited the amount of itemized deductions that high income tax payers could take each year. In 2017 for couples with AGI more than $313,800 deductions were reduced by 3% of their income overage up to a maximum reduction of 80%. This effectively became an additional tax on the wealthy amounting to 1% or more. With the repeal of the Pease limitation itemized deductions are no longer at risk. Who benefits? High income families with significant deductions.

2. **Kiddie Tax Rule Change.** Prior to 2018, children (under age 19 or full-time students under age 24) were taxed at their *parent's* marginal tax rate if they had unearned income (such as dividends, interest) over $2100. Under the TCJA, <u>unearned</u> income in children's accounts is now taxed under the *trust* tax brackets. The Estate and Trust tax brackets are compressed, starting at 10% for unearned income under $2550, but quickly jumping to 24%, 35% and the top bracket of 37% at income over $12,500. Who benefits? Accounts with limited income and possibly smaller balances may actually pay lower taxes under the new law. However, lower- and middle-income families where children have <u>large</u> UTMA accounts could see an increase tax burden with rates going as high as 37%.

3. **Alimony.** Currently when couples divorce the alimony paid by one spouse is deductible to them and taxable income to the recipient. For divorce agreements <u>after 12/31/18</u> this has been significantly changed. Alimony payments will no longer be deductible, and the income received is not reportable. For those contemplating a divorce currently this is a big issue. Who benefits? The new law benefits the *recipient* and removes a sizable tax deduction from the *payor*. One could expect to see a flurry of divorce activity this year before the new tax treatment goes into effect.

4. **1031 Exchanges Limited.** IRC Section 1031 (also known as like-kind exchange) allows you to postpone paying taxes on a sale of investment or business property when you reinvest the proceeds in a similar property. There are complicated rules to follow, but the tax benefits are significant. Prior to the TCJA the 1031 exchange was used for investable assets like machinery and equipment, artwork, franchise licenses and patents, livestock, classic cars, airplanes or boats. Under the new tax laws, a like-kind exchange will <u>only</u> apply to real estate. Who benefits? Those involved in real estate transactions for business use.

5. **Moving Expenses.** This above-the-line deduction has been eliminated. The TCJA repealed the moving expense deduction and furthermore made employer reimbursement of moving expenses <u>taxable</u> as income. Who benefits? The only category that was carved out was active duty military personnel who move pursuant to a military order.

6. **Family & Medical Leave Act Tax Credit.** Employers who offer paid family medical leave will have a little help from the government in terms of a tax credit. The TCJA provides employers with a business credit of 12.5%-25% of the wages paid during the leave provided the employee is paid at least 50%-100% of their normal wages. This incentive is in place for 2018 and 2019. Who benefits? Employers who participate and employees who get up to 12 weeks paid leave will both benefit from this.

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WestView Investment Advisors
www.westviewinvest.com
www.westviewhhi.com

Burlington Office
95 College St.
Burlington, VT 05401
Phone: 802-489-5342

Ben Nostrand, CEO
ben@westviewinvest.com

Lindsay Antonowicz
Financial Planner & Relationship Manager
lindsay@westviewinvest.com

Louise Gibbs
Research & Trading Associate
louise@westviewinvest.com

Nick Foss, Research Analyst
nick@westviewinvest.com

Matthew Keefe
Client Service Associate
matt@westviewinvest.com

Hilton Head Office
1 Corpus Christi Place, Suite 106
Hilton Head Island, SC 29928
Phone: 843-271-6088

Roy Sokolowski, President
roy@westviewinvest.com

Pat Sokolowski, Vice President
pat@westviewinvest.com

Robert Sokolowski
Investment Advisor
rob@westviewinvest.com

Jennifer Sokolowski
Investment Advisor
jenn@westviewinvest.com

7. **Sexual Harassment Settlements.** Perhaps in a nod to the "me too!" movement, the TCJA has removed the tax deduction that businesses have been allowed to take when settling a sexual harassment or sexual abuse claim **if** the payments are subject to a nondisclosure agreement. Who benefits? Employees may benefit from the additional financial pressure that this places on businesses who will have an added incentive to control harassment in the workplace.

8. **529 Plan Accounts.** Families who are saving for college have long used 529 Plans to provide tax free growth. The original mandate of the 529 was that the distributions from these accounts would be tax-free if they were used for qualified higher education expenses. The TCJA expanded this to include expenses for elementary or secondary public, private or religious schools up to $10,000/year. Who benefits? Families with children enrolled in private schools.

9. **REIT Income.** Real Estate Investment Trusts, or REITs, have always been an interesting investment vehicle for individuals looking for income. REITs are required to distribute 90% of their taxable income each year which typically comes from interest on mortgages, rents, etc. in the form of dividends. Under the TCJA there is a new provision which provides for a 20% pass-through deduction for qualified business income; although much of the discussion about this has revolved around S-Corps, LLCs and partnerships, this also applies to REITs. Who benefits? REIT shareholders will receive a deduction of 20% of REIT dividends that they receive, which effectively lowers their tax rate from a maximum of 37% to 29.6% on this income.

10. **Marriage Penalty.** There have been attempts to eliminate the inequalities in the tax code in the tax brackets applied to individuals vs married couples. In the final version of the TCJA the marriage penalty was removed for all brackets EXCEPT the top tax bracket of 37%. Individuals reach the 37% bracket at a taxable income of $500,000, whereas married couples hit this at only $600,000. Who benefits? Taxpayers below the $600,000 threshold will now be treated equally in terms of their marginal tax rate.

We recommend consulting your CPA or tax professional early this year to be aware of what the changes will mean to you personally.

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- The consumer is in the best shape they've been in for many years. Unemployment hit a new low of 3.7% on October 4th, the lowest since 1969. Wages are rising at an average of 2.8% annually. Home prices are up +5.9% from last year and investment balances are up as well. No wonder, the Conference Board's consumer confidence number hit 138.4 in September, the best it's seen in 18 years. Also, easily understood, the retail sales numbers rose 6.5% over the summer months.

- The corporate tax cuts of last December appear to be working as planned. The S&P earnings growth rate for 2018 has exceeded 20% and after-tax margins have achieved a record high of 9.7%. Corporations have been raising dividends, increasing buybacks, and paying employees at a higher rate.

- Amazon and Apple both achieved a never before seen trillion-dollar market cap during Q3. I'm not sure if that has predictive value either positively or negatively but it is certainly something to take note of.

- Speaking of Amazon, their announcement of a $15/hour minimum wage was brilliant from both a political and business perspective. Despite the increased labor costs, I predict that Amazon's margins will go up relative to their competitors that now have to pay at least $15/hour and don't have the technical expertise and efficiencies that Amazon has. Brilliant, Mr. Bezos!

- All the good news in the US economy may come with a cost. As we've discussed many times over the last 10 years, the actions that the Federal Reserve has taken- very low interest rates for a very long time, quantitative easing (QE), etc. should ultimately manifest in the economy in the form of inflation. The Feds target was 2% inflation and it has only been recently that we've begun to run at a demonstrably higher rate – currently 2.7% (CPI headline number). Consequently, the Fed has begun to raise Fed funds rates more aggressively (another ¼ point last week) to combat the fear of runaway inflation. Interestingly, the 10-year Treasury Bond (a key interest rate gauge) which has been trading in a stubborn 2.8% -3.1% range broke out of that pattern yesterday to the upside (and significantly) closing today (Friday October 5th) at a yield of 3.233%.

- Mortgage rates have been rising as well settling around the 4.7% level last week – a level not seen since April 2011. Surprisingly to me, the level of mortgage applications and refi's dropped off almost instantly. Ned Davis Research tells me that refi activity declined 38.4% year over year and purchases were up only .8% year over year.

As always, we keep a close eye on the signs for changes in the market place and work hard to protect your interests. Feel free to call us any time to discuss your portfolios. We love hearing from you!

World Stock Markets Year-to-Date Returns as of 09/30/2018