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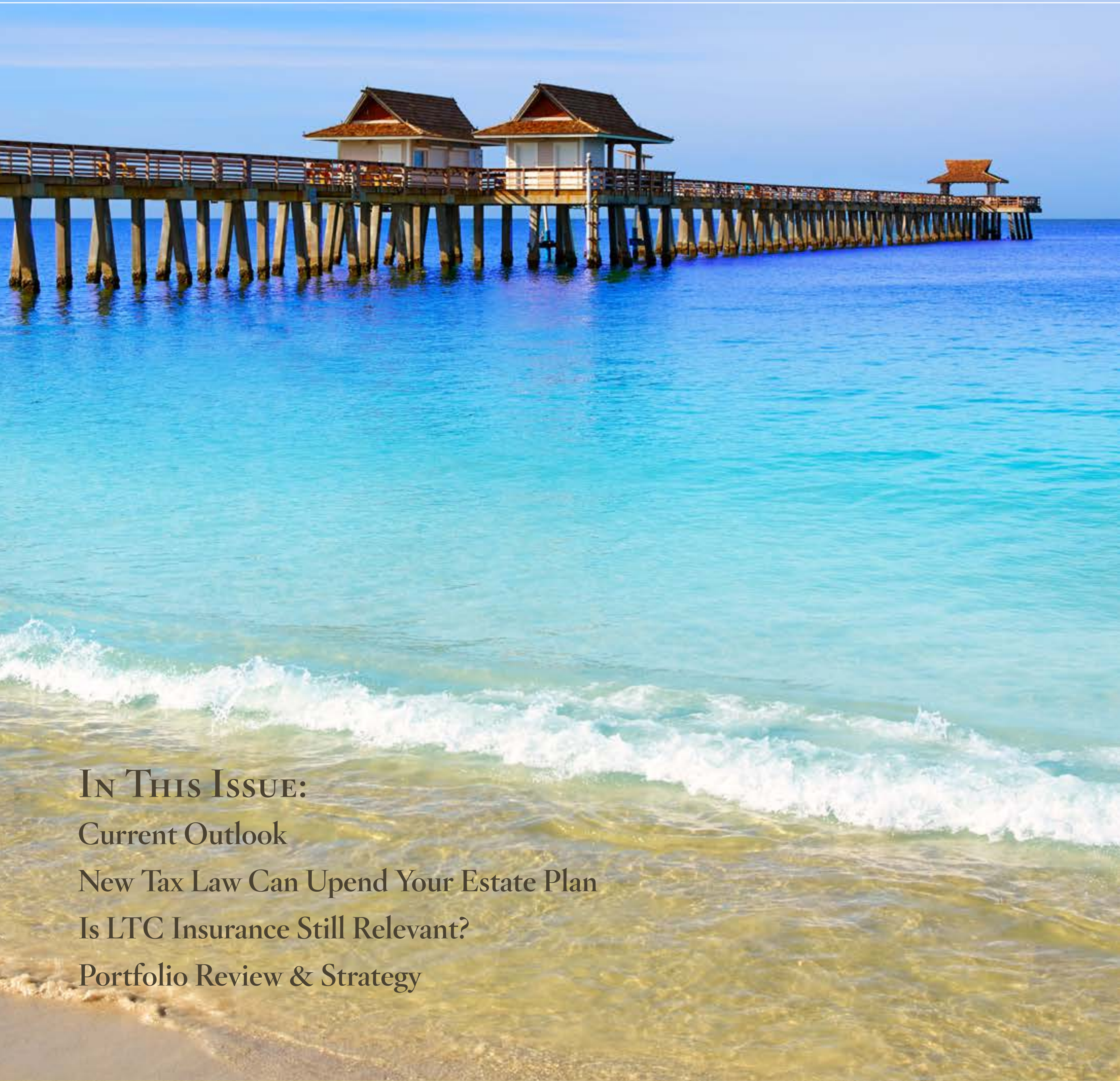
MARKETWATCH

Deeply Rooted in the Community | Fourth Quarter 2018



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Current Outlook

RICHARD E. PYLE, CFA
PRESIDENT, THE SANIBEL CAPTIVA TRUST COMPANY

Within weeks, we will be reviewing 2018 and finalizing our expectations for 2019. So far, this past year has unfolded pretty much as we had anticipated – both economically and regarding the financial markets. Our words of caution regarding "uncertainties" have proven to be correct as we review political developments. Nothing, however, was uncertain about the general direction of stock, bond, and alternative strategies. Fueled by higher economic growth and corporate tax cuts, American businesses experienced sharp profit growth and found the ability to return excess cash to investors.

While short-term interest rates rose as expected due to Federal Reserve Board actions, longer-term rates were held down by the comparatively weak yields offered by the rest of the world. Many financial markets were driven by traders playing the "spread game" of borrowing in low interest rate countries and buying higher-rate U.S. bonds. If those conditions persist and worldwide rates remain low, our bond market will remain unattractive relative to the equity market, and our investment strategies will continue to favor stocks.

We continue to watch closely the shrinking of another "spread"—the difference in yields between U.S. short-term interest rates and U.S. longer-term interest rates. Typically, the wider the "spread" between short and long rates the better the economy can perform, as entities are incentivized to invest for the future. Conversely, the narrower the "spread" the greater the chance that growth slows and the economy recesses. A few years ago, when the Federal Reserve Board was trying to jump-start the economy, they kept short-term rates at near zero while longer term bonds were yielding 1.5% - 2.0%. Today 10-year treasury bonds are priced to yield about 3.1% while two-year government bond rates have been driven higher by the Federal Reserve Board to almost 2.8%. With September's increase in the short-term Federal Funds rate and expectations of another 0.25% increase in December, we could see that "spread" approach zero, increasing the pressure on lenders and investors. We are watching this spread closely and would not be surprised if the Fed halted their rate increases in 2019 until longer-term interest rates world-wide sustainably increase.

One other event we are watching that will impact financial markets is the mid-term Congressional elections in November. Because of the 2016 elections, Washington came under single-party rule for the first time since 2008. As a result, a monumental tax reform package passed that led to a sudden acceleration in corporate profit growth. However, we may experience a return to divided rule after the election. This would give our economy a chance to digest the effects of previous policy changes, but our operating assumption is that we will not experience any roll-back of the tax reforms after the elections. Longer-term issues related to the burgeoning national deficit and debt must be addressed as well. The current path of deficit spending is unsustainable even assuming above-average economic growth. Higher revenue growth and slower spending growth are the only ways to put our fiscal house in order. However, higher taxes and slower spending are also just different sides of the same coin that would place a drag on economic growth!

Thus, our Current Outlook still offers a mix of challenges and opportunities. We expect the rate of profit growth to slow in 2019 to around 8% compared to 20%+ in 2018. At the same time, equity valuations remain reasonable. Corporate profits have been growing faster than share prices, which means price-to-earnings (P/E) ratios have declined. We expect a broadening of the economy world-wide to produce growth of around 4% despite the possible negative impact of trade conflicts. The uncertainty of trade may pose a short-term psychological risk, but we also may see these issues resolved diplomatically, leading ultimately to lower trade barriers. The bottom line: We remain cautiously optimistic and emphasize owning the best companies and fixed-income alternatives to achieve our clients' long-term return goals.

New Tax Law Can Upend Your Estate Plan

Steven V. Greenstein, J.D., CTFA
Wealth Services Advisor

The recently enacted Tax Cuts and Jobs Act, which became effective as of Jan. 1, not only reduced individual and corporate tax rates, but also made significant changes to the tax laws regarding estate and gift taxes. The most notable change was the doubling of the lifetime exemption amount an individual may transfer tax free (either during life or at death) to approximately $11.2 million per individual or $22.4 million for a married couple. These exemption amounts are expected to continue to rise, as adjusted for inflation, each year until 2026.

It is important to put the new $11.2 million lifetime gift and estate tax exemption in context. Five years ago the exemption was $5.25 million; 10 years ago it was $2 million, and 15 years ago the exemption was just $1 million. So today, while most taxpayers will never pay any gift or estate tax, the new higher exemption could drastically alter the outcome of an estate plan drafted prior to this year.

Don't assume that because you may not now owe any federal estate taxes upon death, you can allow your existing estate plan to gather dust in a file. Quite the contrary. For example, if you use funding formulas to set up marital trusts and family/credit shelter trusts upon your death, and those trusts are designed to take advantage of your remaining lifetime exemption, the initial trusts may prove to be overfunded to the detriment of your surviving spouse.

Also, many estate plans include the use of "second look" strategies after the first spouse's death, such as bypass trusts, disclaimer trusts, QTIP and/or Clayton trusts. You may now want to consult with your estate planning attorney to review and possibly update these terms in light of the increased exemption amounts.

It is also important to review any life insurance trusts you may have created in the past that were intended to pay your estate taxes upon your death. Determine if these trusts still make sense or if they should be replaced with another form of asset protection since you may no longer have to pay estate taxes at death.

Since the current lifetime exemptions expire in 2026, high net-worth individuals may want to take advantage of the increased exemptions to make gifts to new or existing trusts, thereby removing the gifted property from the donor's estate. This is particularly timely since stock prices have appreciated greatly since 2009. Putting appreciated stock into gift trusts can help you fund your favorite charitable causes at death while giving you more flexibility to diversify your appreciated portfolio now. Gifting securities outright also can help reduce the value of your estate, but keep in mind that such gifts may lose the opportunity for a step-up in basis at death and instead pass to the recipient with the donor's cost basis.

Always bear in mind that estate planning is not just about reducing taxes. A well-crafted estate plan should be designed to protect assets, further charitable intent, provide for surviving spouses, adult and minor children, and special needs beneficiaries. The recent changes in the law provide a compelling reason to review and potentially update your estate plan with your trusted financial advisors.

Portfolio Review & Strategy

IAN N. BREUSCH, CFA
CHIEF INVESTMENT OFFICER

U.S. stock markets pushed higher during the third quarter of 2018. Many of the same themes we have been highlighting the past several quarters continue to persist. Since the beginning of the year investors have clearly shown a bias for growth stocks over their dividend-paying counterparts. However, more recently we have seen dividend-paying companies participate in the market rally and keep pace with the rest of the broader stock market. This is happening while interest rates continue to move modestly higher, which is a good sign from our perspective. We are finding good relative value among dividend-paying companies considering they continue to post solid business results but have lacked a commensurate stock price increase. We are content to own stocks that move sideways (or even lower) for a period of time as long as the underlying business fundamentals are moving in the right direction.

For the majority of our client base, we remain steadfast in our belief that a combination of growth stocks and income-producing stocks provides better risk-adjusted returns and a more-predictable investment experience over long time periods. With that said, our clients' goals continue to dictate how we invest and the proportion we allocate across various investment opportunities (stocks, fixed-income, and cash primarily).

On September 26th, the Fed announced their decision to raise the Federal Funds rate by another 0.25%. The target range for the Fed Funds rate is now 2% - 2.25%. Interest rates moved higher again over the past several weeks in anticipation of the Fed's decision. We expect the U.S. economy to remain quite strong through the end of the year, giving the Fed the justification to continue to raise rates. However, the continued flattening in the yield curve (when short-term interest rates rise faster than longer-term rates) remains an issue. As also noted in our Current Outlook, the real risk is that short-term interest rates rise above long-term rates, leading to an "inverted yield curve." Interest-rate movements coupled with competing tariffs between the U.S. and China (most notably) are the two primary market risks on which we remain focused.

Our bias for stocks over bonds will remain as long as stocks offer more compelling risk-adjusted expected returns. Considering our belief that interest rates will continue to rise, we remain cautious with our bond purchases. Bond prices fall as interest rates rise (all else being equal); therefore, we believe bonds will continue to be exposed to price risk as we move forward. Reasonable people can disagree regarding the forward prospects of the broader stock market, particularly in the short-term, but it is a virtual certainty that when interest rates rise, bond prices fall. As a result, we will continue to emphasize shorter-maturity bonds for clients who desire income generation and/or reduced volatility. When rates rise, shorter-term bonds don't drop in price as much as longer-maturity bonds.

Despite the risks we highlight above, there are certainly more positive economic data points than negative, and we continue to be pleased with corporate earnings results. Even considering the rally in broader stock markets, valuation levels remain quite reasonable. So the continued rally in stocks is not unwarranted. After all, stocks should trade higher on the back of better business results.

International stocks have performed poorly relative to U.S. stocks this year. While we have limited our direct exposure to emerging markets due to outsized risks, we do own some individual companies headquartered abroad and have been allocating dollars to developed international markets where appropriate. We will continue to evaluate those opportunities as well.

Is LTC Insurance Still Relevant?

Michael R. Dreyer, CPA
President, The Tampa Bay Trust Company

According to the U.S. Department of Health and Human Services, a 65-year-old now has a 70% chance of needing some form of long-term care in his or her lifetime, most likely due to chronic illness, cognitive impairment, or mobility issues. On average, a 65-year-old couple will spend more than $100,000 on long-term care during their lifetimes – in addition to the $225,000 they will spend on medical expenses in retirement.

Since the 1980s and 1990s, several million people have purchased long-term care insurance to help them offset the costs for in-home care, assisted living, independent living, or memory care. Many of those policies were purchased while the insureds were still in their 40's and 50's. To trigger eligibility for benefits you generally must be unable to complete at least two activities of daily living without substantial assistance from another person for at least 90 days, or be diagnosed as cognitively impaired.

One challenge for those who purchased coverage years ago is that when the insurance companies first offered the coverage they lacked a history of claims experience, miscalculated that people would live longer, failed to anticipate the rapid increase in health care costs, and were unable to achieve adequate investment returns due to the low interest rate environment. As a result insurers incurred huge losses on the policies. Since those policies were subject to annual rate increases, policy holders saw double- and triple-digit increases in premiums or, conversely, large reductions in the benefits paid.

Today, few insurance companies continue to write traditional long-term care policies and have instead developed hybrid solutions, or bifurcated policies, that incorporate life insurance or annuities with long-term care protection. This was done to respond to the financial challenges of aging by creating more flexible and affordable products that met the needs of consumers and attempted to overcome the pricing problems of the past.

Now the question is whether long-term care insurance should be purchased – and if so, at what age? Coverage can be expensive, but the generally accepted principle is that wealthy people probably do not need to buy long-term care insurance. The trick is determining at what level of wealth is it safe to self-insure. A combination of some self-insurance and some limited coverage can be a way to reduce premiums and provide protection to preserve assets.

Gauging when to purchase coverage is also difficult. More than 50% of claims typically are paid after the insured reaches the age of 80, while only 10% of claims tend to be paid to someone not yet 70. That would lead you to think that it's best to wait to purchase a policy to reduce the number of years you pay premiums. But also bear in mind that rejections rise with age, too. Nearly one-third of applicants between 60 and 70 are turned down for health reasons, while only one-tenth of applicants are denied coverage when applying while in their 50s.

As we live longer and health-care costs continue to rise, it is best to speak proactively with your financial advisor about whether to include long-term care insurance as part of your retirement plan. Your advisor can help you find insurance agents or brokers who specialize in that area, who have experience helping clients file claims, and who work with multiple carriers to provide a variety of choices.

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