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MARKETWATCH

Deeply Rooted in the Community | Third Quarter 2018

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Current Outlook

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This summer we have seen evidence of "normalization" in many aspects of the financial markets and in the world economy. For nearly a decade, fiscal and monetary authorities in many parts of the globe were treading lightly. They were dealing with the impacts of the Great Recession here in the United States and debt crises and "Brexit" abroad. However, policy makers are beginning to change their tune. For 10 years, the financial crisis' impacts dictated unusually low interest rates. Until the malaise of weak final demand and low productivity ran its course, central banks were restricted to fostering low borrowing rates and endlessly purchasing their own governments' debt instruments.

The United States is now witnessing a step -up in economic activity. The Federal Reserve Board has reacted to this news with accelerating actions to remove monetary accommodation. Since 2015 the short-term interest rate that the Fed directly controls has risen from 0% to 2%, and indications are that the Fed will not stop until the rate exceeds 3%. This would finally put short-term interest rates at more-normal cyclical levels.

We are monitoring closely the relationship of short-term interest rates to longer-term interest rates. Longer-term rates are set by market factors while, as mentioned earlier, short-term rates are generally controlled by central bankers. A case can be made that because of very low long-term rates in other parts of the world, our long-term rates may not rise much above the current 3% level. If short-term rates, however, rise to or above the long term rate, an "inverted" yield curve will be in effect. Historically an inverted yield curve tends to change investment and saving behavior and portends a recession. Naturally, this could impact our outlook for economic growth and corporate profitability.

Likewise there are strong indications that central bankers in both Europe and Asia are tending toward less accommodation. While Europe still deals with systemic banking issues, the European Central Bank (ECB) has recently indicated that its strategy of quantitative easing is coming to an end. This could move short-term interest rates in that part of the world from negative to positive, but still keep them below rates in the U.S. All of these actions are designed to recognize that the world's major economies are improving and on a sustainable growth path.

There still are issues to deal with both here and abroad that could temper this positive scenario, not the least of which is the surprising emergence of a "trade war" spurred on by the U.S. While this situation may resolve itself through negotiation, the specter of rising tariffs and less trade has investors worried over possible "stagflation" — higher prices combined with slower growth. Another concern is the overall rate of U.S. economic growth in 2019 once current levels of monetary and fiscal stimulus run their course.

The current outlook for business worldwide is one of great optimism. With economic growth accelerating and profits growing at a strong rate due to corporate tax cuts, the year ahead appears positive. However, with short-end interest rates expected to rise and corporate profit growth set to slow down in the next 12 months, over-exuberance must be avoided.

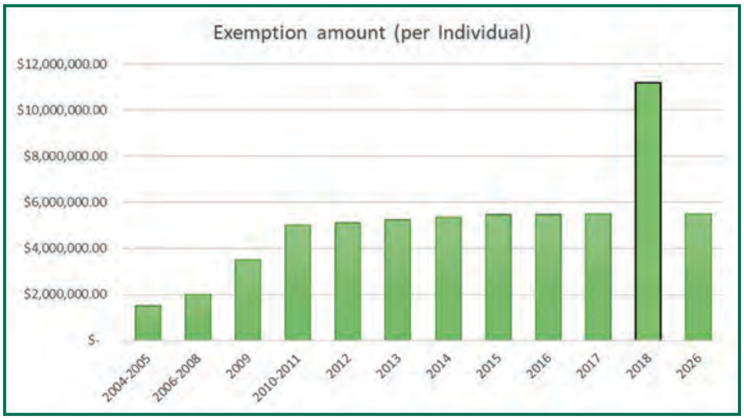
"Normalization" was something that most long-term investors had been hoping for the last several years. Now that it appears to be upon us, we must be vigilant to monitor not only the positives from this development but also the potential negatives of higher interest rates and trade tensions.

New Estate Tax Law Exemption Amounts

Hood Craddock, CPA
Director of Family Office Services

The Tax Cuts and Jobs Act signed into law by President Trump last Dec. 22 ushered in significant changes to the wealth transfer tax system. The sharp increase in the federal exemption amount means that older wills and trusts may be in need of an update. The law also opens new opportunities for estate-planning techniques as well as possible ways to save on future income taxes for your heirs.

What has changed? As of Jan. 1, 2018 and up until the new law sunsets on Dec. 31, 2025 the federal estate, gift, and generation-skipping tax exemption amounts have increased to $11,180,000 per individual ($22,360,000 for a married couple), more than doubling the previous exemption in 2017 of $5,490,000 per individual ($10,980,000 per couple). The tax on assets in excess of these amounts remains at 40%. The graph below shows the gradual change in the exemption over the past 15 years and its planned sharp decrease in 2026.



Consider making lifetime gifts and creating trusts now — A married couple can now transfer $22.4 million during their lifetimes with no additional wealth transfer tax. Consider moving assets out of your estate now in order to use your federal gift-tax exemption instead of waiting to use your federal estate tax exemption at death. Any gifts made now will be grandfathered against the exemption coming back down in 2026. There are many estate planning techniques that can be used to get the most out of the new exemption, including generation-skipping trusts, spousal lifetime access trusts (SLATs), grantor retained annuity trusts (GRATs), intentionally defective grantor trusts (IDGTs), as well as others.

Income tax considerations — Assets removed from your estate with the above techniques can miss out on a big income tax break, however. When passed directly to heirs after death, assets such as stocks, bonds and real estate get a "step-up" in cost basis to the market value on the day the owner died – so heirs selling those assets would pay income tax only on appreciation after the date of death. Assets gifted today, in contrast, don't get the basis step-up. Therefore, individuals or couples who have total estate assets below the new exemption amounts may want to consider leaving those in their estate - being cautious, of course, that the exemption is scheduled to be reduced again in 2026.

Other considerations — Many existing wills and trusts include a provision funding a credit shelter trust or by-pass trust with the maximum current exemption amount. These amounts may not have been available to the spouse at death of the grantor. Therefore, these documents may need to be amended given the size of the new exemption amounts. Consider, too, that certain states do not follow the new federal law when assessing their respective state estate taxes. Any new gifting may still create taxes in states that have their own estate tax.

There are many factors to consider when applying the new estate tax provisions. As part of our comprehensive wealth planning, the Trust Company can bring together your attorney, CPA, and other planners to take advantage of these new laws, transfer the optimum amount out of your estate, achieving positive outcomes for your family and heirs.

Portfolio Review & Strategy

Ian N. Breusch, CFA
Chief Investment Officer

U.S. stock markets continued to move modestly higher during the second quarter of 2018 despite pockets of volatility along the way. As is often the case, broader market measures of performance do not always capture the underlying details of what moves markets – particularly over short periods of time. For example, the U.S. stock market continues to be led by growth stocks, while dividend-paying companies have largely lagged this year. As interest rates rise (even modestly), the relative value of dividend-paying companies diminishes somewhat in favor of bonds now yielding modestly more.

However, we fully expect these pricing issues to be short-lived since the fundamentals of dividend payers remain fully intact. Moreover, there is ample evidence that dividend-paying companies outperform non dividend-paying companies over the long term. It remains appropriate for the majority of our clients to maintain a balance between growth and income within their portfolios – with the understanding that certain segments of their portfolio will out/under perform at different times. Of course, everything we do from an investment standpoint remains custom-tailored to your individual needs and goals.

We have been pleased with the earnings results of the companies we follow so far this year. Fourth- and first-quarter results have been quite strong. Considering we remain optimistic about broader U.S. economic growth, it stands to reason that companies should continue to post solid results through the end of the year, particularly when you add in the benefits of corporate tax reform.

On June 13th, the Federal Reserve Board announced their decision to raise the federal funds rate by another 0.25%. This move was largely anticipated by market participants. However, the Fed still anticipates two further rate hikes in 2018 (four hikes in total). If economic growth continues to expand, inflation continues to increase, and unemployment remains low, the Fed will have the fundamental justification for more rate hikes. However, there are other issues at play. The rate decisions by the European Central Bank (ECB) also play a role in setting prevailing interest rates here. European bonds serve as an alternative to U.S. bonds; therefore, the pace and timing of European monetary tightening will affect U.S. bonds. To the extent interest rates continue to rise, bond prices will fall, with the most pain being felt by holders of longer-term bonds, particularly those who continue to hold them. Though interest rate risk is inherent with all bonds, as the yield curve flattens, we continue to emphasize shorter maturity bonds for clients who desire income generation and/or volatility reduction. We also continue to find more value in U.S. Treasury and corporate bonds instead of municipal bonds on a tax equivalent basis.

Our team of portfolio managers continues to monitor corporate earnings results and interest rate movements closely. As such, our bias for stocks over bonds remains for the time being. Quite simply, we believe stocks continue to offer a better risk-adjusted return than bonds – all else being equal. However, we are willing and prepared to make bonds a larger portion of client accounts as appropriate when, or if, interest rates rise to a level that makes them more attractive on a relative basis.

The Wisdom of Warren

Timothy P. Vick
Director of Research

At a time when the average Fortune 500 CEO is 57 years old and vulnerable to incessant challenges by shareholders and activists, Berkshire Hathaway Chairman Warren Buffett remains the sage beyond reproach. At 87, his stature, stamina, and performance have eclipsed even the triumphs of the elderly Rockefeller, Carnegie and Ford, as Buffett's wealth of knowledge – for running a corporation, for allocating capital, for mentoring future business leaders – keeps compounding on itself like Berkshire's share price.

As he presided over his 52nd annual meeting in Omaha in May, one wondered if we were seeing Warren for the last time. So shareholders these days naturally try to prod Buffett into death-bed "tell-all" indictments of America's and Washington's wrongdoings. Instead, Buffett's messages to shareholders remain timeless, agnostic and crisp. America has endured far worse social conditions and political divisiveness than today, he believes, and businesses and investors would do well to ignore the daily media and political sideshows that capture ratings. Rather, rivet your resources to your core strengths and rivet your attention to your long-term plans. During uncertain times, he said, "Never forget two things: First, *widespread fear* is your friend as an investor, because it serves up bargain purchases. Second, *personal fear* is your enemy. It will also be unwarranted."

Buffett sits atop the investing world with a net worth of $84 billion precisely because of this ability to keep passion and emotion outside the sterile proverbs of finance and mathematics. Following the 2016 election, for example, Buffett saw an economy ripe for rebound, took advantage of other investors' uncertainty, and made key investments that earned his shareholders tens of billions of dollars. Alas, he is not finished.

Patience and optimism were the central themes at Berkshire's annual meeting – optimism that Berkshire will thrive long after Buffett; optimism in the U.S. economy; in America's political system and leaders; and that future generations of Americans and businesses will continue to thrive as no other nations' generations. "Venturesome pioneers crafted a system that will deliver increasing wealth to our progeny far into the future," he wrote to shareholders. "Yes, the build-up of wealth will be interrupted for short periods from time to time. It will not, however, be stopped... Babies born in America today are the luckiest crop in history."

No anecdote summed up Buffett's exemplary life more than his first investment, made during the darkest days of World War II. Going against the "doom and gloom" pundits of the day who touted owning gold, Buffett bought a preferred stock for $38 and sold it four months later for a meager profit. After the war, the same stock traded for $200. That experience caused Buffett to embrace patience.

"If you had put $10,000 into a basket of stocks in 1942, you'd have $51 million today, and you wouldn't have had to do anything," Buffett told us. "All you had to do was figure that America was going to do well over time, overcome difficulties, and that if America did well, American businesses would do well...You just had to make one investment decision in your life (to stay invested)." A $10,000 investment in gold, in contrast, would today be worth just $400,000, Buffett noted.

"We have operated in this country with the greatest tailwind at our back that you can imagine," Buffett said. "You can't really fail (at investing) unless you buy the wrong stock, or just get excited at the wrong time... You do not have to know much about accounting or stock market terminology or what the Fed is going to do next time, and whether it's going to raise rates two times or three times. None of that counts at all in a lifetime of investing," he said. "What counts is having a philosophy to stick with, to understand why you're in it, and that you forget about doing things you don't know how to do."

Indeed, part of the secret of Buffett, I've learned, is that when there is nothing that *needs* to be done, Warren is probably the best at it.

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