

Ivory's Economic Outlook

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You can have it all. Just not all at once.

Oprah Winfrey

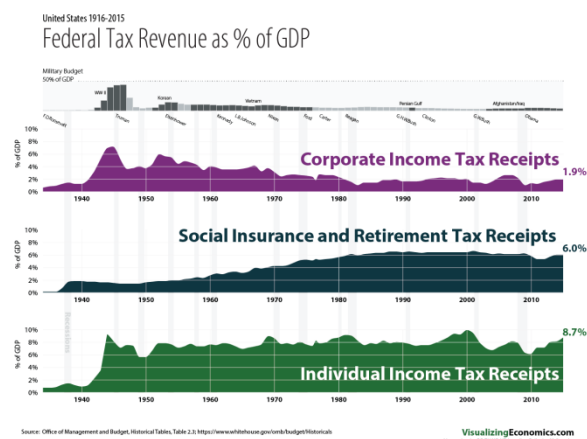
Father time is undefeated, an obvious observation to everyone except young people and fools. I know this because I finally beat my dad at golf, once a scratch golfer, by shooting 11 over par. That wouldn't be such a bad score, except we only played 9 holes.

For the most part my parents are on top of their game. Mom still puts cerveza in the pot when she cooks arroz con pollo on Sundays. My 83 year old father, a retired CPA, still rescues family and church members alike from IRS sized holes they dig for themselves, some still holding the shovel as they reach for assistance. I don't know what it is about filing taxes and going to the dentist, but they sure spend a lot of time on the "to do" list.

Fortunately, most Americans are getting a tax cut. It seems that Congress believes we pay too much and could use a little relief. Boy were they right. Most of us pay taxes when we make money, spend money, have money, invest money or die with too much of it. Perhaps that's why taxes are one of the four best ways to lose wealth - divorce, lawsuits and doing something stupid rounding out the lot.

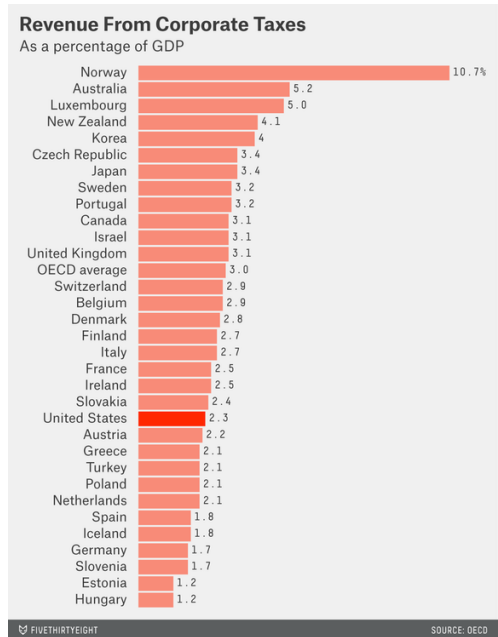
Tax reform was premised on the notion that corporations pay too much and are not competitive. To address this egregious imbalance, corporate tax rates dropped from 35% to 21%. Companies are also allowed to bring home untaxed cash they earned overseas at a special rate of 15.5%. The idea is to immediately increase government revenue and reduce the incentive for global companies to leave money beyond our borders in an effort to avoid high taxes at home.

I can see both sides of the argument. On one hand corporate tax receipts as a percent of the economy are below the OECD average for developed nationsⁱ and corporate earnings have never been higher. Also, when companies were allowed to bring home money from overseas in 2004 at 5.25%, they actually laid people off and used the infusion of money to pay dividends and buy back sharesⁱⁱ. Lo and behold, CEOs admitted the exact same things would happen this go around as wellⁱⁱⁱ. On the other hand they likely won't keep as much cash overseas if they pay less to keep it here. If you can't beat 'em, change the legislation to accommodate them.



Individual tax payers received relief as well. The standard deduction will almost double, tax rates assigned to brackets decline and the child tax credit is now \$2,000 per child for households that make less than \$400,000. Small businesses with pass through income (LLC, S-Corp, Sole Proprietors) get a 20% deduction on their income up to certain limits. In exchange for all these goodies, the \$4,050 personal exemption is gone and a maximum of \$10,000 can be deducted for state and local taxes, which includes state income and property taxes. Other deductions that were eliminated include home equity loan interest and unreimbursed business expenses.

Should you be a high wage earner in a high tax state who is denied state and local tax deductions, the law does you no favors. Most Americans, however, will see an immediate tax cut, albeit temporary. Congress saw fit to make the corporate tax breaks permanent, while the individual breaks go away after 2025. In fact, the tax cuts will increase the national debt by \$1.5 trillion, and that assumes the individual tax cuts disappear. Perhaps the deductions they eliminated will be restored, but I wouldn't bank on it.



Taxpayers should also be aware that the tax brackets increase according to chained CPI, which is different than traditional CPI. Chained CPI will rotate the items calculated to account for elasticity of demand. For example, if the price of Starbucks increases, chained CPI assumes consumers will go to Dunkin' Doughnuts instead. This has the effect of showing a slower rate of inflation. When the tax brackets cannot keep pace with wage growth or real inflation, it serves as an imbedded tax increase because taxpayers hit the higher brackets sooner.

There are two things at work: not only will any tax benefit become marginalized over time, but the legislation could become a full-fledged tax hike after the individual breaks disappear after 2025. Like father time's winning streak, this should come as little surprise given the state of our national debt. What is unusual is the timing of the tax cuts, the fact that the United States has the 5th lowest tax burden of the 35 OECD developed nations notwithstanding^{iv}.

The scouting report on a 17 year old Alex Rodriguez said he "can field, throw, hit, hit for power, and steal an occasional base". Barry Bonds was said to have had "power and speed production, plus good patience, and a sharp college career". Both players became instant all-stars and were earmarked for baseball's Hall of Fame. Despite a blossoming career, they took steroids to improve their performance and destroyed any chances of making it to Cooperstown, ruining their reputations in the process.

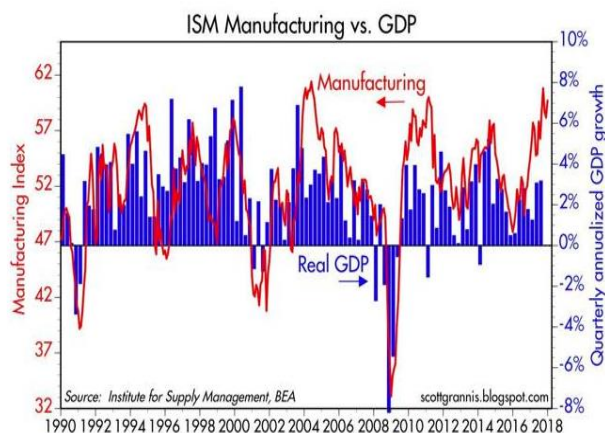
Uncle Sam is prone to invite Santa Claus to Capitol Hill during slow economic times to hand out stocking stuffers taxpayers can spend, which in turns boosts economic growth. We held our noses when the Federal Reserve executed Quantitate Easing because we feared the worst after the housing crisis. The odd thing about stimulating the economy with tax cuts today is that our economy is already pretty strong.

This is not a debate about whether tax cuts are fair. The top 1% pay close to 40% of all federal income taxes.^v If I risked everything to make it to the top of the ladder, the last thing I'd want to hear is how

lucky I am to be rich. The broader concern is that tax cuts are traditionally incorporated to pull us out of a ditch, and right now one does not exist.

Please note that consumer confidence is at a 17 year high^{vi}, manufacturing is rising faster than at any time since the 1st quarter of 2015^{vii} and durable goods ordered rose faster in 2017 than in any year over the last six years^{viii}. We've even seen attractive GDP readings, as wage growth is growing at the fastest pace since 2009^{ix}. Congress essentially took the same course of action as Barry Bonds and A-Rod, which is to stimulate that which did not need stimulating.

When an economy becomes overheated, the potential exists for the Federal Reserve to combat inflation and raise interest rates faster and higher than what investors had already baked into the pie. It remains to be seen if the tax cut meant to promote growth accomplishes the opposite by inviting the central bank to remove the punch bowl before everyone gets their fill. Meanwhile, the proposed budget raises the spending caps by \$300 billion, adding insult to an injured U.S. debt burden that would also cause rates to rise^x.



This is one of theories being floated around in the aftermath of a 4.1% one day market decline. We can live with a 2% drop, but 4% really gets your attention. It has been suggested that fear of rates rising faster than anticipated nudged the snowball at the top of the hill. Stock prices are a function of future earnings, and the present value of cash flow to be received later tends to decline when rates go up. When the speed of a rate increase catches investors by surprise, values are reanalyzed, sometimes in violent fashion.

It's also important to note that humans are not impacting the market with emotional responses to volatility, rather algorithms and high frequency operations are responsible for 50-60% of all trades on a normal day, and as much as 90% during times of high volatility^{xi}. I review stock charts to get a sense of a security's risk range. This can be accomplished by drawing a line connecting the highest points of a stock and the lowest points, known as trend lines. There are also outputs that measure the momentum of a security versus the rest of the market and the strength of any movement.

When certain milestones are breached, it triggers a buy or sell trade depending on the circumstances. Once the computers identify common data points to execute a trade, it gets crowded and that snowball I mentioned earlier finds itself rolling down the hill. It is akin to dropping an envelope in the mail box - once it's there it's going to be delivered whether you change your mind or not.

A larger concern will come in April when companies report first quarter earnings. If you recall, corporate earnings were declining on a rate of change basis in 2016. This should have triggered a pull back, but stock buybacks and low interest rates served as performance enhancing drugs. When companies reported earnings in 2017, they were compared to modest 2016 numbers. This year the expectations will be higher and companies may not have the benefit of cheap money.

In truth, the allocation of the portfolio is perhaps the best defense against market volatility. There are ten sectors that represent the S&P 500: energy, finance, consumer staples, discretionary spending, technology, industrials, materials, healthcare, telecommunications and utilities. During times of growth and inflation, industries that can raise prices and expand margins have traditionally been in favor. One of the reason consumer staples and utilities are lagging is because economic growth has less of an impact on their bottom line.

Rising interest rates will also have a dissimilar influence on different industries. Banks make money by selling loans. As the cost of money increases, so too does their revenue. Consumer discretionary companies also prefer environments that boast wage growth and benefits from taxpayers facing less exposure on April 15th. Maintaining a higher allocation to companies in these areas is the prescribed course of action, but we'll see. Even as I write this newsletter the market jumps back and forth between green and red faster than you can say Bitcoin.

I noticed a dent on my son's car when he was home for break and he responded without a moment's hesitation that the dent was there when we bought the car. What he didn't know is that I anticipated a fender bender here and there because I was once a new driver who dented his own father's car back when stone washed jeans were all the rage. If my memory serves me correct, I also used the same excuse. So much for evolution.

Rising volatility was bound to happen, and if we're being honest, it's long overdue. Provided the economic conditions have not changed or computer trading doesn't hack our portfolios, we'll stay the course with a diversified mix that represents the various industries of note. We already know that our tax rates are temporary; it remains to be seen what happens to market instability.

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ⁱ OECD

ⁱⁱ The last time companies got a break on overseas profits, it didn't work out well, CNBC.com, 4/26/17

ⁱⁱⁱ Trump's Tax Promises Undercut by CEO Plans to Help Investors, Bloomberg.com, 11/29/17

^{iv} Taxes Are Low in the U.S., But Other Stuff Is Expensive, Bloomberg.com, 11/27/17

^v Tax Foundation

^{vi} U.S. consumer confidence remains near 17-year high, CNN.com, 12/27/17

^{vii} U.S. Manufacturing Output Rose in December for Fourth Month, Bloomberg.com, 1/17/18

^{viii} Global Growth, Dollar, Push Durable Goods Orders up 2.9 Pct, U.S. News & World Report, 1/26/18

^{ix} America gets a raise: Wage growth fastest since 2009, CNN.com, 2/2/18

^x Congress votes to reopen government, passes massive budget deal, CNN.com, 2/9/18

^{xi} Machines are driving Wall Street's wild ride, not humans, CNN.com, 2/6/18