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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

As the economy continues to expand, and the stock market continues to rise, it is easy to become complacent and not pay sufficient attention to changes in front of us. The biggest change in the last quarter was the new tax law. Time will tell whether it fulfills its supporters' goal of improving the nation's international competitiveness. It may have collateral effects on the stock market, and could also reach even farther into diverse financial areas like small business income, real estate prices, and charitable donations to name just a few. There will be seen and unforeseen changes. Where there is change there is also opportunity.

The Economy

The economy's growth rate posted a 3.2% advance in the third quarter, following a 3.1% gain in the second quarter. These were the best two sequential readings since 2014, but still well below the 4 - 8% "normal" peak growth rates before 2000. There may not be much room to improve, however. Unemployment is near 50-year lows, so we won't get much growth from hiring new people who want to work. It might be possible to coax more people to start looking for jobs, since the labor participation rate remains 5% below the January 2000 high. Interestingly, the decline is found in the under-55 age group. An increasing percentage of older people continue to work, as the challenges of the new retirement paradigm, which relies on personal savings and 401(k)s, are becoming realized.

Expansion of government and personal debt can give the impression of increasing spendable income – up to a point. Studies suggest that the rate of economic growth and improvement in standard of living become smaller as debt increases. Our national debt overhang may be the real reason that it is difficult to maintain the higher growth of years past. The recent tax cut seeks to increase economic activity, but many observers suggest it will also increase the government debt burden, which would be counterproductive. For the bill's supporters to be correct then, it would be necessary for economic activity to increase government, corporate and personal income enough to stop debt from absorbing an ever greater share of the economy.

The Markets

The stock market continued to be robust, producing double-digit percentage gains while keeping volatility to a minimum – everything an investor could want. This characterization, of course, has the benefit of perfect hindsight. A year ago, not many would have predicted this. In fact, many were expecting the opposite.

On the other hand, bonds, the other staple of investors' portfolios, did not fare as well. The intermediate-term Treasury bond ETF (IEF) had a total return of 2.6% for the year, which, while not great, was still better than a bank account. But this return recovered only part of the loss sustained after bond prices peaked in 2016. The total return of IEF has been a loss of 4.1% since then. There is some good news for savers, however. Recent Fed actions to raise interest rates have made money market funds' yields visible again without using a magnifying glass, and online bank savings account rates have also increased by several tenths of a percent.

The Tax Bill

The recently passed tax bill has been the subject of much discussion. It is complicated enough to allow many commenters a foothold to make their favorite financial or political point. It seems to us, taking the bill as a whole, there are two major thrusts: to reduce taxes on corporations and to try to replicate the Reagan-era "simplification" by reducing the use of itemized deductions.

The idea behind the corporate tax reduction is to make corporations more able to compete, especially internationally, and to generate additional profits to invest for business growth. The highest tax rate for big corporations will be 21%. Small businesses get a different break. Owners will generally be able to reduce their net income from the business by 20%. For service business owners like lawyers and financial advisors, the benefit will be phased out if their personal income is above the 24% tax bracket.

Some people question whether the corporate tax breaks will actually be re-invested in the business (particularly since recent low interest rates have already facilitated most all of their necessary investment). They suggest that the tax savings will go toward stock buybacks or earnings increases, both of which could be good for the value of their stocks and the market in general. Given the excessively high valuation the stock market places on earnings today though, a fair question would be whether higher earnings would actually translate into higher prices, or whether it would simply bring the valuation calculation back down to earth a little.

Whether an individual or family will pay more or less tax depends on their individual circumstances, because there are so many competing changes. To paraphrase Nancy Pelosi, "You'll have to do your taxes to see what's in it". However, there are some items that are visible enough to get a sense of the impact. Tax brackets were lowered, producing a lower base tax. The standard deduction was raised, but eliminating individual exemptions offsets this benefit. These changes work to the benefit of small families with less than two or three children. It can hurt larger families, but that too may be offset by an increase in the child tax credit, as well as the ability to use a 529 plan for $10,000 of elementary and secondary education expenses. Taxpayers that currently have large deductions may also pay more.

The bigger issue, and obvious goal, is that the higher standard deduction reduces the benefit of itemizing deductions for many people. This could potentially reduce charitable donations. Additionally, limits have been placed on some favorite deductions like mortgage interest ($750,000 for new mortgages) and state and local taxes ($10,000). Other deductions have been eliminated completely. These include home equity loan interest, new alimony (after 2018), non-national disaster casualty losses, moving expenses and other miscellaneous deductions, including payments to financial advisors. While this move may not simplify the tax code very much, it will tend to make filing easier for many people, while possibly causing a tax increase for some higher earners. A consequence of these changes could be that the price of real estate, especially second homes, will grow more slowly, because a lower mortgage deduction will make homes become less affordable.

There are also seemingly unrelated additional provisions that were included, such as in increase in the exemption amount for the alternative minimum tax, an increase in the exclusion amount for the federal estate tax, the adoption of "chained CPI" which will calculate cost of living increases at a slower rate, and the elimination of the Obamacare insurance mandate.

The changes mentioned here are only some of the highlights. As you may imagine, there is much more detail below the surface. In light of the tax changes, reviewing or creating your financial plan may be appropriate. If you would like help looking into your financial future, evaluating your risks, managing your investments, or planning to manage your income effectively, please call or e-mail.

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