# Wealth Management

# Investment Management Group

*REVIEW & OUTLOOK* *written by Broadway Bank's Portfolio Managers*

SECOND QUARTER **2018**

## Are Tax Cuts Helping?

U.S. economic growth is on solid footing with first quarter GDP revised to +2.0% and expectations for second quarter growth even higher. But it is unclear how much credit goes to the Tax Cuts and Jobs Act (TCJA) that became effective on January 1, 2018. The Tax Policy Center expects the reform will boost U.S. GDP by 8/10 of a percentage point in 2018 which is fairly consistent with what the International Monetary Fund recently said about their own expectations for U.S. GDP growth at 2.9% this year (up from 2.3% in 2017).

The reform package was, for all intents and purposes, a corporate tax cut. Changes to just two items—the permanent cut in the corporate tax rate from 35% to 21% and the permanent elimination of the corporate alternative minimum tax —account for 95% of the $1.5 trillion tax package. Since taxes represent an expense for businesses, lower taxes mean higher profits. That said, earnings for the first quarter were up over 25%. If you strip out the impact of tax reform, however, earnings grew by a more normal 9% according to one well-known economist. Given that the stock market moves based on earnings growth, the only way to continue to generate abnormally high earnings is to continue to cut taxes, which is unlikely.

With regard to personal income taxes, consumer spending continues to account for about 70% of our economy so the fact that the individual tax cuts are temporary, with most provisions ending in 2025 and returning to 2017 levels thereafter, suggests long-term uncertainty about the reform package despite some clear near-term positives. Lower tax rates tend to boost household incomes which, in turn, should boost aggregate demand, but because a disproportionate piece of the tax benefits will impact high income individuals with the highest proclivity to save and the lowest propensity to spend, there could be implications for growth. Yet another caveat is that much of the savings from individual tax cuts are going into the gas tank. Crude generally averaged $45-55/barrel last year but is up by 22.7% so far during 2018 which could dampen the positive benefits of tax reform.

While there are certainly some profoundly positive aspects of the tax package, some implications of reform are clear while others simply are not yet understood. In the meantime, there are several things you can discuss with your team of financial experts that may help you take advantage of reform provisions:

1. Assess whether it continues to make sense to pay account management fees for an IRA out of a taxable account now that such fees are no longer deductible as miscellaneous itemized deductions.
2. Evaluate whether tax-free municipal bonds still maximize after-tax returns in an environment where tax rates are lower.
3. Consider bunching your deductible expenses if you would not otherwise have enough in one year to exceed the increased standard deduction.

## Positive Returns for Major U.S. Stock Indices

Prior to tax reform, a huge bull market in stocks had been running for almost 8 years. The stock market reacted strongly to the idea of tax reform with the S&P 500 up over 21% last year (roughly twice the long-term average), but it seems to be a little more skeptical this year, with only 6 out of 11 sectors of the market showing positive returns for 2018 thus far. The S&P 500 peaked on January 26th and has now gone over 100 trading days without making a new high. The index has generally been range-bound and is up 2.7% so far this year, falling far short of the 9.3% return registered during the first half of 2017. Moreover, returns this year have been fairly concentrated with a small group of six stocks, predominately in the Technology and Consumer Discretionary sectors, accounting for 99% of the market's overall advance according to Bloomberg. It is precisely this type of environment where active portfolio managers can shine. To that point, some of the names in our portfolios that have done particularly well this year relative to their sectors include quality companies such as Costco, Nike, TJ Maxx, Occidental Petroleum, and EOG Resources. In contrast, detractors include names in the Consumer Staples sector which is down 8.6% this year. Some examples of these companies are General Mills, Kraft Heinz, and Altria, but names like Starbucks and Johnson & Johnson also fell somewhat short of expectations.

One particularly bright spot in equity markets has been the small cap category where tax reform has had some of the biggest impact because of the purely domestic focus of many of these companies. As a group, small cap stocks have increased 9.4% this year while their mid cap peers are up a more modest 3.5%.

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## Alternative Assets

In an environment where U.S. stocks were generally up, alternative assets tended to underperform, as expected. The HFRX Global Hedge Fund index, a benchmark used to track performance of hedge funds, is down 0.9% for the year while energy-related Master Limited Partnerships are down 0.6% and Real Estate Investment Trusts have risen 1.3%. As a group, alternative investments have historically performed best when the broader stock market delivers negative returns given that their main purpose is to serve as a hedge against downside risk among traditional asset classes.

## Softness in International Markets

After abnormally strong returns for emerging market and developed international stocks last year (of 37.8% and 25.7%, respectively), both have since struggled. Non-U.S. assets were impacted by a stronger dollar which reduces returns to U.S. dollar based investors. Emerging markets were further impacted by higher interest rates which makes it more expensive for countries with significant amounts of U.S. dollar-denominated debt to repay those debts. These factors, coupled with concerns about a possible trade war, weighed on non-U.S. markets this year. Developed international equities, as measured by the MSCI EAFE index, fell 2.4% during the first half of 2018 while emerging markets were down 6.6% over the same period. Both areas continue to offer welcome diversification benefits and exposure to business cycles outside the U.S. and have arguably more room to run over the near-term than do domestic markets, making them a valuable part of diversified portfolios.

## Rising Interest Rates Impact Fixed Income

The yield on the 10-year U.S. Treasury is important because it impacts borrowing costs for the government, private debtors, and municipal issuers. Because this rate has now risen for four consecutive quarters, that has meaningfully impacted fixed income markets. While the 10-year Treasury ended the quarter at 2.86%, it reached a 7-year high of 3.10% in mid-May and has increased from 2.30% over the past 12 months. Rising rates have pressured fixed income returns with the benchmark Bloomberg Barclays US Aggregate bond index down 1.6% for the year and sectors like high yield and Treasury Inflation Protection Securities essentially flat through the first half of 2018.

Beyond the absolute level of interest rates, another key indicator in the bond market is the difference between the yield on short-term and long-term bonds. This spread between the yield on 2-year U.S. Treasuries and 10-year U.S. Treasuries contracted to 0.33% in the second quarter to one of the lowest levels registered over the last decade. If this turns negative, it could signal softening economic growth ahead.

## Monetary Policy Tightening Continues

The primary reason for the contraction in the difference between short- and long-term interest rates is that the Federal Reserve continues to hike short-term rates in an effort to cool the economy and circumvent potential inflation issues. The Fed has already raised its key overnight rate twice this year (and seven times since they began hiking rates in December 2015) and is on track to raise rates two more times during 2018. As higher interest rates take hold, we expect these measures to keep the economy from overheating.

## Looking Ahead . . .

While U.S. markets remain strong, there are several issues on the horizon that continue to bear watching, including mid-term elections, trade concerns, geopolitical issues, and rising interest and inflation rates. On the other hand, tax reform and repatriation of corporate cash from abroad should continue to support the market. Broadway Bank's Wealth Management Group remains focused on customized portfolio management and diligently assessing the impact of each of these factors, among others, on potential returns going forward.

Sources: Bloomberg

| Index | YTD | 1 Year | 3 Years** |
|---|---|---|---|
| Dow Jones | -0.7% | 16.3% | 14.1% |
| S&P 500 Index | 2.7% | 14.4% | 11.9% |
| MSCI EAFE* | -2.4% | 7.4% | 5.5% |

*EAFE = Europe, Australasia, & Far East International Index
**Annualized Return

| | |
|---|---|
| 2 Year Treasury Bond Yield as of 6/30/18 | 2.53% |
| 10 Year Treasury Bond Yield as of 6/30/18 | 2.86% |
| 2 Year Muni Bond (AAA) Yield as of 6/30/18 | 1.65% |

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