OCTOBER 2017

PERSPECTIVES

BFS Wealth Management
A FOCUS FINANCIAL PARTNER

Market Recap

It continues to be a very good year for investors - better than expected. At the beginning of the year we thought U.S. stock markets might generate returns of 5-7% for the calendar year. The S&P 500[1] is now up 12.5% year-to-date.

International stock markets have continued to outperform U.S. markets in 2017. The MSCI EAFE index[2] for developed international stock markets is up 17.2% year-to-date. The MSCI Emerging Markets index[3], which is an index for emerging markets, is up 25.5%.

U.S. bonds have done surprisingly well this year in spite of March and June rate increases and the expectation of another in December. The U.S. Federal Open Market Committee seems determined to normalize interest rates very slowly, and thereby minimize the effect of doing so on stock markets. The Committee has indicated that it will soon begin a program to normalize its balance sheet, which means it will not be buying nearly as many bonds in the marketplace as it has done in recent years. This will be a bit of a headwind for bonds going forward, as aggregate demand may fall.

Volatility has been almost eerily low all year long.[4] This is not normal! Although we have not had a pullback in the S&P 500 in excess of 5% since early 2016, it is normal to have approximately three to five such pullbacks in any given year. This low volatility is not the new normal. When we do start to see some volatility again, do not worry. It is just the markets breathing in and out.

Forecast

As is always the case, stock market indexes are driven by expectations for corporate earnings growth times the multiple investors are willing to pay for those earnings. When we prepare market forecasts for stocks, we have to focus on what is likely to affect corporate earnings growth expectations six and twelve months out, and whether the multiple investors are willing to pay will rise or fall. Right now, the outlook for corporate earnings growth is looking good for two reasons: 1) a global economic expansion is underway with central bank support; and 2) very significant tax reform that is likely to increase corporate earnings and the spendable income of individuals, is likely to be passed within the next six months.

The so-called "Trump Tax Proposal" is likely to be the most significant tax policy change since the 1986 Tax Reform Act. Courtesy of the Tax Foundation, its most significant proposals are as follows (comments in parentheses are ours). There is no way to tell what will make it to the final bill, but the outlines are now public and the discussion, debate and horse-trading will now begin.

Changes to the Individual Income Tax

- Consolidates the current seven tax brackets into three, with rates on ordinary income of 12 percent, 25 percent, and 35 percent. The administration did not specify the income thresholds to which these brackets would apply (a 37-38% top tax rate is probably most likely).
- Nearly doubles the standard deduction from $6,350 to $12,000 for single filers and from $12,700 to $24,000 for married filers.
- Provides "tax relief" to households with child and dependent care expenses, the form of which is not specified.
- Eliminates all itemized deductions including the state and local tax deduction, except for the charitable deduction, retirement savings deduction, and the mortgage interest deduction.
- Eliminates "targeted tax breaks that mainly benefit the wealthiest taxpayers," which are not specified.
- Eliminates the Alternative Minimum Tax.

Changes to Business Income Taxes

- Reduces the "business tax rate" to 20 percent. This presumably implies that the corporate income tax rate would be reduced from 35 percent to 20 percent, as well as creating a maximum tax rate of 25 percent on pass-through business income (the business tax rate will most likely end up being in the 25% range).
- Moves to a territorial tax system, which would exempt foreign-source income from U.S. tax.
- Enacts a deemed repatriation at an unspecified rate of currently deferred foreign-source income.

Other Changes

- Eliminates the federal estate tax.

All in all, the document does not present many details about the administration's intentions regarding tax reform. However, the document does indicate some of the administration's central priorities for tax reform: large rate cuts for U.S. business income, substantial individual income tax reductions, and the curtailment of certain tax preferences.

As far as our forecast is concerned, the expectation of tax reform that will increase corporate earnings (by as much as 15% in some cases) should be positive for stock markets, as will the continuation of the global economic expansion. However, we expect that the multiple investors are willing to pay for earnings may contract a bit, which means investors are not likely to reap all of the benefits of expected corporate earnings growth. Nevertheless, we expect stock markets to give us solidly positive returns over the next six months – a seasonally strong part of the year in any event.

On the other hand, fixed income returns are affected by interest rates and inflation. We expect inflation rates to stay low for the next six months – less than ½ of the long-term historical rate of 4%.[5] However, we expect rising interest rates to be a bit of a headwind for fixed income, resulting in below average, but positive returns over the next six months.

Portfolio Management

We are very happy with the composition and asset allocation of our portfolios right now. In our humble opinion, performance this year has been great! Nevertheless, the management of our portfolios is an ongoing interactive process with regular monitoring and updating, designed to meet your investment objectives over time.

Recently we asked Goldman Sachs Asset Management to review our model portfolios in detail and to give us their opinion of them, as well as their

The Score Board

	09/30/17	YTD (Change)
Dow Jones Industrial Average*	22405.09	13.4%
S&P 500*	2519.36	12.5%
NASDAQ Composite*	6495.96	20.7%
MSCI EAFE (USD)*	1973.80	17.2%
Bloomberg Commodity Index	84.46	-3.5%
Barclays Aggregate Bond Index	1938.46	3.14%
10 Yr U.S. Treasury Bond Yield	2.33%	-12 bps
30 Yr Fixed Mortgage Rate	3.87%	-34 bps
Prime Rate	4.25%	+50 bps
Crude Oil ($/barrel)	$51.67	-4.1%
Gold ($/oz.)	$1,284.80	11.5%
U.S.$/Euro	$1.18	12.4%
Core Inflation (ex food/energy)		1.7% **
Inflation (with food/energy)		1.9% **

* Without dividends
** Unadjusted 12-mos. ended August 2017
bps (1 Basis Point = 1/100%)

UNCH (Unchanged)
Sources for Score Board and quoted statistics: WSJ, US Dept. of Labor, Federal Reserve

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Portfolio Management (continued)

recommendations. Having access to some of the brightest analytical financial minds in the business is something we appreciate and don't take for granted.

Goldman Sachs did make one suggestion, which was for us to add emerging market debt (EMD), bonds issued by less developed countries, to our model portfolios. Adding EMD to our portfolios should improve the risk-return characteristic of the combined portfolio, and thus add a diversification benefit.[6] We have minimal exposure to EMD in our model portfolios currently. As a result of Goldman's recommendation and after further analysis by BFS Wealth Management's investment committee, we are now researching EMD funds to add exposure to this asset class. This is just one example of how we work with industry leaders in our attempt to create fundamentally sound, well-constructed portfolios for our clients.

Talk With Us!

As you have likely seen, Equifax (one of the three main credit bureaus), recently had a very serious cybersecurity breach affecting 143 million accounts. Your sensitive personal data may have been stolen. Here are some things you should do right away to protect your personal information and help to prevent stolen data from being used against you.

1. **Freeze Your Credit:** Each credit bureau gives you the option to freeze your credit, which helps prevent criminals from being able to open new accounts with your stolen information. You can do this online or via phone, but you will need to do so directly with each individual credit bureau. Once your credit is frozen, you will have to un-freeze it before applying for any new lines of credit or credit cards.
    1. **Equifax (800-349-9960):** https://www.freeze.equifax.com/Freeze/jsp/SFF_PersonalIDInfo.jsp
    2. **Experian (888-397-3742):** https://www.experian.com/freeze/center.html
    3. **TransUnion (888-909-8872):** https://freeze.transunion.com/sf/securityFreeze/landingPage.jsp
2. **Opt-Out of Pre-Screened Credit Offers:** You likely have received numerous mailings from credit card companies trying to persuade you to open new credit cards. You can stop this by visiting this website: https://www.optoutprescreen.com, or calling this number: 1-888-567-8688.
3. **Check Your Annual Credit Report:** Each of the three bureaus allow you one free credit report check per year by visiting this website: https://www.annualcreditreport.com. It is important to check these at least once each year to see if there has been any suspicious activity.
4. **Use Two Factor Authentication:** This is an additional safety measure. When your try to log into a bank account or the like, the company will send a numeric code to your cellphone that you have to then enter into a log-in box, or, they will ask you a security question that only you can answer. This just helps to insure that it is really you making the transaction.
5. **Change Passwords Frequently:** Change your passwords on a regular basis and create ones with at least 12 unique characters to make them difficult to crack. We suggest using a password program or app that will create your passwords for you and remember them. The program or app will then assist you when you try to login to your accounts. You only need to remember the password to the program or app!

BFSG and its key technology partners are constantly reviewing data security in light of emerging cyber security threats, through product enhancements, process reviews and expert input. If you want to know more about cybersecurity protection, **TALK WITH US!**

1. The S&P 500 is designed to be a leading indicator of US equities and is commonly used as a proxy for the U.S. stock market. Price return quoted.
2. The MSCI EAFE index is a measure of the equity performance of developed markets, excluding the U.S. and Canada. Price return quoted.
3. The MSCI Emerging Markets index consists of 23 emerging markets country indexes. Price return quoted.
4. As measured by the CBOE Volatility Index (VIX), which shows the market's expectation of 30-day volatility.
5. Source: BLS, FactSet, J.P. Morgan Asset Management. Core CPI is defined as Consumer Price Index excluding food and energy prices.
6. Based on Goldman Sachs Global Portfolio Solutions' strategic long-term (10 year) assumptions as of March 31, 2017. Past performance does not guarantee future results. Past correlations are not indicative of future correlations, which may vary. Investments carry the risk of loss, including the loss of principal.

Disclosures