BFS Wealth Management
A FOCUS FINANCIAL PARTNER

PERSPECTIVES

OCTOBER 2018

Market Recap

U.S. stock markets turned in a powerful summer quarter.[1] That is somewhat unusual. The summer rally certainly disrespected the adage, "sell in May and go away til Labor Day." In fact, the rally started back in early May, really took off on July 1st and then never looked back, rising 7.2% for the quarter. The surge was powered once again by growth stocks, especially high momentum growth stocks, and a lot of the return was concentrated in just a few stocks, which made it hard to keep up with the index unless your portfolio was concentrated in those few stocks. Value stocks continued to underperform growth stocks.[2]

International developed and emerging stock markets[3] continued to slide and are negative for the year. The good news is that they are much cheaper relative to U.S. stocks. We raised our allocations in these sectors up and expect them to turn around, and perhaps even perform better than U.S. stocks over the next few years.

Regarding alternative investments, real estate stocks have been hurt by rising interest rates. Home buyers are adjusting to mortgage rates that are still low by historical standards, which have not been seen for a long time. Rising interest rates make homes more expensive. The same is true of other types of real estate. Infrastructure stocks have also been weak, and we are still waiting on the long-awaited funding of infrastructure improvements, which is a world-wide need. Such funding will help these stocks, but will it ever come? Our emerging markets debt allocation in most clients' portfolios has recently been adding to portfolio returns after the asset class seems to have found a floor during the quarter.

The fixed income (bonds) outlook remains challenging. It looks like the Federal Reserve Open Market Committee (FOMC) will raise the Fed Funds rate one more time this year for a total of four increases this year, and maybe three to four times next year, as well. This action creates a headwind for bonds. It is very difficult to generate attractive returns in such an environment, yet it is very important to maintain bond positions for their diversification and asset protection benefits during stock market declines.

Concerns about tariffs and their effect on corporate earnings seems to be waning. We now have agreements with South Korea, Mexico and Canada. Efforts will likely turn to Japan and Europe. Discussions with China may not restart until after the mid-term elections, so we will have to wait and see what happens in that arena. When all these negotiations are complete, we think the outcome will be an incremental positive for corporate earnings and that global stock markets will benefit from a resolution of the uncertainty surrounding this issue.

Forecast

In our last issue of Perspectives, we featured a piece put out by Goldman Sachs wherein they stated that they believed the S&P500 would end the year at 2850, a 7% gain for the year.[4] Well, we have surpassed that target, with the S&P 500 closing the third quarter at 2914, a 9% gain for the year so far. Can we give some of those gains back and yet close the year at 2850? Of course, but that is not what we expect.

Economic conditions continue to be fantastic and well anchored. Lower taxes have boosted consumer spending and the capital spending cycle is now beginning to ramp up, which should result in productivity growth. The stage was set even before the late 2017 tax reform, which was like lighting a match to dry tinder. The fire under our economy was then stoked by regulatory reform and a good global economy. The 27% increase in corporate earnings this year to date vs. last year is a combination of tax reform, stock buybacks, revenue growth and margin expansion.[5] Approximately 8-9% of the earnings growth is due to tax reform and about 1-2% is due to stock buybacks. The rest is due to organic growth in revenue and margins. That is powerful. This corporate tax reform is with us to stay – until the next round of tax reform. Therefore, corporations will save about the same amount of money due to tax reform in 2019 as they did in 2018. However, the tax savings will not grow, so corporate earnings growth will fall in 2019. Nevertheless, we expect corporate earnings to grow an outstanding 7-9% in 2019 vs. 2018. We think the U.S. stock market could rise that much, also.

Some concern has been expressed about stock market valuations being too high. They are reasonable. The price to earnings ratio (P/E) of the S&P 500 is 16.8 times earnings per share. That compares to a 25-year average of 16.1 times.[6] However, we think that the P/E should maybe even be higher. While interest rates are expected to continue to increase, the FOMC is expected to stop increasing the Fed Funds rate at a lower point than in previous interest rate hiking cycles. If interest rates are lower than in the past, companies will have lower interest expenses, which translates into higher profits. In addition, because the cost of capital is lower, companies will be able to finance more projects. Using that logic, the P/E has room to expand, which would be very good for stocks. Time will tell!

Portfolio Management

We are proactively managing your portfolios. One thing we learned in 2008-2009 is that you cannot just sit back and let the market hand you what it will. Most mutual fund managers are going to be fully invested during difficult times, whether they should be or not, because their clients have hired them to get exposure to a certain asset class – not to raise cash. For this reason, and the fact that the strategy has been performing so well, we have increased our exposure to individual stocks for our wealth management clients that hold individual stocks. We can and will sell them quickly if market conditions warrant doing so sometime in the future. We also invest some of your funds in exchange traded funds (ETFs), such as a total stock market ETF. These are

The Score Board

	9/30/18	YTD (Change)
Dow Jones Industrial Average*	26458.31	7.0%
S&P 500*	2913.98	9.0%
NASDAQ Composite*	8046.35	16.6%
MSCI EAFE (USD)*	1973.59	-3.8%
Bloomberg Commodity Index	85.20	0%
Barclays Aggregate Bond Index	1913.79	-1.6%
10 Yr U.S. Treasury Bond Yield	3.05%	+65 bps
30 Yr Fixed Mortgage Rate	4.74%	+82 bps
Prime Rate	5.25%	+75 bps
Crude Oil ($/barrel)	$73.25	21.2%
Gold ($/oz.)	$1,191.50	-8.8%
U.S.$/Euro	$1.16	-3.4%
Core Inflation (ex food/energy)		2.2% **
Inflation (with food/energy)		2.8% **

* Without dividends
** Unadjusted 12-mos. ended August 2018
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)

passive investments that give us exposure to certain market indices. They can be sold at any time during a market day, if the need to do so arises (which is very rarely).

We are also being more tactical in managing portfolios for our wealth management clients. For example, alternative equity investments, though they have important diversification characteristics, have not been performing nearly as well as the major U.S. stock market indexes, which have been doing better than expected this year and are expected to be strong next year, also. As a result, we are in the process of significantly reducing our exposure to alternative investments in favor of increasing exposure to U.S. equity markets.

There will always be something in your portfolio that is not doing as well as something else. That is because you have, and need, diversification in your portfolio – and not all of your eggs in one basket. However, we still want to be doing everything we can to optimize your performance over time. We are on it!

We are actively managing portfolios all day, every day, in order to pursue the best returns possible for the amount of risk taken considering your goals!

Talk With Us!

It is that time of year again. Clients are starting to think about making charitable contributions before the end of the year. As a result of the recent tax reform, more clients will be taking a standard deduction and their charitable deductions will no longer be available. However, there are some very beneficial provisions of the previous law that were continued, however many clients don't seem to know about them. With this Talk With Us!, we are going to talk about just two – the qualified charitable distribution from an IRA, and donor advised funds. If you are going to make charitable donations between now and the end of the year, you may want to take advantage of these tremendous tax strategies!

Qualified Charitable Distributions For those over age 70½ with a traditional IRA, a Qualified Charitable Distribution (QCD) may now be the optimal method of charitable giving, whether you itemize deductions, or not. When a taxpayer makes a direct charitable gift from an IRA (a QCD), the donated amount is excluded from Adjusted Gross Income (AGI). AGI is an important number used in various tax calculations, taxation of Social Security benefits and the level of Medicare premiums. Not having to add your withdrawal to your AGI, because you donated it directly to a charity, means you pay NO TAXES on that withdrawal or distribution! QCDs are only available for IRAs. Distributions from 401(k) and 403(b) accounts are not eligible for this tax saving treatment, however, distributions from inactive SEP and Simple IRAs are eligible. The total amount of these QCDs in any one year cannot exceed $100,000 per person.

To make a Qualified Charitable Distribution from your IRA to a charity, you must complete a form requesting that Schwab write a check on your account to the designated charity. That check will then be sent to you and you will deliver it to the charity, either by mail or in person (make sure you request a receipt of your donation). You cannot also deduct this donation as a charitable donation on your tax return.

Donor Advised Funds If you are younger than age 70 and will not be itemizing deductions, you may be better off "bunching" several years of charitable donations into a single tax year to exceed the new standard deduction and itemizing deductions every other year. The best way to implement this "bunching" strategy is by funding a Donor Advised Fund (DAF) or a charitable trust. By utilizing a DAF and making a high enough contribution, you can take a charitable deduction in the year the contribution is made, and subsequently direct smaller gifts to charities over time. DAFs are most advantageous when highly-appreciated securities held for more than one year are used for funding, rather than cash. By gifting highly-appreciated securities from taxable investment accounts, you receive a tax deduction for the market value of the gifted securities and eliminate the future tax liability on the securities' unrealized gains.

If we can assist you with any of your charitable donations or in opening a Donor Advised Fund, please **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 S&P 500 Growth index comprises S&P 500 stocks with above-average combinations of the ratio of earnings growth to price, sales growth, and momentum. The S&P 500 Value index comprises S&P 500 stocks with above-average combinations of book value-to-price, earnings-to-price, and sales-to-price. The weightings of both indices are by capitalization, although the weight of some stocks is divided between the Value and Growth indices.
3. The MSCI ACWI ex USA index captures stocks in developed markets countries (excluding the U.S.) and emerging markets countries. The index covers approximately 85% of the global equity opportunity set outside the U.S.
4. Source: Goldman Sachs, "Portfolio Strategy: U.S. Equity Views", 6/20/18
5. Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management. EPS levels are based on quarterly operating earnings per share.
6. Source: FactSet, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management. Price to earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since December 1989, and FactSet for September 30, 2018. Average P/E and standard deviations are calculated using 25 years of FactSet history.

Disclosures