JUNE 30, 2019

QUARTERLY REVIEW

UPDATES ON: Asset Allocation | US Equities | US Fixed Income

ASSET ALLOCATION

Following a remarkable equity rebound in the first quarter of 2019, both stocks and bonds produced positive returns during the second quarter. This occurred despite notable slowing global growth, concerns over potential trade wars, and decelerating US earnings. The primary driver of asset returns during the quarter focused on the Federal Reserve's (Fed) next interest rate move, an expected rate cut. Interest rates declined over the last three months on the expectation of Fed action; bonds also rallied during the period.

Our asset allocation strategy shifted slightly during the quarter to capitalize on an aging economic and market cycle, as consistent growth companies tend to outperform companies with more cyclical earnings. We maintained our focus on US companies over international firms, and US companies again outperformed during the period. Bonds produced a positive return for the quarter as interest rates declined with slowing economic growth. Our overweight toward corporate bonds produced excess returns over treasury securities, which was somewhat offset by our focus on shorter maturity bonds. Intermediate and longer bonds rallied ahead of shorter-term bonds as yields declined.

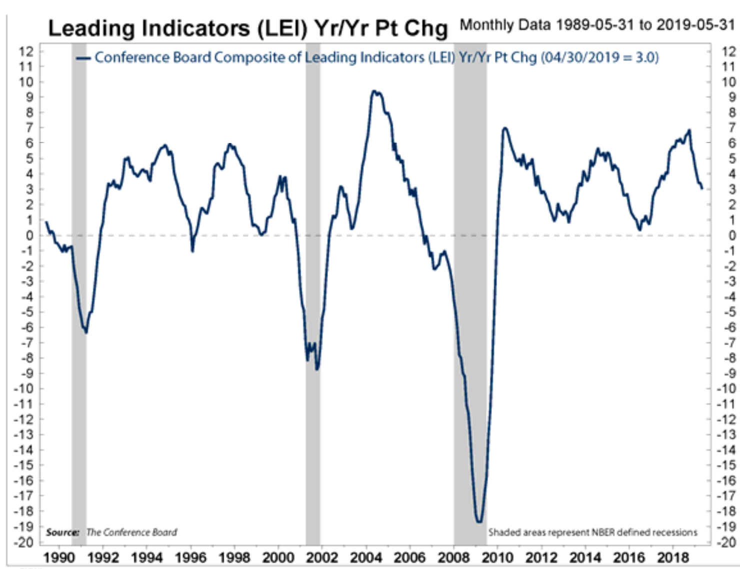
The US economy continued to produce solid growth in the first quarter of 2019, as real GDP grew at 3.1%. Growth slowed sharply during the second quarter, however, as fears of trade wars with China and Mexico impacted business and consumer confidence. We expect full-year GDP to moderate to a level of 2.0-2.5%. Low unemployment continues to fuel growth as levels remain at lows not seen since the 1960s. Wage growth has picked up, fueling higher disposable income. Leading economic indicators (LEIs) remain positive but have weakened over the last few months, which needs to be watched. This indicator is a strong signal of recession and though it has weakened, it remains positive, as shown in the chart at right. As such, we do not forecast a recession in the foreseeable future.

We continue to find equities relatively attractive but stay vigilant toward watching growth levels and indicators that point to economic weakness, which could negatively affect stocks. While we are currently tilted toward US investments, we continue to watch for signs of global bottoming, which may provide an opportunity to increase our international equity exposure. The US dollar strength is a key signal and the dollar has displayed weakness over the last couple of weeks in June. We find mid-cap companies attractive based on their valuation levels and more domestic revenue base.

International growth has weakened significantly this year and many countries' interest rates have collapsed. German bond yields have again moved into negative territory attempting to stave off a recession. The UK is still trying to formulate a plan for Brexit, and China is struggling with US tariffs and slowing growth in their country. Monetary and fiscal stimulus should provide a bottoming sometime over the summer. While the G-20 Summit in June did not bring about any definitive agreement with China, President Trump did not add to the rhetoric and said that the US would not impose any new tariffs on Chinese exports. China also agreed to resume broad purchases of American farm products and other goods.

Despite rising wage levels, inflation remains contained. Declining interest rates and a relatively flat yield curve continue to point toward soft growth levels. The shape of the yield curve is forecasting a rate cut as early as July, which could provide headwinds for bonds. As such, we remain positioned with a short-term structure. We also continue to favor corporate credits and mortgage-backed securities over treasuries to secure higher yields. We maintain exposure to TIPs (Treasury Inflation-Protected Securities), which will do well in a rising rate environment.

Given the late stage of the economic cycle, we currently do not have exposure to high-yield bonds. We also maintain no exposure to international bonds due to the weaker economic environment and extremely low (and sometimes negative) interest rates internationally. The key focus is likely to remain on the Fed, which is in the position to keep this historically long recovery going into the foreseeable future. ■



At the beginning of the year we noted that decelerating earnings growth, rising interest rates, and trade disputes all represented key drivers for the equity markets, and these factors continued to have an outsized impact on equity markets in the second quarter. At the start of the second quarter, the Fed had paused monetary policy changes and interest rates were on the decline, earnings had come in with modest but surprisingly positive growth, and trade talks between China and the US were on track for an agreement to be announced in early May. As concerns dissipated, US equities cruised along in April and finally eclipsed the record highs posted in the fall of 2018. Then the tentative trade agreement fell apart.

The trade dispute between China and the US is now on center stage. While progress could be announced at any time, the uncertainty introduced by failed trade talks is taking a real toll on US businesses. US equities dropped by about 7% in May and economic data in recent months has been uniformly dreary. Indicators from services to manufacturing and hiring have all slowed markedly. One measure of this is the Citi US Economic Surprise Index depicted below, which illustrates that economic data has consistently disappointed the lofty expectations set in the immediate aftermath of the 2017 tax bill. This measure tends to oscillate over time – as economists over-extrapolate both positive and negative data – and has often turned around at levels similar to where we stand today. Expectations may have gotten low enough for the economy that positive surprises may be more likely going forward.

The Fed is well aware of the economic deceleration in the US and is no longer waiting patiently to see if rates should be increased or decreased but has guided the market to expect reduced interest rates as soon as July. US Equity markets met the Fed's guidance with relief and promptly recovered the losses from May and set new highs again in June. Inflation remains muted and provides the Fed with significant flexibility to adjust short-term interest rates as it sees fit in the pursuit of its mandated dual targets of price stability and full employment. The impact of monetary stimulus through reduced interest rates should not be understated. The Fed has not reduced interest rates in more than ten years, so it is easy to forget what a powerful tool it has at its disposal. Lower interest rates will almost certainly benefit the economy over the short run as financing becomes more affordable for businesses and consumers. Longer term, it is harder to have confidence that monetary policy will have the same result as in prior cycles since interest rates remain at or below zero overseas and were near zero in the US just a few years ago.

It is difficult to estimate whether monetary stimulus will be sufficient to reaccelerate economic growth in the face of a protracted trade war with China, and the earnings growth that drives stock prices hangs in the balance. Earnings are currently expected to grow 9% this year and about 10% in the following few years, but earnings were roughly flat in the first quarter and will need to promptly accelerate to meet expectations. Despite the obvious risk to earnings estimates, equities could still perform reasonably well as reduced interest rates could boost stock valuations as other investment options like bonds become less attractive.

It is a sad state of affairs that the Fed is removing the ability to earn a return on safe assets that exceeds prevailing inflation rates when it had only recently become available. Investors may soon find themselves back in the uncomfortable position of being herded into risk-taking by the Fed. While economic data have been disappointing, US Equity investors have to be careful not to get too pessimistic. An old Wall Street adage is "don't fight the Fed," and it is entirely possible that for the time being this adage may be worth heeding as we could be headed back into an environment characterized by the more recently coined acronym "TiNA," which connotes that There is No Alternative to equities in an environment of near-zero interest rates.

Ultimately, as we weigh the prospective risks and returns available in US Equity markets, we continue to see relative appeal in equities given reasonable valuations, subdued expectations, and proactive monetary policy. At the same time, we remain mindful that we are likely in the later stages of the business cycle as reflected in the shape of the yield curve, as discussed in recent newsletters. As a result, we remain fully invested in stocks, with a bias towards higher quality businesses and a decreased emphasis on areas that can benefit from rising interest rates like banks. It is unfortunately difficult to see anything resembling normalizing interest rates again in the immediate future, and that is the source of both opportunity for equity investors and consternation for investors overall. ■

Over the past three months the outlook for short-term interest rates has changed substantially. At the end of the first quarter, the market ascribed a 70% chance of the Fed keeping the Federal Funds interest rate steady, while a mere three months later, the market believes with virtual certainty that the Fed will cut its short-term rate by at least 0.25% at the July meeting. Currently, the market is pricing in three cuts between now and the end of 2019.

What has changed?

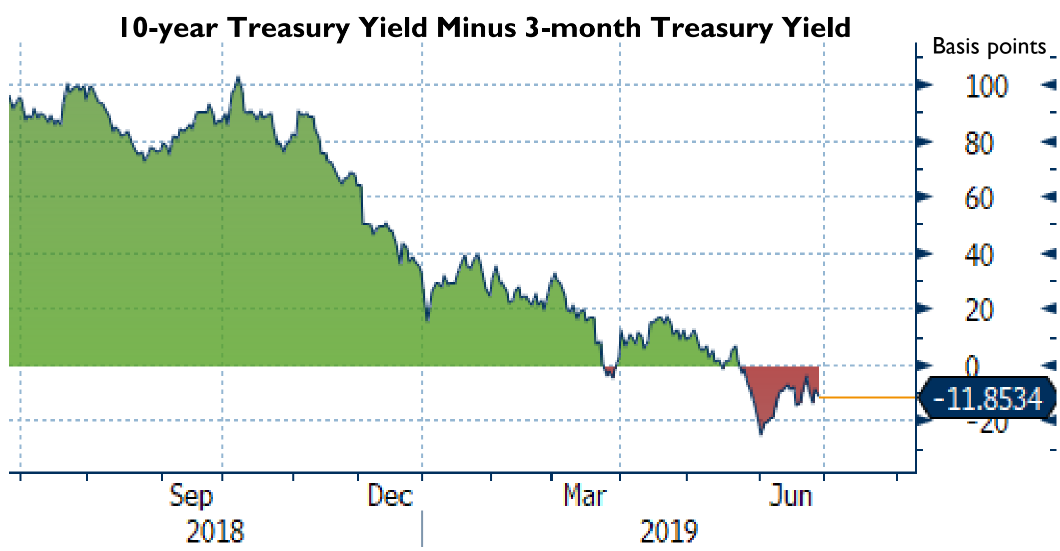
- *Outlook for global growth has slowed*
- *Trade rhetoric has increased*
- *The Fed's inflation measure has remained below the 2% target*
- *The yield curve has decidedly inverted*

What has changed? The outlook for global growth has slowed. The International Monetary Fund has decreased its forecast for global GDP growth from 3.6% in 2018 to 3.3% in 2019, while the World Bank cut its forecast for global economic growth to 2.6%, down from 3.4% in 2018. US GDP forecasts have likewise declined, with consensus currently believing that GDP will decline from the 3.1% reported in Q1 2019 to 1.8-2.0% for the remainder of the year.

Trade rhetoric increased sharply in May, culminating with the administration announcing tariffs on imported goods from China. This may further reduce GDP growth in the US and cause companies to spend time and money modifying their supply chains to avoid the new tariffs.

The Fed's preferred inflation measure, the Personal Consumption Expenditure Core Price Index, has remained stubbornly below the Fed's symmetric 2% target. All four monthly readings in 2019 have been below 1.75%. Fed Chair Jerome Powell has suggested that a rate cut may permit inflation to accelerate.

The inversion of the yield curve where the 10-Year Treasury interest rate has declined below the 3-month Treasury Bill interest rate has raised concern that a recession may be on the horizon. This portion of the yield curve inverted briefly in March, as discussed in our last newsletter, but subsequently stabilized at a positive level for April and part of May. It has now become decidedly inverted since the last week of May as shown in the chart at right.



As 2017 was the year of a globally synchronized recovery, with most economies accelerating, 2019 looks to be the year of globally synchronized monetary policy easing. Not only the Fed, but also the Bank of Japan, the European Central Bank, and the Royal Bank of Australia are expected to reduce short-term borrowing rates over the course of 2019. Only the Bank of England is expected to raise rates.

On the long end of the yield curve, long-term interest rates are low globally and have been declining for many years. In many cases, long-term interest rates have gone negative. While the US 10-year government bond yields only 2.05%, a 10-year German government bond yields negative -0.30%, and a 10-year Japanese government bond yields negative -0.14%.

Why are long-term interest rates so low? Economists believe this is a function of aging demographics and slowing labor productivity. Aging demographics mean fewer workers are available to participate in the economy. Slowing labor productivity means those who are working are not growing their output as quickly as they once did. Both factors seem unlikely to change any time soon for developed economies, so the question becomes, how should one invest in fixed income in a low interest rate environment?

Continued on Page 4

US FIXED INCOME, CONTINUED

We continue to be overweight corporate credit in client portfolios, which adds an extra point or so to yields for that portion of the portfolio. Although the US 10-year government bond pays only 2.05%, a 10-year A-rated US corporate bond pays 2.94%, while a 10-year BBB-rated corporate bond pays 3.53% as illustrated by the chart below. We may also increase yield by adding longer maturities or duration to client's fixed income portfolios in response to the rapidly shifting interest rate outlook. We must remember, however, that the fixed income portion of client portfolios are meant to provide stability and not generate high returns through excessive interest rate or credit risk. This late in the economic cycle, we will continue to manage bonds prudently in an effort to reduce overall portfolio risk within the context of an increasingly uncertain financial market environment.

Spread or Incremental Interest Rate on BBB-rated Corporate Bonds over US Treasuries

GLOBAL MARKET RETURNS

		Last 3 Months	Last 12 Months*	30-Year Annual Return**
US Equities	S&P 500 *(Large US Companies)*	4.30%	10.42%	10.02%
	Dow Jones Industrials *(Selected Large US Companies)*	3.21%	12.20%	10.98%
	Russell 2000 *(Small US Companies)*	2.10%	-3.31%	9.28%
	Russell 3000 *(All US Companies)*	4.10%	8.98%	10.03%
International Equities	MSCI World Index ex-US *(Developed Markets)*	3.79%	1.29%	4.98%
	MSCI Emerging Markets *(Emerging Markets)*	0.61%	1.21%	N/A
Fixed Income	Bloomberg Barclays Int. US Gov't/Credit *(Intermediate Investment Grade Maturities)*	2.59%	6.93%	5.49%
	Bloomberg Barclays US Corporate High Yield *(Non-investment grade "junk")****	2.50%	7.48%	8.03%
Inflation	US CPI Urban Consumers Less Food and Energy NSA	0.78%	2.10%	2.40%
Treasury Bill	US 3-Month Treasury Bill Index	0.63%	2.31%	3.04%

Source: Bloomberg Capital Markets

* Includes dividends for equity indices
** Annualized
*** CPI data for time periods is date ended 5/31/2019

FLP FINANCIAL PLANNING

Summer is upon us!
This is a welcome change from what was, for some, a wet and chilly spring. With the arrival of warmer weather, our attention often turns to vacation or rental properties. Some rent out the family lake house to generate some extra income, others look for new income-producing rental properties, and some even considering converting their "getaway" into their year-round home. But when it comes to real estate, tax considerations are sure to play a role. Whether you are renting, converting, or exchanging – there's a lot to think about.

RENTAL INCOME AND DEDUCTIBLE EXPENSES

It's Personal

If you keep a second property for personal use, but also rent it out for a "fair market rate," the IRS has a set of rules regarding the income and deductible expenses for that dwelling.

If you rent out a residence for **14 days or fewer** during the year, you don't need to report the rental income, and rental-related expenses aren't deductible. However, if you itemize, you may still deduct your mortgage interest, property taxes, and casualty losses as normal.

If you rent the dwelling for **15 days or more**, you will report your rental income on Schedule E. Related expenses may be deducted, but only in appropriate proportions (more below). These expenses include mortgage interest, real estate taxes, and casualty and theft losses. They also include the cost of repairs, operating expenses, and depreciation.

"Personal Use" days, according to the IRS
- By Owner
- By Owner's family
- By anyone charged less than Fair Market Rate

Not Personal Use Days
- For property maintenance or repair

Deductible rental expenses are limited to the proportion of days that the dwelling was used for rental purposes. In other words, the IRS doesn't want you deducting rental expenses for personal use. The appropriate portion of deductible expenses is determined by dividing the total days rented by the total days used.

$$\frac{\textit{Days Rented}}{\textit{Total Days Used}} = \textit{\% of expenses allocated to rental use}$$

Home or Dwelling?

If the dwelling's rate of personal use is (the greater of) 14 days or 10% of rental days, it is also considered a "home." Once home status is achieved, deductible rental expenses are limited to gross rental income. In other words, you can't deduct more than you earn.

If you rent your vacation home for 15 days or more, but your personal use is less than (the greater of) 14 days or 10% of the days you rent the home, the IRS does not consider the property to be used as a home. Division of expenses should still be performed (as discussed above), but you may deduct your rental expenses beyond your gross rental income. This can create some nice tax savings – but also opens you up to additional tests/limits. This is a topic that should be explored with your tax advisor.

A second home can be a great getaway as well as a nice source of income.
If you have reportable rental income, it is advisable to employ a tax professional.

Tax-Efficient Transfers for Investment and Rental Real Estate

Upgrading your rental property? Swapping the ski lodge for a beach house? A *1031 Like-Kind Exchange*, named for the IRS Tax Code Section under which it was established, allows a taxpayer to exchange one investment/rental property for another one. If the swap meets the stated requirements of Section 1031, there will be little (or no) tax due on the exchange. Further, the cost basis of the original property will transfer to the new property. Use of the 1031 exchange can defer the capital gains and depreciation recapture on the sale of the original property until the final disposition of the subsequent investment property.

Since the property you are selling and the property you are buying rarely close on the same day, most 1031 exchanges are termed "delayed exchanges." In such a case, a *qualified intermediary* holds the sale proceeds for eventual use in the purchase. Receiving the proceeds of the sale directly, without the use of an intermediary, will nullify all the tax advantages of the exchange. A delayed exchange also must be completed within a specified timeframe. The property to be purchased must be identified within 45 days and the purchase must be completed within 180 days of the original property sale.

Once the exchange is completed, if any of the proceeds from the original sale remain and are paid out to you in cash, or if your overall loan liability is reduced as a result of the exchange, a portion of the exchange will need to be reported on your taxes as a capital gain. There are no restrictions on how many times, or how frequently, you can make 1031 exchanges.

Conversion of Investment and Rental Real Estate to a Personal-Use Residence

Occasionally, a piece of investment real estate needs to be converted to personal-use property. When this occurs, the details of the property's tax treatment during the investment period will need to be preserved to determine capital gains treatment and depreciation recapture when the property is sold. In general, all depreciation will need to be claimed in the year of the property sale and capital gains are pro-rated between the periods of investment and personal use. If the personal use of the property after conversion was as a principal residence, the pro-rated gains may be excluded from taxes. There are additional rules for property originally purchased before 2009.

If the property being converted to personal use was originally purchased through a 1031 exchange, there are a couple of additional restrictions on conversions. First, the property must remain a rental property for a minimum of two years following the 1031 exchange with strict limitations on the personal use during this period. Violating this provision can invalidate the 1031 exchange and lead to an unexpected taxable event. Second, the combined holding period of the property as investment and personal residence must be five years before any principal residence exclusion can be taken on the sale of the property.

In short, a conversion of investment property to personal-use property can result in considerable tax deferral and reduction, but also requires a detailed analysis of the facts to ensure that tax treatment is accurate.

When it comes to real estate ownership and investing, taxation is sure to enter the fray. Good record keeping, thoughtful planning, and collaboration with your advisor are crucial elements to successful outcomes. As always, please contact us or consult with your tax professional with any thoughts, questions, or concerns.
And above all – enjoy the summer!