Q2 2018

KFS
Kummer Financial Strategies, LLC
Helping You Create Financial Independence

PERSPECTIVES

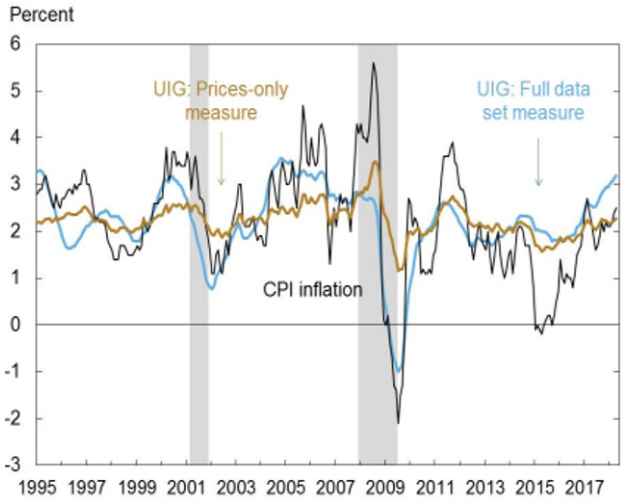
Economic Update

From an economic perspective, the first half of 2018 has been marked by both positive and negative surprises. What might the remainder of 2018 have in store for the United States and the global economies?

Quick Update – Rounding Third

Our major economic theme this year, *Rounding Third and Heading Home*, is playing out. Our theme remains that the U.S. economic cycle has entered its boom phase which, based on historical standard, tends to precede an eventual economic recession.

- In the United States, we thought the gross domestic product (GDP) growth would accelerate to 3 percent. While the official data has yet to be produced for Q2, the Atlanta Federal Reserve's real-time estimate of growth for the U.S. economy was roughly 3.8 percent (annualized) at quarter end. If we combine that potential result with the Q1 GDP growth of 2.2 percent (per the Commerce Department) it gives us an average annualized GDP growth rate of 3 percent for the first half of 2018. The last time the U.S. economy grew by this level was in 2005 when the overall GDP growth rate was 3.3 percent. We stand by our earlier view that U.S. economic growth will be in the 3 percent range for the year.
- At the beginning of the year we also suggested inflationary pressure would start to build throughout 2018. This has been occurring. For the 12 months ending in May 2018, consumer prices increased 2.2 percent, up from an annual rate of 1.8 percent at the end of 2017. Various points of evidence suggest the acceleration to our inflation target of 2.5 percent should occur in the second half of this year. As an example, witness the New York Federal Reserve's underlying inflation gauge data (UIG) depicted in the accompanying chart. As can be seen, the UIG (blue line) tends to coincide with the black line (consumer prices) over time. As can also be seen, the UIG is currently suggesting underlying inflation pressures are now slightly above 3 percent on an annual basis. This data suggests continued upside inflationary pressure going forward.



Source: New York Federal Reserve

- Combining GDP growth and inflation gives us the trailing nominal GDP growth rate of 5.4 percent, among the highest growth level the economy has witnessed in more than 10 years.

Consequently, looking in the rear-view mirror confirms our *Rounding Third and Heading Home* theme is playing out well. However, before we take a victory lap, we need to sharpen our focus going forward. Are events currently playing out which may disrupt our growth/inflation acceleration theme?

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Second Half of 2018 and into 2019 – Heading Home

In our annual outlook piece from the first of the year, we highlighted a short list of potential disruptors – factors which, if they came to fruition, could alter our positively-biased view on the national and global economic outlook. These disruptors include two factors currently weighing on investor's minds.

- **Washington:** We suggested political events could unfold and disrupt economic and eventual capital market trends. This is happening as the Trump administration's trade policies are weighing heavily on people's minds. Multiple trade tariffs have been announced/threatened by Washington for a variety of reasons. None of these trade tariffs have been put in place (the first is due to be in place in July). The potential economic risks of a full-blown trade war could be:
  - Upward pressure on inflation trends (as tariffs are imposed costs/prices tend to rise).
  - Central Bank (Federal Reserve) policies may be altered to adjust for the added building inflationary pressure, resulting in more aggressive action (rising interest rates) by the Fed.
  - Negative impact on consumer and business economic sentiment. The uncertainty which rising tariff rates can generate have the potential of lowering overall economic activity and growth.
  - The bottom line on tariffs, or threatened tariffs is not good – this disruptor has the capacity to lower overall economic growth and raising inflationary pressures.
  - We currently hope the uncertainty these actions are casting upon the global economic environment is part of the Trump process of negotiation. We believe this may be causing the current economic uncertainty.
- **Federal Reserve:** We have consistently been of the view that the Fed would raise rates four times this year. The consensus view has, until recently, held that no more than three interest rate increases would occur this year. Now, consensus has joined our view that the Fed will raise rates four times in 2018. This higher level of interest rate assumption is weighing on certain segments of the economy.
  - We continue to hold the view that the Fed will raise rates twice by the end of this year, followed by three rate increases in 2019. If enacted, these moves will take the Fed Funds rate above 3 percent by the end of 2019.
  - Additionally, the Fed has continued to shrink the size of their balance sheet. At the planned rate, the Fed will have reduced their balance sheet by about $1 trillion by the end of 2019. That action impacts monetary liquidity levels and interest rates.
  - Asset price volatility is affected by liquidity and its ability to absorb headline risks. Tightening liquidity in combination with trade issues and a late cycle rise in inflation may, at times, push asset price volatility upwards during the second half of 2018.
  - The Feds actions are starting to be viewed as a building disruptor.

Disruptors are appearing and will probably continue to have some degree of negative effect on economic growth, inflationary pressure and interest rates during the second half of 2018.

Last Word

Even with all the above, we remain positively inclined towards the U.S. and global economic growth prospects. On balance, foreign economic growth is still positive, but some are taking a wait and see attitude towards the trade and monetary policy issues mentioned above. When the "smoke" of uncertainty is present, people tend to delay purchases and transactions. We sense this is currently happening in Europe and China.

On the other hand, if trade uncertainties diminish, we suggest overall economic growth in the United States should eclipse the 3 percent level, and global growth should chug along at a 4 percent overall growth rate for 2018.

We maintain our view that global economic growth will remain positive in 2018 and into 2019. The real question is…how positive and with what risks?

The economic cycle continues to mature.

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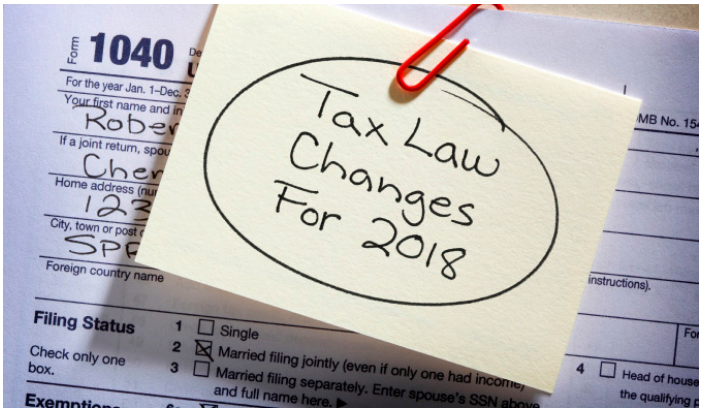
5 Most Common Questions About The Tax Cuts & Jobs Act

New Tax Laws Could Impact Your 2018 Tax Filings

Question #1: Will it still make sense for me to itemize deductions on my taxes?

Answer: With the new tax plan, there is a standard deduction of $24,000 for couples and $12,000 for singles. If your itemized deductions are over $12,000 or $24,000, respectively, then it may make sense to utilize those vs. the standard deduction.

Keep in mind, though, that some of the items you may have deducted in the past, now have monetary limits or are no longer able to be deducted for example, state and local income taxes (SALT) are now limited to $10,000.



Question #2: Will I still be able to deduct interest from my home equity line of credit (HELOC)?

Answer: You can no longer deduct interest on your home equity loan unless it is used to substantially improve a qualified residence or acquire a second home. So, if you use your HELOC to purchase a car, as an example, that interest will no longer qualify. In addition, there are new rules on deducting your mortgage interest.

Question #3: I utilize a 529 plan to save for my child's college education. Is it still a viable savings tool under the new tax laws?

Answer: Yes. In fact, the uses for the funds in the 529 plan have been expanded under the new Tax Cuts and Jobs Act. The new law permits qualified education expenses to include elementary school and secondary school, not just college.

However, it limits the 529 distribution for elementary and secondary school to $10,000 annually per beneficiary.

Question #4: With the passing of the Tax Cuts and Jobs Act, and the changes to the estate and gift tax, I've been advised to review my estate plan. Why is that?

Answer: Prior to 2018, the tax laws permitted you to transfer $5 million ($10 million if married) during life, or upon death, without being taxed. The new tax law doubles the exemption amount.

For 2018, with inflation adjustments factored in, individuals are expected to have an $11.2 million exemption ($22.4 million if married). This exemption increase is temporarily in effect for 2018 through 2025.

It's a good time to review your estate plan to ensure it will accomplish what you initially intended it to. With the temporary increase in lifetime giving, it's also a good time to explore new planning opportunities, such as:

- Qualified Personal Residence Trusts (QPRTs)
- Grantor Retained Annuity Trusts (GRATs)
- Asset protection trusts
- Spousal trusts
- Gifting family LLC interests

Question #5: Will the new plan impact my state tax filings?

Answer: The simple answer is, it depends. With the changes to the standard deduction limits, many tax payers will be begin using it instead of itemizing deductions. You'll want your tax professional to look at how this will impact your state tax filings because some states may require you to use the state's standard deduction, which could be lower than the federal. If so, you may find your state tax amount increase since your state's AGI will be higher with the state's standard deduction.

How To Plan For The Second Half Of 2018

No amount of bad news would upset the market in 2017. Even January of 2018 appeared to be on a track to the moon, and then the long-awaited correction hits. This took the equities market down a few notches in February and March, only to remain range bound the last few months.

The concern is we won't break out of this narrow trading channel investors now live in, back and forth over the same territory. However, we did see the predictions outlined in December as the economic workshop mostly come to fruition. Now it is time to review and think about the second half of the year, and what to expect.

Six months ago, we thought the market was vulnerable to a near-term correction, that tax reform would pass and that yields would creep higher. Also, we were on the lookout for corporate earnings to fuel a higher market.

All of these things did come to pass. So, what caused renewed volatility even though we are in a similar economic backdrop?

We would need to go all the way back to 1960 to see the low volatility we had during 2017.[1] It appears that volatility is normalizing. This means the normal gyrations of a typical market are returning, poised to take direction from every news tidbit. This sensitivity is actually common in a late-stage recovery. If you figure our recovery from the Great Recession began back in 2009, this could definitely be considered the latter stage.

Interest rates and valuations are also adjusting. Corporate earnings continue to be strong, but the stock market seems to be ignoring this as "old" news. Valuations are becoming more reasonable after some recent pull backs in the equities market and we have been moving sideways since. Valuations are back to where they were in 2007 and 2008 but interest rates were a lot higher then, so we could support even higher stock prices here.[2]

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This may suggest that equity returns will be lower than they have historically been, which is also common in late stage cycles. This does not necessarily mean that bonds would perform any better since we are in a rising interest rate environment which puts downward pressure on bond prices.

In the next six months the Fed will likely continue with a gradual pace of interest rate hikes. The economic growth along with this slow, measured stance from the Fed puts us at a low risk for a near-term recession. The current correction phase is likely to linger; yields could go higher but they are starting to stabilize. Due to the supply of the Fed rolling off bonds from their balance sheet, yields have been kept relatively low.[3]

Higher market volatility, or back to normal is still favorable for equities. These market fluctuations could be caused by growing concerns about inflation and there could be earnings disappointments, especially since the pace of earnings growth has been so significant, it may be hard to beat. Political uncertainty is a concern, both at home (tariffs) and abroad (Italy) and geopolitics including North Korea, the Middle East and Russia. Rising budget deficits and debt could put a damper on future growth as well.

Investors need to be nimble in this environment. Heading into the summer months when markets are sleepy and just ahead of a mid-term election will likely continue to bring market fluctuations. This does not mean investing is not good, just tempered compared to last year.

It is important to be aware of your goals and align your strategy to current opportunities. This is a good time to revisit your financial plan and make sure your investments are positioned for this late-stage recovery.

What's New at Kummer Financial

We hope everyone is enjoying the summer and thank you for all your support as Kummer Financial grows with Mariner Wealth Advisors. We appreciate your referrals and we always welcome the opportunity to help those you know. Please do not hesitate to let us know of any changes in your world so we can keep your plan current.

We are excited to be continuing our annual participation and sponsorship of The Alzheimer's Association 2018 Walk to End Alzheimer's. If you are interested in donating or participating, information is provided on our website. We welcome everyone who would like to come walk with us for this important event.

We are growing this year and would like to welcome David Martin, CFP® and Wealth Advisor, to the planning team, as well as two new Client Service Associates, Kathy Riggs and Rebecca Henry. Kathy and Rebecca will be assisting clients and the financial planning team.

We will continue to bring you information to use in our ongoing education series as well as articles and research available on our website. Check in on our website for details and new upcoming education events.

Be sure and stay current with our economic updates posted to our website and Facebook. Click the Newsflash button on the KFS website for current events and economic updates.

[1] Morningstar Direct, S&P Returns.

[2] JP Morgan Guide to the Markets.

[3] Excerpts from Brett Lapierre, CFA, Economic Workshop 6.6.18