COLORADO FINANCIAL MANAGEMENT®

Be thankful we're not getting all the government we're paying for.
-Will Rogers

January 2018

SUMMARY:

The excellent performance of 2017 can be attributed to various factors such as foreign stocks, falling inflation, and the new tax law.

Inflation has remained low, but there may be early signs of changes.

The expectation of the Federal Reserve to raise interest rates and reduce the amount of bonds they own is the number one cautionary flag that could signal a recession or bear market.

Estimates for 2018 earnings growth are very high.

The lack of a valuation cushion and excessive optimism are two factors that encourage us to exercise caution.

We provide a summary of the new tax law.

Economic & Market Review

by Brad Bickham, CFA, CFP®
Chief Investment Officer

The fundamentals of the economy continue to look excellent as they have for almost nine years:

- We have full employment, prosperity, and extremely low inflation.
- The core CPI has just posted its smallest increase in 33 years.
- Commodity prices have fallen to a 21 year low.
- Labor costs have risen very modestly.
- Productivity numbers are the best in six years.
- Consumer confidence is at an all-time high.
- Home sales last year beat the record set in 1977.

For the economy, the only clouds on the horizon are the continued sluggishness of our foreign trading partners, a possible uptick in inflation due to higher oil prices, and potential ramifications of the Kosovo situation.

That was from our newsletter written April 15, 1999, but it seems like it could have been written yesterday. Back then, the stock market (S&P 500) did indeed continue to rise another 15% and for another year, but ultimately it reached an overvalued extreme and fell 50%. The Nasdaq 100 fell 80%.

We are not predicting any such event, but we are reminded that when everything looks good investors get overconfident, and things can change quickly. In July 2007, Chuck Prince the CEO of Citgroup infamously said, "When the music stops…things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing". The problem is, like in the game of musical chairs, the music may stop before you are ready, and there may not be any chairs.

So let's study the facts in order to better predict whether the music will play a little longer.

The following table summarizes returns for 2017 and for the last five years.

As Of 12/31/17	2017	Last 5 Years (Ann'l)
60/40 Balanced World Index	15.8	7.8
World Equity Index (ACWI)	24.0	11.0
U.S. Equities (Wilshire 5000)	21.0	15.7
U.S. Equities Small Caps (Russell 2000)	14.7	14.1
Foreign Equities (ACWI-ex U.S.)	27.2	6.8
U.S. Bonds (Bloomberg Aggregate)	3.5	2.1
HFRI Fund of Funds Composite	6.8	3.8

By anyone's measure, 2017 was a great year for investors. As shown, foreign stocks had the highest returns, but all equity markets were good. Many of our clients worry that since the stock market was up so much last year it is bound to fall any day, but it doesn't work that way. The market doesn't fall just because it went up.

Last year's gain can be explained by fundamentals, both past and expected. Earnings grew by 17% last year, almost equal to the price gain in the market. Add to that the facts that (i) the economy accelerated from 2% growth at the beginning of the year to 3% growth in the final three quarters and (ii) inflation and long-term interest rates fell, and you have the reasons for such a good year in stocks.

As you know, in December, Congress passed a tax reform law. The biggest change was to reduce taxes on corporations. This has given the market another boost as it looks forward to 2018.

This explains the past. What about the future?

Economy. As mentioned, the economy accelerated in the last 3 quarters of 2017. There is very little reason to be worried about the economy right now. In addition to strong growth in the U.S., foreign economies are also accelerating: Europe, Japan, and China are all growing. Even Greece is apparently out of recession.

The Fed, Inflation, & Interest Rates. Inflation has remained remarkably benign. There are a number of forces involved that we will only understand after looking back in a few years, but we can reason that the internet (Amazon) has caused downwards pressure on prices and global trade has contributed to keeping inflation under control for a long time.

There are early signs of changes, but they are not yet significant. Wages are now increasing at a 2 ½% rate, up from 2%. The price of oil has moved up from $50 to $60. A falling dollar has increased the cost of imported goods. And, there has been some movement toward tariffs and trade policy that might shift costs higher.

The Federal Reserve has increased the Fed Funds rate three times in 2017, and the current target is 1.25% - 1.5%. This year the Fed is expected to raise the rate 2-3 more times, and they are reducing the amount of bonds they own which is sometimes called 'quantitative tightening'. This is the number one cautionary flag because it is rising interest rates that usually cause recessions and bear markets. It is important to note, however, that the Central Banks of Europe, Japan, and China are still in monetary easing modes.

Earnings. Earnings were better in 2017 than we expected. Nearly every year analysts are overly optimistic about earnings for the coming year. Last year was no exception, but actual earnings for the S&P 500 are now expected to be $125 for 2017 (companies are just now reporting 4th quarter earnings). At the beginning of the year, the estimate was $130. This is a much better (closer) result than normal, and it represents a 17% increase over 2016. That is the highest level of year-over-year growth since 2011.

In part due to the cut in corporate taxes, estimates for 2018 earnings growth are very high. The current estimate from S&P is for $150 of earnings, which would be a 21% gain from 2017. Some estimates are even higher.

Valuation. Cautionary flag number two is valuation. As we write this on January 26th, the S&P 500 is trading at $2,855. Based on 2018 earnings of $150, the P/E ratio is 19x, which is close to 20% above its long-term average of 16x forward earnings. If earnings disappoint, or there are other negative surprises, the market has no valuation cushion to support it.

Financial Stress. We added this indicator after the last financial crisis. There are currently no significant indications of bubbles except perhaps the mania around Bitcoin. As fundamental investors, we cannot value Bitcoin, or even Tesla. We view these as speculative; they are not indications of widespread mania like we saw during the tech or real estate bubbles.

We would point to excessive optimism as another cautionary flag... at least for the near term. We follow a sentiment indicator produced by Ned Davis Research which shows investors to currently be the most optimistic in the 24-year history of the indicator. This is usually followed by below-average returns. Returns are usually highest after extreme pessimism. Lord Nathan Rothschild said in 1810, "Buy to the sound of cannons, sell to the sound of trumpets." This is as true today as it was then.

Politics. In today's polarized climate, we choose to say as little as possible about politics. Suffice it to suggest there are two ways you can look at the strong economy and stock market. If you are a supporter of the current government, you can give them credit. If you are an opponent, you can claim that government has very little to do with the economy or stock market. If you asked our opinion, we would say both are probably true to some extent.

Tax Cut and Jobs Act – What It Means for You

Tim Dutton & Barbara Lommen, CFP®
Financial Planning Team

Much has been said and written about the changes that will affect your income taxes for 2018 following the passage of the Tax Cut and Jobs Act last December. Here is a narrative of the changes that we think will affect most of our clients. Please see the 2017-2018 comparison table on the last page for more details. For a more in-depth analysis of your situation, please consult your tax professional.

INDIVIDUAL INCOME TAXES:

- The income tax brackets are changing, which will result in a slightly lower marginal rate for most but not all tax payers.
- Long term capital gains rates remain the same, but they will use the 2017 income brackets of 0% (ends at $38,600 Single and $77,200 MFJ), 20% for the top bracket (starting at $452,000 single and $479,000 MFJ) and 15% for the remainder.
- The Medicare surtax of 3.8% on net investment income will continue to apply to taxpayers with AGI above $200,000 (single) and $250,00 MFJ.

Deductions and credits

- The standard deduction will almost double, but the personal exemption will be eliminated.
- The child tax credit will double to $2,000.
- Some itemized deductions are reduced or eliminated:

- State, local, and property taxes will be limited to a $10,000 deduction.
    - Mortgage interest deduction will be limited to $750,000 of mortgage debt on a first and second home.
    - Interest on home equity lines of credit can no longer be deducted.
    - Miscellaneous itemized deductions will be eliminated.
- Medical expenses can be deducted to the extent they are over 7.5% of AGI for 2017 and 2018; the threshold will increase to 10% in 2019.
- The phase-out of itemized deductions has been eliminated.

Alternative Minimum Tax (AMT)

- The AMT exemption amount increases by 29% and the phase-out levels are a lot higher in 2018.

Gift and estate taxes

- Taxes will only be applied to gifts or estates larger than $11,200,000 per person.

Education savings

- Education savings in 529 plans can also be used for certain educational expenses in primary and secondary school up to a maximum of $10,000/year.
- If clients have UGMA/UTMA accounts for their children, the tax rate applied to those accounts will be increasing to the trust range of 10%-37%.

BUSINESS TAXES:

- The existing graduated corporate tax rates (15% to 35%) are replaced with a flat corporate rate of 21%.
- New 20% qualified business income deduction for owners of flow-through entities (such as partnerships, limited liability companies and S corporations) and sole proprietorships, but several exceptions apply.

Corporate AMT

- The 20% corporate AMT has been repealed.

Depreciation

- Accelerated expensing of assets to 100% and expansion of qualified assets to include used assets. This will be effective for assets acquired and placed in service after September 27, 2017, and before January 1, 2023.

Last Word

Rick Lawrence
President & CEO

At the top of the newsletter, Brad's piece is an interesting snapshot of the state of the economy, monetary policy, corporate earnings, valuation of large cap stocks, financial stress, and the political environment. These are the six discussion areas around which we build our sense of what to expect in the coming months and year. Good discussion.

We provide in this note information on the tax changes that were enacted several weeks ago. There are lots of adjustments, phase outs of old rules, limits on deductions, etc. It seems that for individuals and families it remains to be seen (and experienced) how significant the bottom line changes will be. One thing we know for sure, the change in the corporate tax rate is material, and driving 2018 earnings estimates up. Lots to decode here, and it may take a year to see how all this will sort out!

We sponsored a session this week in Longmont, which about 35 clients and friends attended. There were two speakers who guided us through discussions about planning for long term care expenses and the effects of recent tax and other regulatory changes on estate planning. Pretty complex and sobering topics for a happy hour meeting with clients; and I applaud everyone who gave us their evening. The discussions we shared during and after the presentations show the importance of understanding and maintaining focus on your financial plan. I hope when you meet with your advisor that you take time to review your plan, and make sure we know if there is any updating to be done. This is valuable information for both of us, as we strive to make your investments fulfill their roll for your future.

Don't have a plan yet? We finished more than 140 plans last year and are always looking for more chances to help clients work through and document this important thinking.

This coming week we are having our second annual All Client Investment Committee meeting in Boulder. Anyone receiving this newsletter is welcome to attend this meeting, just make sure we have your RSVP so we know how much breakfast to serve. Good chance to sit down with a bunch of people and think about where the markets are likely to go and what we can be doing to ensure that we are ready to benefit from the ups, and manage the downs. Brad, Josh and Dave each have a presentation ready, and it promises to be an interesting morning. We took the lead on these meetings from Josh and Dave, who have been doing annual sessions like this for several years at the original Colorado Financial Management in Johnstown. Great tradition.

Our company passed a fun landmark in January, exceeding $1.5 billion in managed assets for the first time. Kudos to Mike Sargent and Brad Bickham, employees #1 and #2, who started this gig 30 years ago. We'll have more to say on that later.

As always, we close with a thank you to all of our clients. It is a pleasure to work in a place whose mission is to make your lives better. All of us appreciate the chance to work with you.

Many happy returns,
Colorado Financial Management
www.colofinancial.com

COLORADO FINANCIAL MANAGEMENT®

2017 Tax Rules Taxable Income			2018 Tax Rules Taxable Income		
Rate	Single	Married	Rate	Single	Married
10%	$0 - $9,525	$0-$19,050	10%	$0 - $9,525	$0-$19,050
15%	$9,526-$38,700	$19,051-$77,400	12%	$9,526-$38,700	$19,051-$77,400
25%	$38,701-$93,700	$77,401-$156,150	22%	$38,701-$82,500	$77,401-$165,000
28%	$93,701-$195,450	$156,151-$237,950	24%	$82,501-$157,500	$165,001-$315,000
33%	$195,451-$424,950	$237,951-$424,950	32%	$157,501-$200,000	$315,001-$400,000
35%	$424,951-$426,700	$424,951-$480,050	35%	$200,001-$500,000	$400,001-$600,000
39.6%	Over $426,700	Over $480,050	37%	Over $500,000	Over $600,000

PERSONAL INCOME TAXES	2017	2018
Standard Deduction	$6,350 single- $12,700 MFJ	$12,000 single- $24,000 MFJ[1]
Personal Exemption	$4,050	Eliminated[1]
Child Tax Credit	$1,000	$2,000 (refundable < $1,400) [1]
State & local tax deduction	Full	Limited at $10,000[1]
Mortgage interest deduction 1st and 2nd home –excl. HELOC	< $1,000,000	<$375,000 single, <$750,000 MFJ[1]
Home Equity Line Interest deduct	< $100,000	Eliminated[1]
Personal casualty & loss deduction	> 10% AGI	Eliminated[1]
Medical expense deduction	> 7.5% AGI	> 7.5% AGI in 2018, >10% - 2019>
Misc. itemized deductions	>2% AGI	Eliminated[1]
Moving expense deduction	All job-related	Eliminated[1]
AGI based reduction itemized deductions	$261,500 single-$313,800 MFJ	Eliminated[1]
529 plan funds used for	College only	< $10,000 for primary & secondary
AMT exemption	$54,400 single - $86,200 MFJ	$70,300 - $109,400 MFJ[1]
AMT phase-out	$123,100 - $164,100 MFJ	$500,000 - $1,000,000 MFJ[1]
Gift and Estate Tax exemption	$5,490,000	$11,200,000[1]
UTMA/UGMA tax rates	Individual	Trust rate
Roth conversion	Can be re-characterized	Cannot be re-characterized

CORPORATE TAXES	2017	2018
Corporate tax rate	35%	21%
Pass through income taxation	Income tax rate	$20,000 deduction (some limits)
Corporate AMT	20%	Repealed
Accelerated expense depreciation	50%	100% -also expanded categories
Section 179 limit and phase-out	$510,000 and $2.030,000	$1,000,000 and $2,500,000
Interest expense deductibility	No limit	Limited to 30% EBITDA

[1] expires 2025