BRIAN D. LOWDER, INC.

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INSIDE THIS ISSUE

- **Financial Market Overview**
- **Financial Market Outlook**
- **Investment Outlook and Recommendations**
- **How Tax Reform Affects Individuals and Corporations**
- **Company Announcements**

FINANCIAL MARKET OVERVIEW

The U.S. and world stock markets continued to defy the odds and naysayers during the fourth quarter of 2017 by posting an above-average 6% gain. The overall stock market earned a positive return in each quarter of 2017 and finished the year with an impressive 20% gain. It is equally important to note that about two dozen stocks (primarily tech/internet) were responsible for most of the annual stock index performance.

Once again, the top performing investment category (within the U.S. stock market) during the third and fourth quarters was the information/technology sector. On average, the technology sector was up 32% in 2017. Most water utility stocks also posted 30% and higher returns during 2017.

Growth stocks continued to outperform value stocks during the fourth quarter 2017 and during the entire calendar year. Growth stocks outperformed value stocks by a two-to-one margin. In addition, large-company stocks outperformed both mid-cap and small-company stocks.

Gold and silver prices also rose modestly during the fourth quarter – gold was up nearly 2%. International stocks (world index excluding U.S.) rose during the fourth quarter, but not us much as U.S. stocks. During the 2017 calendar year, international stocks were up 23% and emerging market stocks (small international companies) performed much better – up about 35%.

As expected, fixed income or bonds continue to rise and fall modestly in reaction to gradual interest rate increases and more rate increases are expected for the foreseeable future. Short-term bond returns ended the fourth quarter with a fractional loss (-0.7%) and intermediate-term bonds posted a similar loss as well (- 0.89%). The 10-year U.S Treasury Note started the year paying 2.39% interest and finished the year offering nearly the same interest of 2.4% for new purchases. In general, fixed income (bonds) posted flat to slightly positive returns during 2017.

Real estate (REIT's) prices were flat during the fourth quarter – down 0.12% and the total return (price change plus income) advancing only 3.3% during the entire 2017 year. As expected, rising interest rates negatively impact fixed income (bonds) and interest-rate sensitive asset categories (real estate, utilities, etc.).

The following chart displays sample returns of various asset categories during the fourth quarter of 2017 and the entire calendar year:

Yr-To-Date 2017	**4th Qtr. 2017**	**Index Return (*includes dividends reinvested*)**
+ 25.08%	**+ 10.33%**	**Dow Jones Industrial Average (^DJI)**
+ 21.12%	**+ 6.25%**	**Standard & Poor's 500 Index (^GSPC)**
+ 20.62%	**+ 5.97%**	**DJ U.S. Total Stock Market (VTI)**
+ 29.23%	**+ 7.69%**	**Large-company stock-Growth (IWF)**
+ 12.87%	**+ 4.92%**	**Large-company stock-Value (IWD)**
+ 24.69%	**+ 6.58%**	**Mid-Size Stocks – Growth (IWP)**
+ 11.91%	**+ 4.97%**	**Mid-Size Stocks – Value (IWS)**
+ 21.99%	**+ 4.32%**	**Small-company stock- Growth (IWO)**
+ 6.69%	**+ 1.31%**	**Small-company stock- Value (IWN)**
+ 23.76%	**+ 2.67%**	**International (EFA)**
+ 35.21%	**+ 5.16%**	**Emerging Markets (EEM)**
+ 3.30%	**- 0.13%**	**Real Estate Investment Trusts (VNQ)**
		Fixed Income
- 0.12%	**- 0.71%**	**Short-term U.S. Treasury (SHY)** *(includes appreciation)*
+ 1.93% *(includes appreciation)*	**- 0.89%**	**Intermediate U.S. Treasury (IEF)**
		Alternative Investment Category
+ 12.82%	**+ 1.71%**	**Gold (GLD)**

All returns calculated using adjusted historical quotes from finance.yahoo.com

Continued on page 2

Continued from page 1

FINANCIAL MARKET OUTLOOK

For the second year in a row (2016 and 2017), the negative forecasters got it wrong. Last year (2017) was a year of contradictions. Despite terrible hurricanes, provocation by North Korea with continuous testing of missiles to one day carry nuclear warheads, and the constant and embarrassing bickering between our two political parties, the financial markets continued to advance.

Simply stated, the financial markets do not care much about these things **unless** they hurt corporate profits. And so far, the stock market rise in 2017 was an accurate predictor that economic growth would improve and Tax Reform would eventually be passed into law. The result would be corporations would be better off (U.S. multinational companies would pay a lower income rate from 35% down to 21% when profits are brought back to the U.S.), business activity would accelerate and profits would improve thereby positively impacting stock prices. We are clearly on that path.

It is very difficult for individuals to separate their political, personal and other beliefs from the variables that actually impact financial market behavior. In the end, most individuals will gravitate toward whatever "financial forecast" matches their personal beliefs or feelings. Financial market performance is not the number one priority in this country for sure, but when individual investors are deciding how to allocate their investment accounts (what asset classes and in what proportion), they need to separate their political beliefs and personality traits of politicians from the variables that actually impact financial market performance.

Again, the main determinant of a *sustainable* stock market advance is economic growth (Gross Domestic Product) and the primary determinant of a *longer lasting* bear market is an economic recession. Almost "everything else" may cause either a short-term rally or correction.

INVESTMENT OUTLOOK AND RECOMMENDATIONS

The near and mid-term outlook remains positive for continued improvement in worldwide economic growth. Currently, the U.S. economy is growing above a 3% annual rate. The stock market anticipated better economic growth and some kind of passage on the Tax Reform package by advancing during the entire 2017 year. So, in retrospect, the market got it right. U.S. economic growth is accelerating and continues to come in better than expected – a primary reason why stocks continue to advance.
We took the middle road last year. Our client portfolios were still invested in stocks, but a lower exposure at the beginning of the year along with continued stock purchases periodically throughout the year. In retrospect, we could have shoved all cash into stocks and been rewarded nicely.

For 2018, we will continue increasing our clients' exposure to stocks equally between international and U.S. equities. We also believe value stocks are more attractive and underpriced relative to the overall market and growth stocks. Large-company growth stocks - especially the technology/internet sector - have had an exceptional run over the past 14 months. The probability of a rising stock market ***1-2 years from now*** is still higher than the probability of a lower stock market valuation.

We also expect interest rates to continue rising slowly. Rising interest rates are not positive for fixed income (bond) investments. Rising interest rates cause bond values or prices to fall. Investors still receive the income, but when combined with a loss in value, the total or net return is very small. In 2017, fixed income total returns (income plus or minus price changes) were below 3%. We expect the same scenario during 2018. Dividend-paying stocks from large established companies with predictable or steady gross revenues are a slightly better choice than fixed income (bonds).

In addition, with rising corporate revenues and economic growth, we also expect wages to rise which may eventually result in rising inflation rates. Mild inflationary growth is not a bad thing. But, we will watch this variable closely because when interest or inflation rates rise faster than expected, other asset classes are more attractive. Material stocks, energy companies, commodities and metals become more attractive as economic growth accelerates, inflation picks up, and the world's consumption of basic materials/natural resources will increase.

We have identified and shared our Buy recommendations in your second quarter reports mailed in July 2017. We are maintaining those recommendations and will not repeat them again with your fourth quarter reports. We have also identified the actions we will take if the improving U.S. and worldwide economic growth scenario does not unfold as expected or after a reasonable passage of time.

HOW TAX REFORM AFFECTS INDIVIDUALS AND CORPORATIONS

The new Tax Bill was signed into law just before Christmas. Much has been written and opinions vary on who benefits the most and whether taxpayers will pay more or less income taxes in 2018 compared to 2017. Generally, most individuals and large multinational corporations will benefit and see their income tax burdens decline under the new law, but some individuals will disproportionately benefit more than others

Continued on page 3

Continued from page 2

and California (and other high-income tax states) residents with higher incomes will likely pay more.

Each individual or family must evaluate their own circumstances to determine whether the positives are more than or less than the negatives in order to determine whether they will receive a net benefit or higher income tax cost.

Benefits:

1) **Income tax RATES will be lower.** The number of income tax brackets remains the same at seven, but the rates are lower. See the comparison below:

   2017: 10% 15% 25% 28% 33% 35% 39.6%
   2018: 10% 12% 22% 24% 32% 35% 37%

   It is true that high income tax bracket taxpayers can earn more income in the 35% bracket in 2018 before hitting the top 37% bracket compared to 2017(an additional 130K of income will be taxed 35% in 2018 whereas, the same income would be taxed 39.6% under the 2017 income tax brackets). However, those who highlight this seeming "benefit to the wealthy", also don't point out that top tax bracket taxpayers will lose a lot of deductions (discussed later) next year as well.

2) **The Standard Deduction will nearly double.** Some taxpayers have many deductions and others (particularly those who are renters) have very few. The standard deduction means anyone can use this standard or fixed deduction amount regardless of how many or few deductions they have. The standard deduction will increase from $12,700 to $24,000 for married couples and increase from $6,350 to $12,000 for single taxpayers. This jump in the standard deduction means an additional $5,650 of income for singles ($11,300 for marrieds) will not be taxed.

3) **The Child Tax Credit will double to $2,000 per child.** This tax credit increase shelters an additional $1,000 of income from being taxed per child. And the income limits on who may claim the credit have been substantially increased (single taxpayers can take the per child tax credit if total income is below $200,000 but it can only be taken if total income is below $75,000 in 2017) and $400,000 for couples (up from $110,000 of total income in 2017).

4) **Small Business Owners will see a 20% deduction on reported income.** Small business owners operating as pass-through entities such as S Corps and limited liability companies, will have a new 20% deduction on income. Lower reported income means lower income taxes paid.

5) **Alternative Minimum Tax won't likely affect families with income less than 1 million.** Under the current tax code, more and more middle-income families have had to pay some AMT tax even though it was originally designed (in 1969) to ensure that only the very wealthiest were subject to additional tax. In effect, the new AMT calculations are unlikely to affect taxpayers with 1 million or less in total income.

6) **Individuals/Marrieds Can Pass a Larger Estate Before Death Taxes Apply.** Beginning in 2018, each individual can EXCLUDE $10.98 million of the value of their estate from the 40% estate tax ($22.40 million for married couples). In 2017, only $5.49 per person can be excluded from estate tax at death.

7) **Top Corporate Income Tax Rate Reduced from 35% to 21%.** The top corporate tax rate, which affects *publicly traded companies*, will drop from the highest rate of 35% to 21%. Big savings for corporations with substantial profits and an incentive for U.S. companies with subsidiaries in foreign countries to stop leaving the profits there (and taxed at a much lower rate) and bring profits back to the U.S. Prior to 2018, U.S. tax rules have treated the profits and cash overseas as not liable to U.S. corporate taxation *until it is repatriated to America.* Instead, companies have been leaving profits overseas and consequently, they expand and hire workers overseas rather than in the U.S. Tax legislation would start in 2018 to tax the offshore cash by as much as 15.5% - which provides an incentive to get U.S. companies to invest back home.

Drawbacks:

1) **New Limits on Deductions – 10K Limit on Deducting State/Local Income Taxes and Property Taxes.** This new $10,000 deduction limit applies to the combined total of property taxes and state/local income taxes paid. This new limit is going to affect a lot of people and is easily the most unpopular change – especially in states like California, Oregon and New York where many homes have property tax assessments of over 1 million dollars and the annual property tax bill exceeds $10,000. Many California taxpayers who earn over $300,000 in combined income can easily have property taxes exceeding $10,000 and California income tax paid exceeding $30,000. But only $10,000 of the $40,000 in my example would be deductible. This means smaller deductions and both higher reported income and higher reported federal income taxes.

2) **Lower Allowable Home Mortgage-interest Deduction and Eliminates the Deduction for Interest on Home-equity Loans.** Currently, taxpayers can deduct interest on a home mortgage of up to a $1 million dollar loan. Effective for home *purchases* made as of December 15, 2017, the cap for mortgage interest deduction is $750,000. The $1 million dollar loan limit for interest

Continued on Page 4

Continued from page 3

deduction remains in effect for existing homes (homes purchased before December 15th, 2017). Taxpayers who have borrowed against their home value (home-equity loan) will no longer be able to deduct the interest paid on that loan. In big cities where real estate values are high, this interest deduction limit may impact the values of expensive homes. In San Francisco, 58% of all new loans for home *purchases* exceed the new $750,000 limit for interest deductibility.

3) **The $4,050 Personal Exemptions (a deduction for each family member) will be eliminated in 2018.** This elimination hurts nearly everyone who earns less than $261,500 (single taxpayer) or $313,800 for a married couple. In 2017, a married couple with two children could deduct $16,200 off their income and avoid Federal income tax on that amount. Now, these taxpayers will be treated the same as high-income taxpayers – no personal exemptions at all.

4) **Elimination of Miscellaneous Itemized Deductions.** One section of Schedule A – Itemized Deductions is called *Miscellaneous Itemized Deductions*. Here, taxpayers total all investment management fees, accounting/tax preparation costs, safe deposit box fees, estate planning fees (cost of drafting or amending your Will or Trust), unreimbursed employee expenses, union dues, job search costs, uniforms, etc. and to the extent the TOTAL exceeds 2% of your gross income, then only that portion is deductible. Doesn't matter anymore – none of these items will be deductible after 2017.

How all of these changes add up for each individual taxpayer or family depends on income level, family size, which state you live in, whether or not you itemize deductions, whether you own a home and how much of these deductions which used to be totally deductible will be lost or eliminated. It's very hard to generalize the specific impact on an income tax return and anyone who says or writes that everyone will pay more or less, or states the wealthy will pay less and so on should be ignored.

COMPANY ANNOUNCEMENTS

Happy New Year - wishing you a happy and healthy 2018!

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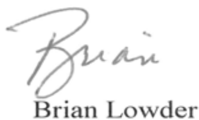
Best Regards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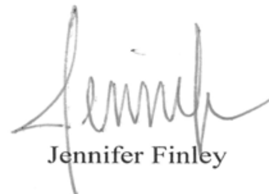
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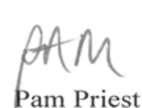
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