BRIAN D. LOWDER, INC.

QUARTERLY NEWSLETTER

Volume 21, Issue 2 July 2018

INSIDE THIS ISSUE

- **Financial Market Overview**
- **Financial Market Outlook**
- **Investment Outlook and Recommendations**
- **Current Topics Impacted by Tax Reform and Court Rulings**
- **Copies of 2017 Income Tax Returns**

FINANCIAL MARKET OVERVIEW

The overall U.S. stock market finished up over 3% during the second quarter, but still remains well below its January 2018 record high. The stock market advance was very uneven - the Dow Jones Industrial average was up only 0.7% during the second quarter and the global or international stock indexes were down just under 2%. And, during the last two weeks of the quarter, the overall stock market was down 2.2%.

The Technology/Internet sector was once again the top performing stock category during the second quarter. On average, the technology sector was up 6.75%. The NASDAQ stock index, loaded with the biggest technology stock companies, was up over 10% during the first 6 months of 2018 with 7.5% of that gain coming in the last three months. Energy stocks performed well as the price of oil climbed 13% during the second quarter after energy stocks fell 6% during the first quarter.

Growth stocks continued to outperform value stocks in both the first and second quarters by a 2-to-1 margin. Value stocks (similar to most of the stocks included in the Dow Jones Industrial Average), which include primarily established companies with well-known names, posted modest gains.

U.S. small-company stocks posted the largest and most surprising gain – up about 8% during the second quarter. Small-company stocks had been trailing the overall stock market averages over the past 12 months, but with the economy picking up nicely, these companies appeared to be the best bargains during the second quarter.

Real estate (REIT's) also rebounded nicely during the second quarter, but still remain nearly flat over the first six months of 2018.

Gold prices were down almost 6% during the second quarter and emerging markets (smaller-country international stock indexes) fell over 9%. China's Shanghai Composite stock market is down nearly 20% since January 1st.

Fixed income or bond prices continue to fall modestly in reaction to continuous and gradual increases in interest rates with additional small increases expected for the foreseeable future. Short-term bond returns ended the second quarter with a fractional gain (+0.11%) and intermediate-term bonds continued to post modest declines (-0.11%).

The 10-year U.S Treasury Note started the year paying 2.4% interest and by the end of the second quarter, the yield was 2.85% on new issues (the rate was over 3% three weeks ago). As interest rates continue to rise, the interest income is slightly higher on new bond issues, but bond prices or values of previously issued bonds that pay lower interest fall as interest rates rise. Over the first six months of 2018, the decline in value of bonds exceeded the interest income resulting in a combined or total return on bonds of nearly -2.0% during the first half of 2018.

The chart on the following page displays sample returns of various asset categories during the second quarter of 2018:

Continued on page 2

Continued from page 1

Yr-To-Date 2018	2nd Qtr. 2018	Index Return (*includes dividends reinvested*)
- 1.81%	+ 0.70%	**Dow Jones Industrial Average (^DJI)**
+ 2.52%	+ 3.55%	**Standard & Poor's 500 Index (^GSPC)**
+ 3.17%	+ 3.91%	**DJ U.S. Total Stock Market (VTI)**
+ 7.07%	+ 5.67%	**Large-company stock-Growth (IWF)**
- 1.84%	+ 1.18%	**Large-company stock-Value (IWD)**
+ 5.27%	+ 3.07%	**Mid-Size Stocks – Growth (IWP)**
- 0.33%	+ 2.38%	**Mid-Size Stocks – Value (IWS)**
+ 9.61%	+ 7.22%	**Small-company stock- Growth (IWO)**
+ 5.26%	+ 8.24%	**Small-company stock- Value (IWN)**
- 2.86%	- 1.98%	**International (EFA)**
- 7.63%	- 9.67%	**Emerging Markets (EEM)**
+ 0.02%	+ 8.92%	**Real Estate Investment Trusts (VNQ)**
		Fixed Income
+ 0.02%	+ 0.16%	**Short-term U.S. Treasury (SHY)** *(includes appreciation)*
- 2.04%	- 0.11%	**Intermediate U.S. Treasury (IEF)** *(includes appreciation)*
		Alternative Investment Category
- 4.04%	- 5.68%	**Gold (GLD)**

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

FINANCIAL MARKET OUTLOOK

Presently, investors have a "mixed bag" of concerns and positive outlook about the overall economy and the future direction of the financial markets.

The biggest driver or main determinant of a *sustainable* stock market advance is economic growth (increase in Gross Domestic Product). GDP growth in the U.S. and worldwide has definitely improved and should no longer be debated. The U.S. annualized GDP growth has improved and reached a 3% annualized rate of growth since 2017 and the estimated second quarter 2018 growth rate is expected to be near 4%. Further, the consensus economic growth rate forecast for 2018 is 3% or better. Previously, annual GDP growth had averaged well below 2% in the U.S. since the 2008 financial crisis began through 2016. Maintaining a 3% or better average annualized GDP growth rate is the ideal target.

Secondly, the economic growth rate should continue to hold steady and improve at least over the next year or two because Tax Reform lowered the income tax rates for both individuals and corporations. Lower personal income tax brackets results in extra take-home pay and extra take-home pay increases spending by individuals and families. More spending improves economic growth.

Corporate tax rates have been reduced from a 35% maximum rate to a flat 21%. In addition, corporations are allowed a *one-time* income tax break on approximately $2.6 trillion in profits that multinationals have socked away overseas in recent years under a "deferral rule" that previously permitted companies to hold profits offshore tax-free, as long as the money was not brought back into the U.S. or repatriated. Under the new tax reform laws, no such deferral rule exits after 2018 and these accumulated profits can be taxed this year at either a 15.5% rate for cash holdings or at 8% for more illiquid investments *when brought back to the U.S.* These overseas profits brought back to the U.S. will be taxed at the much lower tax rate (15.5% or 8%) compared to the prior 35% maximum rate

Just one corporation, Apple, has over $250 billion cash in overseas profits. These foreign cash balances will return to the U.S. and corporations have the opportunity to reinvest these funds into U.S. operations and/or pay large one-time dividends to shareholders. Whether these funds are distributed in dividends or reinvested in business operations, the additional funds have a positive economic impact.

In summary, economic growth appears to have momentum for at least another one to two years just from the effects of Tax Reform alone.

Wherever there is optimism, you will also find the pessimistic perspective or outlook on economic growth. And that perspective is: The economy has been *juiced up* by these one-time corporate tax cuts to bring overseas profits back to the U.S. After 2018, the repatriation or return of corporate profits back to the U.S. and taxed at the one-time lower rate of 15.5% or 8% will no longer exist. Therefore, this one-time return of profits will not be repeated and in 1-2 years and therefore this massive inflow of capital and positive impact on near-term economic growth will not

Continued on page 3

Continued from page 2

reoccur resulting in lower economic growth down the road. These same economists expect the U.S economy to slow down and expand by a lower 2% annual rate in 2020. The problem with this pessimistic forecast is the implication that one variable (no more one-time income tax benefits for bringing foreign profits back to the U.S.) is used to predict what the *entire* economy and financial markets will do *two years from now.*

What a difference just one year has made on worldwide economic growth. Last year, daily "news" stories were predicting that rising interest rates would kill the anemic economy, Tax Reform would not be beneficial for the financial markets and would NOT likely be passed by Congress anyway, potential military conflict with North Korea is imminent and other stories that we refer to as belonging in the "everything else" category.

Over the last 15 months, nothing in the "everything else" category prevented the stock market from advancing nearly 30% since the Presidential election day. My point is not political, rather, daily news stories and monthly volatility in the stock market is not where investors should focus their attention and should not be the reason for making investment selections or changes to their overall asset allocation. The worldwide economy and the U.S. economy in particular is growing better than it has in 10 years.

Perhaps the biggest cloud hanging over future economic growth as well as the financial markets is Tariffs and a "Trade War". Yes, in a worst-case scenario, a trade war with retaliatory tariffs would have a devastating impact on the United States and all other major country's economic growth. We can't think of another scenario (besides war) that would have such a crippling impact on worldwide economic growth. Every single country would be negatively impacted and could lead to crippling economies. Second, every country's leadership knows this fact. *Everyone loses*. That's why the probability of this scenario occurring beyond a short period of time is small.

Other countries, like Canada, China and others have been using tariffs placed on American products for many years. They are protecting their economies and specific industries such as autos in China and Europe and dairy products in Canada. Fast-forward to today, China has become an economic powerhouse by producing goods at a lower cost compared to Europe and the U.S. These tariffs implemented here and there over the last two decades didn't have much of an economic impact initially. Now, with maturing and competitive economies around the world and corporations able to build plants anywhere in the world, the issues of tariffs have to addressed – and it isn't a pleasant topic for any country's leadership to deal with.

Every country is going to initially stand tall to protect industries in their own country and refuse to eliminate their tariffs placed on American goods yet complain loudly if and when the U.S. starts placing new tariffs on their goods.

Then, you add leadership personalities into the mix – and the U.S. has one of the most blunt and direct leaders in the entire mix, and you have quite the scene going on. Most likely, it's going to be worked out. The current high tariff levels will not continue. Eliminating tariffs altogether in all countries on a specific date isn't likely to happen either even though this is the most theoretically fair choice.

The most likely scenario is initially some new and modest tariffs will go into effect – it doesn't appear likely that each country's leadership will immediately agree to what they will eventually have to agree upon. Some existing and exorbitant current tariffs in effect for years will be greatly reduced and some *new* tariffs will likely go into effect - perhaps with an agreement to strive toward total elimination of tariffs way down the road.

You know how these "global initiatives" work. Big pomp and circumstance initially as the world leaders agree to a long-term scenario (like reduced carbon monoxide levels, eliminate global warming) and in this case, total removal of tariffs. They will agree to reduce

Continued on page 4

Continued from page 3

some tariffs here and there over time, and other countries will place new tariffs in effect over time. And then as most country's leadership changes over time, there will be new adjustments or agreements down the road.

It's too early to predict when and where these tariff negotiations will settle, but the end-of-world predictions of a full-on tariff war seems to be overblown and have a small probability of occurrence.

INVESTMENT OUTLOOK AND RECOMMENDATIONS

The second quarter ended with stocks declining 2.2% over the final two weeks. And, a lot of the investing public and portfolio managers have been piling into the same stocks that posted exceptional returns during the second quarter: Apple (+12%), Alphabet formerly named Google (+12%), Amazon (+23%), Facebook (+25%) and Netflix (+42%). *Without these 5 stocks and a few other technology names, the overall U.S. stock market would be flat or slightly negative over the first six months of 2018*.

Our outlook with regard to continued economic growth and its positive impact on the stock market have not changed. Economic growth worldwide is still in place for continued improvement.

At this time, altering (reducing) our exposure to stocks in client portfolios in reaction to the worst-case scenarios of a trade war with China, Canada or Europe does not seem prudent. The changes we have been making this year will continue. Further, we will implement other adjustments and focus on the specific types of equities (stocks) and fixed income (bonds) that our clients should hold. Below is a summary of the changes made recently.

First, we have greatly reduced, and in many client accounts, eliminated most of the bonds and bond mutual funds – the Fixed Income portion of the portfolio. We have replaced these bonds and bond mutual funds with short-term Certificates of Deposits with 6-12-month maturities.

Interest rates have been gradually increasing over the past eighteen months – rising from a 65-year low up to current levels. Additional interest rate increases are expected appropriate now that the economy has reached average growth rate levels (3%) and rate increases are likely to continue at least over the near-term. As interest rates rise, the value of individual bonds and bond mutual funds decline. The general concept is rather easy to understand. While the fixed interest rate income continues to be paid on older bonds, new bonds offering higher rates of interest become more attractive.

As interest rates continue to rise, newer bonds paying higher interest are more valuable. Thus, the *fixed* income on older bonds become less valuable and therefore bond prices (values) fall. When the *decline* in bond values is combined with the *interest income* received, the total return becomes zero and often negative because the interest income is received is less than the decline in bond values.

Using short-term certificates of deposit in the fixed income portion of client portfolios rather than mid and long-term bonds helps maintain clients' exposure to the safe fixed income category without losing value as bond funds do during periods when interest rates are rising.

Second, most of the stock market's gain over the past year and especially the year-to-date gains have come primarily from the technology/internet sector. Approximately 10 big-name tech stocks have appreciated far more than most of the traditional or commonly recognized companies that make up the overall U.S. stock market indexes such as the Dow Jones Industrial Average or Standard & Poor's 500 Index. One sector (technology) is performing at the higher end of fair valuations and other non-technology

Continued on page 5

Continued from page 4

sectors should follow as the economy continues to achieve an average 3% annual growth rate.

"Value" stocks (big-name established companies) appear to be one attractive sector that hasn't fully participated in the recent stock market advance compared to tech and large-growth companies. Additionally, the large-company and high dividend-paying stocks that have performed so well in 2016-2017, are now near full-valuation levels. We may be reducing clients' exposure to these types of companies (utility stocks, water companies, telecommunication companies, etc.)

Three, we have and will continue adding more small-and company stocks to client portfolios under the expectation that the recent economic growth and increase in corporate earnings will broaden out beyond the large-company technology sector. Small-company stock values are beginning to move up and the overall small-company stock index was up over 7% during the second quarter.

Maintaining a target or slightly higher percentage allocation to stocks is the direction we are taking. Of course, contingency plans are always part of any investment strategy regardless of the economic outlook.

We will continue implementing our Buy recommendations periodically as we have in the past. We view the probability of a rising stock market ***1-2 years from now*** as being higher than the probability of lower stock market valuations. The path toward that expectation is not always smooth and our current volatile stock market reaction to tariffs and whatever else may arise is normal.

We have included our Buy recommendations in your second quarter 2018 quarterly 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.

CURRENT TOPICS IMPACTED BY TAX REFORM CHANGES AND COURT RULINGS

State sales taxes on internet purchases may be coming to your state soon. A recent Supreme Court ruling in S. Dakota requires sellers that have *no physical presence* in a state and make more than $100,000 in sales or 200 transactions or more annually, are required to collect sales taxes from Dakota buyers. State sales taxes on online purchases for multistate transactions still has languished on Capitol Hill and Congress has not presented a solution ….. yet.

Using 529 College Savings Plans for K-12 Education. Under Tax reform and beginning in 2018, the new law allows (Federal) income *tax-free* distributions of up to $10,000 per student per year to pay tuition for elementary and secondary private and parochial schools. Prior to 2018, distributions from 529 Plans were only tax-free when used for qualified college education expenses (tuition, dorm, etc.).

Not all states will follow the new federal law. More than 30 states so far have already clarified that they will follow the federal law and treat 529 distributions for K-12 schooling as "qualified education expenses". However, California, Oregon, and several other states say they will tax the distributions. State income tax rates are mostly single digit tax rates and the amount subject to tax is the gain in the 529 account – not the original contribution(s).

How Long Should You Keep Prior Year Tax returns? At least three years is the standard answer. Generally, that's how long the IRS has to question items on your income tax return and to bill you for any additional tax. It's also the same time limit taxpayers to amend a tax return and seek a refund. The IRS can go back up to six years if over 25% of income was omitted, and if there is fraud involved, *there is no time limit*.

Continued on Page 6

Continued from page 5

COPIES OF 2017 INCOME TAX RETURNS

The due date for 2017 income tax returns was April 18, 2018 and the first extension date was last month. Please request that your income tax preparer send paper or electronic (email) copies of your 2017 income tax returns to our office as soon as possible after completion. Our investment decisions, income tax management and retirement planning strategies are greatly improved when we have your most recent income tax returns in our files.

Contact Us

Brian D. Lowder, Inc.

Brian D. Lowder, CFP®, CFA
Michael Kinnear, MBA, MSFS, CFP®
Clinton Winey, MBA, CFP®, CFA
Jennifer Finley
Pamela Priest

Address
12780 High Bluff Drive Suite 100
San Diego, CA 92130

Telephone
(858) 794-6800

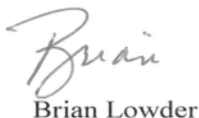
Fax
(858) 794-6906

Website
www.bdlowder.com

Email
brian@bdlowder.com
mike@bdlowder.com
clint@bdlowder.com
jenn@bdlowder.com
pam@bdlowder.com

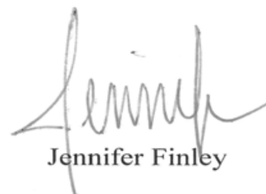
Brian D. Lowder, Inc., a California Corporation, is a fee-only wealth advisory firm specializing in comprehensive financial planning and investment management. Brian D. Lowder, Inc. is registered with the Securities and Exchange Commission and licensed by the State of California Department of Corporations as an Investment Advisor.

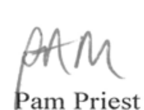
Best Regards


Brian Lowder

Clinton Winey

Michael Kinnear


Jennifer Finley


Pam Priest