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FINANCIAL MARKET OVERVIEW

Volatility in stock prices continued into the third quarter 2019. Overall stock market performance ended the quarter up 1%-2%.

During the third quarter 2019, the overall stock market was up about 1.3% in July, dropped 2.6% during August, and rose about 2% during September. The net performance of the U.S total stock market index during the third quarter was less than 2% even when dividends are included. Year-to-date, the total stock market index was about 20% (dividends included).

Growth stocks and value stocks performed about the same during the third quarter, however value stocks finished the end of the quarter with more momentum. Large-company growth stocks rose 1.73% during the third quarter compared to a 1.46% return for "value" stocks. However, the performance of mid-size and small-company *value* stocks outperformed mid-small *growth* stocks during the third quarter.

Real estate (REIT's) performance was the big winner. With interest rates dropping, real estate values jumped. REITs were up over 7.5% during the third quarter and up nearly 28% year-to-date. Lower interest rates help reduce the cost of carrying mortgages.

International and emerging market stocks (smaller-country international stock indexes) continue to trail the U.S. stock market performance. International stocks were down almost 1% and emerging markets dropped 4.75% during the third quarter.

Gold prices surged again. After climbing nearly 10% during the second quarter, gold prices were up another 4% during the third quarter. Year-to-date gold is up 14.5%, but still trails the 20% return for U.S. stocks.

Fixed income or bond **prices** continue to rally. The good news is bond **prices** are up during the past three quarters, but the bad news is prices are up because interest income or yield is still dropping. Interest rates continue to decline - for three consecutive quarters. When interest rates decline, *bond prices or values* increase. Short-term Treasury bond returns ended the third quarter with a 0.58% gain and intermediate-term Treasury bonds posted a 2.76% gain.

The 10-year U.S Treasury Note was paying 3.76% interest at the end of 2018. Today, the 10-year Treasury Note rate is only paying 1.65% interest. Even more astonishing, the interest paid on a new 30-year maturity U.S. Treasury Bond is only 2.5%. The interest rate on six-month certificates of deposit are only 1.85%. Yes, six-month CD's are paying slightly more interest than a 10-year U.S. Treasury Bond.

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The following chart displays sample returns of various asset categories during the third quarter of 2019 and year-to-date:

Year-To-Date 2019	3rd Qtr. 2019	Index Return (*includes dividends reinvested*)
+ 15.39%	+ 1.19%	**Dow Jones Industrial Average (^DJI)**
+ 20.40%	+ 1.76%	**Standard & Poor's 500 Index (^GSPC)**
+ 19.94%	+ 1.06%	**DJ U.S. Total Stock Market (VTI)**
+ 22.96%	+ 1.73%	**Large-company stock-Growth (IWF)**
+ 17.52%	+ 1.46%	**Large-company stock-Value (IWD)**
+ 24.88%	- 0.74%	**Mid-Size Stocks – Growth (IWP)**
+ 19.23%	+ 1.17%	**Mid-Size Stocks – Value (IWS)**
+ 15.32%	- 3.87%	**Small-company stock- Growth (IWO)**
+ 12.60%	- 0.43%	**Small-company stock- Value (IWN)**
+ 13.33%	- 0.79%	**International (EFA)**
+ 5.44%	- 4.75%	**Emerging Markets (EEM)**
+ 28.18%	+ 7.54%	**Real Estate Investment Trusts (VNQ)**
Fixed Income (includes appreciation)		
+ 2.95%	+ 0.58%	**Short-term U.S. Treasury (SHY)**
+ 9.59%	+ 2.76%	**Intermediate U.S. Treasury (IEF)**
Alternative Investment Category		
+ 14.53%	+ 4.26%	**Gold (GLD)**

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

FINANCIAL MARKET OUTLOOK

The financial markets continue to exhibit volatility and sudden short-term movements in both directions. Yet, stocks are up nearly 20% in 2019. In nearly every month this year, stock prices have moved suddenly in both directions and this continuous stock market volatility seems to bring out the fear for "what if" scenarios.

As financial markets continue to move suddenly over very short time periods and politics have become so divisive, it's hard for investors to ignore these subjects or at least prevent their opinions from overly influencing their investment decisions. Investors need to stay focused and monitor the indicators that have a meaningful and lasting impact on the financial markets. There is plenty of time (late 2020) before any potential change in leadership and economic policy will occur.

One of the two "more likely-than-not events" has already occurred that will provide confidence for continued positive investment performance - lower interest rates. Last quarter, the Federal Reserve did reverse their position and actually lowered interest rates by ¼% after increasing rates several times in 2017 and 2018. Interest rates on home loans are below 4% with variable rate financing below 3%. While lower rates are beneficial for borrowers, investors in fixed income and individual savers are receiving less than 2% investment returns – another reason why money is still flowing into stocks. Again, slow-to-moderate economic growth and low interest rates are a dream combination for stocks and real estate.

Secondly, a lot is riding on this month's U.S.-China meeting to discuss ongoing trade and tariff negotiations. Any improvement or partial agreement, whether substantially different or not, would give both countries' economies a shot in the arm and send both stock markets on an upward advance. The opposite outcome would have an immediate negative impact on both country's stock markets. If the standoff in trade differences continues both economies and financial markets would suffer. Conversely, if trade differences are resolved, both countries would experience improvement in economic growth and financial market returns. Getting rid of uncertainty and what may happen is better than the actual agreement itself. At this point in time, the probability of a resolution is greater than an all out trade war.

Our expectation is U.S. economic growth will be a bit slower for the remainder of 2019 and perhaps into 2020. A 2% to 2.75% GDP growth rate seems likely. If the pending Presidential

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election is a close race, expect stocks to provide an average return in mid to high single digits over the next 10 months.

INVESTMENT OUTLOOK AND RECOMMENDATIONS

The near-term outlook with regard to continued economic growth and its positive impact on the stock market are still in play. However, the pace has slowed compared to the initial growth expansion over the previous two years. Slow to moderate growth is a preferred scenario - which is a key stabilizer for continued economic expansion and predictable financial market performance. Rapid or above-average growth over a few years generally results in higher interest and inflation rates and both of these indicators have a negative impact on the financial markets.

Economic growth (GDP) has slowed in the second and third quarters by a marginal amount – from 3% to 2%. Private sector job growth slowed in September and U.S. factory activity hit its lowest level in a decade. Could this slowing be a new trend? Could the production halt on Boeing 747 MAX planes and the GM strike be a factor in the factory slowdown? It's too early to jump to any conclusions based on monthly data alone.

Interest rates are very low around the world, the U.S. Dollar is strong, economic growth is stable at a 2%-3% annually, employment is solid, and the overall climate for maintaining corporate profits is relatively good. It's the unpredictable short-term political news and impeachment proceedings that causes volatility and that's not going away. The biggest potential game-changer is how the ongoing "trade war" with China unfolds.

We do not plan to make any significant changes to client portfolios currently. The proportion of client portfolios invested in stocks is equal to or above the "normal" allocation at this time. As a precaution, we have reviewed each account, created a master block trade file to reduce stocks by 30% in the event economic activity stalls or any other news that would have a lasting negative impact on the markets suddenly arises. We are ready to execute the stock reductions immediately in the event we feel the need to act quickly.

We expect the stock market to continuing providing a reasonable performance over the balance of the year with potential upward spikes if and when trade agreements are settled with China and other countries. 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.

CHANGING INHERITED IRA RULES

Both the House of Representatives and the Senate on working on slightly different versions of a plan to *tax inherited IRA accounts* sooner when beneficiaries receive an IRA as an inheritance (the rules for individual IRAs will not change – only inherited IRAs). We will begin with the current tax law rules for IRA account holders, identify the changes under consideration when IRA accounts are inherited, identify who the new rules apply to, who will be excluded from the changes under consideration and when these new rules will start.

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First, the phrase used to discuss this topic and the changes under consideration is referred to as "Stretch IRAs". A primary benefit of owning a Regular IRA account is it allows you to **stretch out** taking taxable distributions over your life expectancy. Further, taxable distributions are not required until the owner reaches age 70 1/2. And then, at that time, IRA accounts holders must take Required Minimum Distributions each and every year throughout their lifetimes. How much is required?

Simply stated, you take the year-end value of the IRA account (say $100,000) and divide by your remaining life expectancy (the IRS provides standardized life expectancy tables to use). At age 70 ½, your life expectancy is about 26 years. So, divide the $100,000 IRA account value by your remaining life expectancy (26 years) and the result is $3,846 ($100,000 divided by 26). The IRA account holder is required to withdraw at least this minimum amount and only pays income tax on a $3,846 withdrawal while the balance of the account continues to grow tax-free inside the IRA.

Here's where the change begins. Currently, the tax laws allow the **stretch period to be recalculated and continue** for a longer period of time <u>when a younger person **inherits the IRA**</u> and rolls over the deceased owners' IRA into his/her own Inherited IRA. Thus, the name "Stretch IRA". The Required Minimum Distribution is now calculated using a younger IRA account holder's age who has a new and longer life expectancy than the original IRA holder who died. The taxable annual Required Minimum Distribution is <u>lower</u> for younger persons (adult children or grandchildren) who inherit the IRA because their life expectancy is longer. In my previous example, a $100,000 IRA value divided by a younger person with a say a 40-year life expectancy is a lower $2,500 required distribution compared to $3,846 for a 70 ½ year-old person. The **Stretch IRA** continues for a longer period of time.

Here is a summary of the proposed changes. First, the House of Representatives have already overwhelmingly passed a bill (part of the SECURE ACT) that LIMITS the IRA stretch period **to 10 years – not your life expectancy.** This means the presumably younger person who inherited the IRA only has 10 years before ALL of the remaining IRA account balance MUST be withdrawn and be subject to income taxes. The person who inherited the IRA is not required to take any <u>*annual required distributions*</u>, but must withdraw (and pay taxes) all of the IRA balance no later than a 10-year period – not over his/her longer life expectancy. Impact: The stretch period is shortened and the withdrawals are subject to income taxes much earlier and over a shorter period of time (within ten years).

The Senate version (which hasn't been voted on or approved yet) allows the Inherited IRA account owner to exclude the first $400,000 of inherited IRA account value from the new rules and only the inherited IRA amount above $400,000 must be withdrawn <u>**within 5 years.**</u>

Secondly, the House version with the 10-year required withdrawal period applies to **grandchildren and adult children of the deceased IRA owner who are <u>NOT minors – or stated another way – anyone over age 18</u>.**

In addition, these new rules also allow the following people to be <u>***eligible***</u> to use the **current life expectancy method** and not the proposed 5-yerar or 10-year period: S*urviving spouses, disabled, chronically ill heirs of any*

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age, an heir close in age to the deceased IRA owner, such as a sibling, and minor children.

Lastly, the House version states the new rules shall apply beginning **December 31, 2019** (in three months). The Senate version is silent on when the proposed changes will take effect.

So, what does this mean – should Regular IRA account holders "do something" before December 31, 2019? In most cases, NO. It's just "bad" news for **beneficiaries** of someone else's IRA – they won't be able to stretch out taxable Inherited IRA distributions over their life expectancy (remember though, this proposal excludes *surviving spouses, disabled, minors (under age 18), and siblings close in age to the deceased IRA owner* (the definition of "close in age" has not been defined at this time).

However, any IRA account owner who is considering ***converting a regular IRA to a Roth IRA should NOT do so at this time.*** The biggest complaint is some IRA owners have recently elected to CONVERT, their Regular IRA to a Roth IRA. The reason for converting to a Roth IRA is to allow **tax-free** Roth IRA distributions to be made over someone's younger or longer life expectancy. Inherited Roth IRA withdrawals are never subject to income tax while Regular IRA withdrawals are always subject to income tax.

Converting a regular IRA to a Roth IRA has an immediate cost – the entire Regular IRA value is subject to income taxes immediately. Once income taxes are paid, no matter how long and how much the Roth IRA grows, no future withdrawals will ever be subject to income tax. Can you imagine if you had a Regular IRA, determined that you don't really need all of it to maintain your lifestyle during retirement, and decided it would be a good idea to pay taxes now in one large sum by converting the Regular IRA to a Roth IRA in order to allow your younger adult child beneficiary to inherit the Roth IRA and take future tax-free withdrawals over decades (their longer life expectancy).

This new change would limit the future IRA withdrawal period to 5 or 10 years. So, why pay income taxes now in one large lump sum by converting the Regular IRA to a Roth IRA when the deferral period (for an inherited IRA beneficiary) gets reduced from his/her life expectancy to 5 or 10 years. Not worth it.

Those taxpayers who have already recently converted a regular IRA to a Roth IRA and paid a large income tax bill are livid. It's not fair to change the rules and then not "grandfather" or exclude those taxpayers who have voluntarily paid a large income tax bill today in order to have their beneficiaries spread out required IRA distributions over their much longer life expectancy.

The reason offered for making the stretch IRA withdrawal period for beneficiaries much shorter (5 or 10 years compared to life expectancy) is because IRAs were intended for retirement security – a way to encourage people to save and help provide for themselves along with Social Security or any employer-provided retirement plan during retirement. The intent was never to create a way for individuals to pass on their wealth to the next generation and allow those beneficiaries to trickle the money out (and pay income taxes) over a second life expectancy period.

Let's be honest with another reason to shorten the withdrawal period for IRA beneficiaries: Shortening the withdrawal period means withdrawals must occur faster and of course, income taxes must be paid sooner. The more government programs that need to be funded or improved, the more the cost and need for

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additional tax revenues. The choice is to raise current income tax rates or as in this case, collect taxes sooner by shortening the Inherited IRA withdrawal time to 5-10 years compared to current life expectancy method, which means more taxes will be paid sooner rather than later.

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