CA Financial Services

Client Quarterly

Summer 2017

Compliments of

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Published June 2017, by KMS Financial Services, Inc.
2001 Sixth Ave., Suite 2801 • Seattle, WA 98121 • www.KMS.com
Member: Financial Industry Regulatory Authority • Securities Investor Protection Corporation

Signs of Synchronous Global Growth

It has been 11 years since we could write about a "Global Economy Expanding Across a Broad Front." That headline led the Summer-2006 *Quarterly*, but the article also noted certain "key threats to that rosy picture." Two years later most of the world rolled over into deep recession and financial crisis. Cycles may be variable, but they are hardly extinct.

The recent thrust of economic data suggests that a newly synchronized global expansion is in progress. Strong earnings growth and positive surprises have come from a cross section of major industries and global regions. First-quarter profits for the Standard & Poor's 500 companies generally surprised to the upside with the strongest results since the third quarter of 2011.

Analysts see profit gains of 12% for full-year 2017 and another 11% in 2018. Better numbers have come out of Europe as well with about two-thirds of the continent's public companies beating consensus earnings estimates.

Since the Great Recession of 2008–09, analysts have expressed concern that earnings improvements were primarily a function of cost-cutting and financial engineering. The recession forced the former, and ultra-low interest rates facilitated the refinancing of corporate debt and a spate of share buybacks.

Recent earnings gains appear to be supported by a general pick-up in economic growth and corporate revenue. Growth-responsive sectors such as technology and industrial stocks have posted the most impressive surprises, while defensive sectors such as telecoms, utilities, and consumer staples have trailed. Solid results for financial companies which could benefit from higher interest rates, indicate that investors still see a case for "reflation."

This time around the U.S. isn't carrying the whole load. The International Monetary Fund (IMF) believes that none of the Group of 20 major nations will see a drop in output this year, and their economies will show the least variance in nearly four decades. It may be the first year since 2010 when all major global regions post earnings growth.

Rounding out the picture is persistent growth across developing economies for which the IMF projects a 4.6% growth rate for 2017–18. That's actually a modest reduction from their recent pace, but the developing world's rising contribution to global growth has been a big, multi-decade story.

From 1980 to 2007, advanced economies represented 59% of world GDP, measured in terms of purchasing power parity, while developing and emerging nations combined for 41%. The IMF now expects those relative shares to have fully reversed by 2018. China and India are expected to lead that parade, with Latin America and Russia tending to lag.

As we noted 11 years ago, there are always clouds on the horizon. Absent the results for energy companies, the S&P 500's first quarter earnings would have been roughly in line with analysts' more modest expectations. Subsequent pressure on oil prices and OPEC's uneven efforts to curtail supply could cramp that sector's near-term results. In fact, a general recovery in the commodities sector has been a key component of gathering growth.

Also, no broad survey is complete without noting the extensive geopolitical tensions and hotspots with the potential to undermine investor confidence. And to cap it off, one has to acknowledge that markets have *already* staged a pretty good run predicated at least partially on the picture outlined above. ■

Aligning with Your Best Interest

For two years the financial services industry has grappled with the practical implications of the U.S. Department of Labor's new Fiduciary Rule, which extends DOL's traditional oversight of workplace retirement plans to the realm of Individual Retirement Accounts.

In principle, the Rule sounds simple and noncontroversial. It calls upon financial professionals and their firms to provide investment advice under a "fiduciary duty," striving to act in a client's best interest and avoiding conflicts of interest in the compensation tied to those services and recommendations.

In truth, these concepts have been reshaping our business for years. KMS' Client Acknowledgement of Understanding has long stipulated that the firm and its investment professionals "receive commissions and/or fees in connection with transactions or services provided." The agreement encourages your questions to help us meet our commitment to provide "full disclosure of investment costs and risks."

The DOL Rule's prescriptive elements are bound to accelerate the evolution of modes of compensation and client service. However, nothing replaces the need for candid discussion and clear understanding of the investment services provided, as well as the forms and sources of compensation. KMS and your investment professional welcome that discussion, as we believe it is in your best interest and ours. ■

Actualizing the "Internet of Things"

Financial markets recently celebrated the 20th anniversary of Amazon's debut as a public company. And it has been *21* years since the *Quarterly* first featured the economic and investment potential of the Internet – the "information superhighway," as it was often described at the time.

Back then and for two decades since, fascination with the Internet has mostly revolved around streamlining and enriching people's access to one another, their entertainment media, and retail goods and services. That phenomenon has spread well beyond our desktop computers to tablets, smartphones, etc.

Just as profound are the rapidly advancing capabilities of connected *things* – everyday objects continuously sending and receiving data, enhancing their efficiency and responsiveness to the people and environment around them.

A recent Business Insider Intelligence report estimated that by 2020, this "Internet of Things" will comprise as many as 24 billion devices operating around the world, easily eclipsing the number of traditional computing devices accessing the Internet. The next five years may see some $6 trillion of investment in such devices and technology.

Increasingly, our cars, appliances, and home systems will process and push information to us and an array of service providers and suppliers. If your refrigerator already texts you when the milk's running low, you have a pretty good inkling of what's to come. You'll almost certainly prefer that it ping your designated grocery service instead of bothering you with the news.

Manufacturing and agriculture are also headed for a data-and-connectivity-driven transformation. Just as cars are now loaded with sensors to detect mechanical issues or maintenance needs, the world's machines, power plants, factories and fields will use sensors communicating information across integrated networks of manufacturers, shippers, and other service providers.

Key objectives include more timely delivery of replacement machines and parts, more efficient maintenance schedules and energy use, optimization of equipment performance, comprehensive surveillance of soil and crop conditions – in other words, less friction, less waste, and greater productivity.

Many devices already carry on a robust exchange of data across the Internet, with us plodding humans privileged to drop in on those conversations as required. While much of the developed world has been growth-challenged in recent years, companies that seize the potential of this transformation may enjoy a significant growth premium.

Millions of investors have piled into the acknowledged champions of the Internet of people and products, including Facebook, Amazon, Apple, Netflix, and Google. Maybe the *next* great surge of enthusiasm will embrace the emerging stars of the Internet of *Things*. ■

Investment Performance Review	**TOTAL RETURN *** (dividends and capital gains reinvested)			
Selected Mutual Fund Categories *	**--- Annualized through June 5, 2017 ---**			
	1 yr.	***3 yr.***	***5 yr.***	***10 yr.***
Large-Cap Stocks (Blend)	17.0 %	8.1 %	14.7 %	6.1 %
Mid-Cap Stocks (Blend)	15.5	6.0	14.1	5.9
Small-Cap Stocks (Blend) †	18.6	6.3	13.8	5.9
Foreign Stocks (Large Blend) †	16.7	1.7	9.6	1.1
Diversified Emerging Markets †	23.5	1.1	5.3	1.7
Specialty Natural Resources †	8.1	− 7.1	1.4	−1.3
Specialty Real Estate †	3.6	6.7	9.7	4.2
Cons. Allocation (30-50% Equity)	8.1	3.2	6.4	4.2
Long-Term Bond	1.8	5.8	4.9	7.3
World Bond †	2.9	0.5	1.9	4.0
High Yield Taxable Bond †	11.7	3.3	6.3	5.9
Long-Term Municipal Bond	0.7	3.6	3.3	4.0

* Source: Morningstar. **Past performance is NOT indicative of future results.**

† Small-cap stocks, high-yield (lower rated) bonds, and sector-specific funds may exhibit greater price volatility than the stocks of larger, established companies and/or more broadly diversified funds. Securities of companies based outside the U.S. may be affected by currency fluctuation and/or greater political or social instability.

Social Media *Damping* Market Volatility?

Here's an interesting theory. One of the long-time pillars of international investing, Franklin Templeton's Mark Mobius, believes that social media are a major contributor to the stock market's unusually *low* volatility. Mobius suggests that social media have fostered widespread mistrust of information, including market-related news. Investors are responding by just sitting tight.

Last winter, the *Quarterly* discussed the VIX Index, the so-called "fear gauge" for U.S. stocks. The VIX recently recorded some of its lowest readings since 1993 despite a seemingly daily churn of political turmoil and a reshaping of key elements of the U.S. economy. Are investors really immobilized by a surfeit of information and skepticism, or have they, at long last, embraced a focus on farther horizons than the daily or weekly news cycle?

We don't know. By the time you read this, volatility may have returned with a vengeance. It wouldn't be the first time a market trend turned on its heels just about the time it started being taken for granted. ■

Still of Two Minds When It Comes to Managing Debt

You may have seen the news that in the first quarter U.S. household debt hit a new plateau of $12.73 trillion, topping the previous peak of $12.68 trillion in late 2008. Overall debt levels are best viewed in the context of the total economy. In 2008, U.S. gross domestic product (GDP) was about $14.8 trillion compared to $18.4 trillion in 2016. By that measure, today's debt level still reflects a comparative deleveraging from the prior peak.

More importantly, the *make-up* of our household debt has changed. Student loans and auto financing represent a larger portion, while mortgage and credit card debt are still below pre-recession levels. The rise of student loans versus credit card debt represents financing of a form of long-term investment rather than near-term consumption.

A near decade of very low interest rates has slashed the cost of carrying that debt. Delinquencies and personal bankruptcy filings are at low levels, although student loan delinquencies have risen.

Seven years ago the *Quarterly* detailed distinct differences between those personal borrowing trends and the federal government's debt management. As shown in the accompanying table, U.S. Treasury debt held by the public stood at 39% of GDP at the end of fiscal 2008. A subsequent surge of stimulus spending coupled with a big drop in tax revenues pushed the accumulated debt to 61% of GDP by the end of 2010. The fiscal picture improved in subsequent years, but persistent annual deficits pushed the federal debt outstanding to 77% of GDP by the end of fiscal 2016, headed for 80% by the end of the current year.

Consistent with the contrasts we noted seven years ago, federal debt increasingly represents financing of current consumption in the form of Social Security, Medicare, and Medicaid payments. We hear a lot about ramping up investments in defense and infrastructure, but those partisan battles will be waged over a shrinking share of federal outlays.

Along with entitlements, the Treasury's cost of carrying the debt is rising again. From 2008 to 2013, even as outstanding debt more than doubled, net interest *expense* actually fell as the Treasury refinanced maturing debt at much lower rates.

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Tracking Federal Debt and Debt Management

(*$ amounts shown below are in billions.*)

Fiscal Yr-end	Federal Revenue	Federal Outlays	Annual (Deficit)	Outstanding Fed. Debt	Net Int. Expense	Avg Maturity
2007	$ 2,568	$ 2,729	($ 161)	$ 5,035	$ 237	55.0 (mos)
2008	2,524	2,983	(459)	5,803	253	49.0
2009	2,105	3,518	(1,413)	7,545	187	55.0
2010	2,163	3,457	(1,294)	9,019	196	59.0
2011	2,304	3,603	(1,299)	10,128	230	62.8
2012	2,450	3,537	(1,087)	11,281	220	64.8
2013	2,775	3,455	(680)	11,983	221	67.0
2014	3,022	3,506	(484)	12,780	229	68.3
2015	3,250	3,688	(438)	13,117	232	69.0
2016	3,267	3,854	(587)	14,168	241	69.8
2017 est.	3,300	3,960	(660)	14,828	305	70.4

Source: Congressional Budget Office

Reviewing the Impact of 529 Accounts on College Financial Aid

Another graduation season has come and mostly gone, reminding us of the challenge of funding one of life's great financial milestones. For families who still have a few years to mount that effort, a refresher on Section 529 college savings plans might be in order.

A 529 plan has some distinct benefits and strategic planning opportunities that reach across generations and financial objectives. The most salient of those income and estate tax advantages include:

- Dividends, interest, and capital gains accrue on a tax-deferred basis within the account.
- Withdrawals to cover qualifying education expenses are tax-free.
- Account assets are *not* considered to be part of an account owner's estate for estate tax purposes.

Beyond those basics, there are other particulars to consider. Since most students receive some measure of financial aid, it can be important to understand how a 529 account affects a student's aid eligibility.

Each year, those seeking aid complete the annual Free Application for Federal Student Aid (FAFSA), which gathers information on the income and assets of both the student and his or her parents. The FAFSA looks at a household's income and assets to determine the Expected Family Contribution (EFC) from the student and parents. Colleges will look to meet the remainder of the costs of attending through some combination of grants, subsidized loans, and campus employment.

The first key is that **the EFC does not draw equally from all assets and income.** It looks to as much as 20% of student assets and 50% of student income. It calls on up to 47% of parent income while calling on only 5.64% of parental assets. A 529 account owned by a parent is considered a parental asset (for aid purposes), so only 5.64% of the 529 balance is drawn into the EFC – considerably more favorable than the 20% expected from a traditional custodial account (UTMA) which is deemed a student asset.

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How might qualified withdrawals from a 529 affect aid? In addition to their tax-favored treatment, those distributions from a student- or parent-owned 529 account to pay for current-year expenses are *not* counted in the base-year income that would otherwise increase the subsequent year's EFC.

What if grandparents or aunts and uncles get into the act? Assets in a 529 owned by anyone other than the student or his/her parents have no effect on the EFC calculation. However, *withdrawals* from such a 529 used to cover a student's qualifying expenses are then included as student income (assessed at 50%) on the following year's FAFSA.

In general, these factors seem to suggest that parents and grandparents might prefer to hold assets in a 529 instead of endowing a UTMA account; and that parent-owned 529 assets be spent *first* with the grandparents' 529 assets helping to cover that *final* year.

All that said, every family's situation is different, and the above discussion is limited to federal financial aid. Colleges can make their own rules and introduce additional considerations in setting and administering aid. As has been widely publicized, an awful lot of financial aid is in the form of loans, to be paid back eventually by somebody. Saving is the key, and saving *strategically* can make a real difference. ■

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... When It Comes to Managing Debt

That game appears to have played out with 2017's net interest expense on track for a 35% increase in just two years.

The last column in the accompanying table points up another difference in debt management. Millions of individuals have been able to proactively refinance and lock in those low rates for years – even decades – to come. The U.S. Treasury's pace of restructuring the maturity of federal debt tends to be dictated by the amount of older Treasury securities actually maturing within a particular timeframe. Still, given the high percentage of federal debt issued in recent years, it seems they might have been able to bend the average maturity out a little longer than indicated by the table.

Sometime this summer, Congress will have to run the gauntlet of raising the federal debt limit. That's usually an occasion for heated partisan rhetoric and alarmist posturing. As individuals, we seem to have learned a few things about debt. As a body politic, not so much. ■

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