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An Eye Out for the *Next* Recession

We often hear that the U.S. economy's expansion is now one of the longest on record, though probably not one of the most vigorous. Does that mean that a recession is just around the corner?

The economics team at Guggenheim Investments recently updated their Recession Dashboard, which now projects February 2020 as the likeliest time frame for the economy to turn down. That may be pretty close to the current consensus among economists, and it sounds like a comforting stretch of remaining runway for an expansion that dates back to early 2009.

Then again, that's merely the mid-point of a date range that says an economic pullback *could* start as early as the latter part of 2019. We rarely know when a recession has started until well after the fact.

Leading suspects that could conspire to trip up the economy include an overheating labor market, tighter monetary policy, and a flattening yield curve. None of these developments is pre-ordained, but the unemployment rate has declined to an 18-year low, and many businesses report difficulty finding qualified candidates to fill positions.

Indications are that the Federal Reserve will continue to raise the floor under interest rates, and new mortgages are reflecting that. It also looks like the bond market will have to digest a little richer diet of federal debt in the coming months.

On the other hand (recalling Harry Truman's plea for a "one-handed economist"), the jobs report for May produced a robust headline number – 223,000 net jobs added – and also showed a continuing uptick in the percentage of working age Americans *participating* in the labor force. For much of the past decade a relatively weak participation rate and an aging demographic profile have been cited as limiting factors for the U.S. economy's potential growth rate.

As for concerns over more federal borrowing, there is a flipside. The tax reform package and recent budget deal are expected to provide economic stimulus, at least in the near term. Whether they turn out to be the right mix *longer term* – i.e., supportive of economic growth and sustainable both fiscally and politically – is always an open question. The phrase "permanent tax cuts" is clearly an oxymoron.

There's a tongue-in-cheek adage that the stock market has predicted eight of the last three recessions, or something like that. Whether any given group of economists can claim a better record is questionable. Cautious investors might consider upgrading the quality of their portfolio holdings and reviewing their diversification, given our perpetually cloudy view of future events. ■

Easing the Tax Hit from Those RMDs

If this topic is of interest to you, congratulations are in order, as it means you are in or nearing your 70s with: 1) substantial balances in your IRA; 2) little or no need to draw current income from those accounts; and 3) enough other taxable income that IRA withdrawals would be subject to a meaningful tax rate.

The withdrawal requirement is largely immutable once you reach 70½. Failing to withdraw *at least* the minimum incurs a penalty equal to 50% of the withdrawal shortfall, plus the regular tax due. However, there are strategic steps that can help mitigate taxes and/or use those RMDs to better advantage.

A Spouse of a Different Age? A basic tenet of tax and investment planning is to keep as much as possible invested as long as possible. If you will reach 70½ several years sooner than your spouse, you might consider maximizing contributions

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Noting a Shift on the Regulatory Front

Last summer's *Client Quarterly* discussed the U.S. Department of Labor's Fiduciary Rule which represented a broad expansion of DOL's traditional oversight of workplace retirement plans into the realm of Individual Retirement Accounts.

The DOL rule required financial professionals to provide their investment recommendations under a "fiduciary duty," placing a client's interests first and avoiding *conflicts* of interest in compensation tied to those recommendations and services. Initial aspects of the rule went into effect a year ago, but it still faced unresolved challenges from major segments of the financial industry, plus an emerging shift in regulatory focus under a new president's administration.

At this writing, the DOL's Fiduciary Rule has been vacated by the U.S. Court of Appeals' Fifth Circuit. The Court ruled that the DOL had exceeded its authority, imposing an overly prescriptive regulation that ultimately tended to limit client choice in receiving and paying for financial services and advice.

Meanwhile, the Securities and

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Muni Yields Are Up, Demand Is Down

Yes, you read that right. Investors' appetite for tax-exempt municipal bonds has been cool despite a modest supply of new issues and a healthy uptick in yields. That's a marked contrast with the dynamics of two years ago when tax-exempt yields were at multi-year lows. In July, 2016, yields on 10-year AAA general obligation bonds slipped below 1.5% versus 2.5% today.

Meanwhile, new issuance of muni debt has been running 20% below its trailing five-year average. The new tax bill did prompt a late-2017 supply surge as municipalities rushed to issue advance-refunding bonds. Those are bonds floated to retire outstanding debt at its future maturity date. The issuer invests the proceeds in higher-yielding Treasury securities. This offers investors a relatively secure, tax-exempt yield, while the issuer nets the rate differential between taxable treasuries and the rate incurred on the advance-refunded debt.

The tax bill killed advance-refunding going forward just as the rise in interest rates was set to reduce the strategy's utility. Advance-refunding bonds had represented as about a quarter of new-issue supply, but their weighting in the Bloomberg Barclays Municipal Bond Index is now down to 7% and falling.

For individual upper income earners, effective marginal tax rates remain high compared to a decade ago. And the tax bill narrowed certain avenues to tax reduction at the margin. The deduction for state and local taxes is capped at $10,000, and mortgage interest deductibility is restricted to principal amounts up to $750,000 (down from $1.0 million) for new financing.

Given the above, demand for munis might pick up as long as the broad bond market isn't overly spooked by the so-far gradual rise in interest rates. Cautious investors might consider upgrading the quality of their bonds, laddering maturities over the short-to-intermediate-term, and preparing to be patient. ■

Marking the Calendar on a Wall of Worry

Approaching 2018's midpoint, investors might be wondering what happened to the bull market. At this writing, some major averages are again pushing to new all-time highs, and this spring's periodic setbacks never came close to a "bear market" decline of 20% or more. However, results for a handful of diversified mutual fund categories suggest it's been a choppy ride for modest gain.

2018 Total Return thru June 6th
(Source: *Morningstar*)

Large-Cap Blend	+3.6%
Mid-Cap Blend	+3.9%
Small-Cap Blend	+7.1%
Foreign Large-Cap Blend	+0.3%
Diversif'd Emerging Mrkt	- 0.8%
Long-Term Bond	- 4.4%
High-Yield Taxable	- 0.4%
Muni National Long	- 0.8%

So, what about the rest of the year? As a *positive*, the geopolitical tensions and economic concerns that have roiled markets are in full view. Their relative weight on markets may rise and fall over the course of the following calendar of concerns.

G-7 Summit - June 8: Leaders of the world's largest economies meet with the primary goal of amplifying positions they know to be politically popular in their respective countries.

U.S.-North Korea Summit - June 12: Assuming it happens at all, expectations are sensibly modest.

U.S. Federal Reserve meeting - June 12: May's jobs report probably cinched a bump in rates. Traders are already shifting their speculation to the Fed's *September* meeting.

Mexico's election - July 1: Polls are leaning toward Andrés Manuel López Obrador and his populist MORENA party, prompting fears of a reversal of the economy-opening policies of recent administrations.

Brexit treaty - Oct. 18: As the target date approaches, a few remaining ticklish issues could add to current trade concerns.

U.S. midterm - Nov. 6: We have a history of delivering course "corrections" halfway through new presidential terms. About half the country will mourn the results; some will be apoplectic.

Thanksgiving - Nov. 22: This is an annual antidote to overly negative thinking. ■

Investment Performance Review	**TOTAL RETURN *** (dividends and capital gains reinvested)			
Selected Mutual Fund Categories *	**--- Annualized through June 6, 2018 ---**			
	1 yr.	***3 yr.***	***5 yr.***	***10 yr.***
Large-Cap Stocks (Blend)	15.0 %	10.2 %	12.0 %	8.7 %
Mid-Cap Stocks (Blend)	14.3	8.3	10.9	6.5
Small-Cap Stocks (Blend) †	18.2	9.8	11.5	9.2
Foreign Stocks (Large Blend) †	8.8	5.2	6.2	2.4
Diversified Emerging Markets †	13.1	6.8	4.4	2.2
Specialty Natural Resources †	19.7	5.6	3.5	0.1
Specialty Real Estate †	2.4	5.6	6.8	6.1
Cons. Allocation (30-50% Equity)	4.8	4.3	4.9	4.9
Long-Term Bond	- 0.8	4.0	4.0	6.3
World Bond †	1.4	2.5	1.1	3.0
High Yield Taxable Bond †	0.8	3.7	3.9	6.3
Long-Term Municipal Bond	1.0	3.0	3.0	4.1

* 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.

Donor Advised Funds Now Outnumber Private Foundations

There is a long tradition of wealthy individuals and families establishing private foundations to serve their own and future generations' charitable interests. Private foundations remain a major factor in the charitable world, but donor-advised funds (DAF) have gained popularity and now significantly outnumber private foundations in the U.S. These pages have featured the DAF opportunity over the years, including the following advantages driving their growing use.

Simplicity: Unlike a private foundation, launching a DAF does not involve any IRS approval process. There's no need to draft bylaws or establish a governing board. A DAF is usually an account under the umbrella of a larger charitable fund that administers the fund account, provides related investment and web services, handles tax-related compliance, and processes grants to qualified charities as directed by the donor.

Tax Advantages: Donors can deduct a higher percentage of their gross income for donations to a DAF than for gifts to a private foundation. They can deduct fair market value of *closely held* stock or real estate, while private foundation donors may only deduct their cost basis for such investments. Investment earnings within a DAF accrue income-tax-free, while private foundations pay tax on investment earnings, albeit at a low rate.

Flexibility: There are charitable projects or investment strategies that may be more manageable through a private foundation. But the growing popularity of the DAF approach continues to drive expanded investment platforms and choices. Given the broad universe of tax-qualified charities, DAF donors should be able to substantially shape the way their contributions are ultimately used. Also, a private foundation is required to distribute a certain percentage of its assets in grants each year, a requirement that usually is not imposed on a DAF account.

Privacy: Private foundations also are required to publicly disclose their charitable activities. Although grants directed from a DAF are part of the public record of the umbrella charitable entity, there is no requirement to disclose the identities of underlying fund contributors. The structure provides greater ability to make selective grants on a truly anonymous basis.

Legacy: Like a private foundation, a DAF facilitates family involvement across generations. Family members can be invited to weigh in on the selection of charities to receive grants. Assets can be split off to separate DAF accounts for family members to direct themselves with no gift or transfer tax implications. DAF accountholders can name successors to direct grants from the account or specify alternatives for administering or distributing those assets after death.

Private foundations continue to play an important role, but growing awareness and use of DAFs is raising the profile of charitable planning as a component of long-term strategic wealth accumulation and management. Your advisors can help explore alternatives in keeping with your goals and objectives. ■

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first to his or her traditional IRA or 401(k) accounts. That simply can help forestall the minimum withdrawal requirement being applied to those tax-deferred assets.

Working Past 70½? Those who remain employed do not have to take distributions from a workplace retirement plan until they actually retire. If you are approaching 70 and planning to stay on the job, consider rolling your IRA balances into your employer's plan. That should be done before the year you turn 70½, and the strategy may not be available if you are a contract worker or you own 5% or more of your employer.

Strategic Annuity Planning? A few years ago, the *Quarterly* covered the new flexibility for using qualified longevity annuity contracts (QLACs) in an IRA. These deferred annuities essentially purchase a stream of payments that won't commence for 10 or 15 years. IRA assets used to purchase the QLAC do not count in calculating subsequent RMDs for that IRA owner.

Strategic Roth Conversion? Under certain circumstances, it may pay to convert assets from a traditional IRA to a Roth before the year you turn 70½. For instance, if your other taxable income is low, and you are holding off on taking Social Security benefits, converting some assets might not trigger much tax while reducing future RMD amounts. However, if a Roth conversion *would* trigger meaningful taxes, it probably doesn't make much sense. After all, for the first several years, the RMD is less than 5% of your IRA balance.

The Charitable Route? Once you reach 70½, you can distribute up to $100,000 a year from your IRA *directly* to qualified charities. Such distributions do not count as taxable income, but they do count toward satisfying the RMD. This is most useful if you do not itemize deductions, a likelier prospect in view of the new tax law's near doubling of the *standard* deduction.

All of the above call for consultation with your tax and investment professionals. But you're probably used to that, given the financial success you've already achieved. ■

Better Living Through Mega Student Loans?

Seven years ago, with the economy still hung over from the great sub-prime mortgage bubble, the *Quarterly* wondered whether something similar might be brewing with student loans.

Total student loan debt outstanding was then nearing $1 trillion, and some commentators were questioning the sacrosanct status, or at least the ever-inflating cost, of higher education. However, the years slipped by, the economy recovered, and the sense of crisis faded. Today college is pricier than ever, and total student debt is at $1.5 trillion.

A certain orthodontist recently garnered his 15 minutes of fame by way of a *Wall Street Journal* piece detailing his accumulation of more than $1 million dollars in student loans. The article noted that there are over 100 individuals in similar straits, many having incurred those debts matriculating at some of our priciest medical and dental schools.

Even those who ascend to those professions run up against the daunting dynamics of compound interest. But at the extreme, there is an out of sorts. Federal student loan *forbearance* programs almost ensure that a big chunk of those *mega* student loan balances will end up on taxpayers' tab. So, next time you write that check to your kids' orthodontist, take solace that you might be making a small contribution to controlling the federal deficit. ■

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Exchange Commission has re-asserted its traditional role in setting standards and expectations in this arena. The SEC recently proposed a broad rule requiring brokers to disclose material conflicts of interest; exercise reasonable diligence, care, skill and prudence; and have a reasonable basis to believe a recommendation is in a client's best interest. Firms must maintain policies designed to identify, disclose, and mitigate material conflicts of interest arising from financial incentives.

Just to be clear, any recommendations provided in the context of a fee-based advisory arrangement *are* held to a fiduciary standard, as was the case long before the DOL initiated its rule. Moreover, the obligations outlined in the SEC's proposal simply mirror policies and procedures that have long been in place at KMS.

Regulatory fashions and focus come and go. But as we noted a year ago, nothing replaces the need for candid discussion and clear understanding of investment services provided, as well as the forms and sources of compensation for those services. KMS and your investment professional welcome that discussion, as *we believe it is in your best interest and ours*. ■

For information on our services, please contact:

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