WALKER FINANCIAL ADVISORS, INC.
Registered Investment Advisor

Private Client Update **October 12, 2018**

By: Scott Walker, CFP® and Warren Isenberg, CFP®

Olivia, Scott, Theresa, Warren

Third Quarter Wrap Up – The economy continues to do well, and our equity holdings responded with solid gains. The net average return across all client accounts was 2.86% in the third quarter, and 4.39% year-to-date. Since we own a mix of both stocks and fixed income for most of our clients, our objective is not to beat the stock market index, but rather to construct a tax-efficient balanced portfolio that provides adequate returns with *lower* risk. With that in mind, there have been a few changes recently.

Federal Reserve Chairman Jerome Powell sent shockwaves last week when he signaled that he is less data dependent than his predecessor Janet Yellen. The notion that rate policy should be dictated more by historical rates rather than what is dictated by current economic numbers took many by surprise, and interest rates jumped. The 10-year Treasury yield, which began 2018 at 2.41% is currently at 3.14% and the Bloomberg Barclays US Aggregate Bond Index is down 1.6% year-to-date. Remember that bond prices move inversely to interest rates, and the trend reversal last week with higher rates was powerful and significant. Although there is always the possibility Mr. Powell pares back his comments, we cut loose on our most interest sensitive fixed income position, the Invesco Preferred Stock ETF. We continue to be defensive with our core fixed income positions. **U.S. Treasury Bills**, **Pimco Short-Term Bond Fund** and **T. Rowe Price Institutional Floating Rate Fund** are all positive this year and have significantly outperformed the bond index.

What's next? – With the Fed's comments, it seems evident that short-term rates will continue their march higher. If they rise too much, there is a potential that the yield curve inverts (short-term rates exceed long-term rates), a rare event that has always led to a recession. When recession fears are stoked, no matter how much other data contradicts this notion, stock market corrections happen swiftly. That said, we must point out that the rate increases today are low, slow and measured, meaning an inversion is still a year out at best. And a lot can happen with Fed policy in a year's time. Rest assured, though, we are carefully monitoring these events and will take prompt action if things change.

Mid-term elections are looming and if the Democrats succeed in retaking Congress, many fear grid-lock will tamp out stock gains. We are more sanguine. Democrats would be hard pressed to reverse the 2018 Tax Act while Trump remains POTUS and a bipartisan initiative to improve infrastructure may provide another economic catalyst. Although there is evidence that the gains aren't as good with a divided government, the stock gains are still significantly positive. Since 1979, the S&P 500 stock index experienced annualized gains of 10.8% in periods of a divided government, compared with gains of 16.4% during united governments.

Even with the early October swoon, we are optimistic but not excessively so; stock valuations are high, but nowhere near all-time highs of the early and mid-2000s. We are entering the most favorable quarter of the year for equity returns. Earnings gains are the fuel that power stocks and we think the tax-cut will continue to help bolster corporate profits.

We believe our holdings are well positioned to continue to lead their respective industries, and in light of a potential divided government and current interest rate environment, there is still no recession in the forecast for the foreseeable future. We have 90% of our stock exposure in the U.S. for good reason. The U.S. dollar is the reserve currency of the world and U.S. domiciled companies are global leaders in innovation and technology. That said, having some international exposure still makes sense as any hint of renewed trade negotiations with China could spur a significant overseas relief rally.

<u>Equity Investments</u> – The leadership of large company U.S. technology stocks continued last quarter with our holdings in **Apple, Visa** and **Square** all posting double digit gains. Consumer stocks **Amazon.com** and **Costco** also shot higher. Amazon expects to close on their $1 billion acquisition of online pharmacy PillPack by the end of the year, providing yet another driver of future growth. Costco has experienced strong online growth by making more big-ticket seasonal items like patio furniture available year-round.

Disney also surged in the third quarter as it won a bidding war for 21st Century Fox assets. Fox's popular branded content and direct-to-consumer expertise should prove to be just what Disney needs to compete in the streaming world. **ConocoPhillips** climbed 11.6% and bucked the general downtrend of the energy sector. Bank stocks treaded water, but we still like **SPDR Regional Banking ETF** given the higher interest rate environment and regulatory tailwind. **Berkshire Hathaway**'s diversified business mix, stock portfolio, and $100+ billion in cash make an attractive package that led to a 14.7% pop last quarter.

Our top performing funds last quarter were **Primecap Odyssey Growth**, driven by its outsized tech and health care holdings and **Akre Focus Fund**, which was boosted by its Visa and Mastercard positions. We purged the Matthews Asia Growth Fund in the quarter as trade tensions escalated and Asia's markets sold off. We maintain positions in the **Grandeur Peak** internationally-focused funds as their holdings are broad-based and attractively valued.

<u>Social Security Update</u> - 2018 marks the first year since 1982 that the Social Security trust fund will pay out more than it collects from taxpayers. If no action is taken by Congress to modify payouts or increase the full retirement age, some analysts calculate that the $3 trillion trust fund will be depleted by 2034. With this knowledge and concern, many may be tempted to sign up for benefits early (age 62 is the soonest you can file) and hope to get as much as possible before benefits completely disappear. However, we think this notion is misguided. Keep in mind that payroll taxes account for 79% of promised benefits and legislative actions are most certainly forthcoming. Congress has used its powers in the past to shore up the program and it is highly likely they will adopt more measures going forward. Current proposals include raising the full retirement age to 70 or gradually increasing the payroll tax from 6.2% to 7.4% and eliminating the $128,400 taxable wage cap so higher income tax payers pay more.

Some individuals who are in poor health have no choice but to file for benefits at age 62, but if you do, your benefits will be permanently reduced by 25% to 30%. Furthermore, if you are married, claiming early will reduce spousal <u>and</u> survivor benefits. If you are working or have other sources of income, it is almost always better to wait until your full retirement age, which is age 66 if you were born between 1943 and 1954 and gradually raises to 67 for people born after 1960. Delaying benefits beyond that means your payout will grow by 8% per year until age 70.

<u>Year-End Tax Planning</u> – Given the big changes in the tax law effective for 2018, we recommend that you touch base with your tax advisor to avoid any big surprises next April 15th. We are happy to provide investment income and realized gain information to assist in the process. Changes in itemized deductions may lead to higher taxes for many, as the deduction for State income tax and real estate tax on your primary residence is now limited to $10,000. In addition, tax preparer & investment advisor fees are no longer deductible. In some cases, for those over age 70, it may be better to make a qualified charitable distribution from your IRA account to avoid income recognition on up to $100,000 of your required minimum distribution.

<u>Giving Thanks</u> – Pardon our seasonal play on words, but we want you to know that it is an honor and privilege to serve as your advisory firm. We sincerely appreciate the opportunity to be of assistance in building and protecting your hard-earned dollars.