SECOND QUARTER,
JUNE 30, 2019

DEIGHAN
WEALTH ADVISORS

Objective, unbiased *advice*

MARKET COMMENTARY

In *All-Star Superman*, a twelve-issue comic book series, Superman encounters the Ultrasphinx, a god-like figure who has traveled forward in time from the 80th century B.C. The Ultrasphinx has been tricked into thinking that Lois Lane has stolen Atom-Hotep's crown jewels, and therefore he captures Lane and puts her into a state of suspended animation. Lane's fate rests on Superman's ability to answer the Unanswerable Question: "What happens when the Unstoppable Force (Superman) meets the Immovable Object (the Ultrasphinx)?" Superman responds by saying, "They surrender."

Now, Superman's answer doesn't make much sense from a physical sciences standpoint. According to Newton's Third Law of Motion, for every action there is an equal and opposite reaction. The Ultrasphinx's question is better known as the unstoppable force paradox. Logically, an unstoppable force cannot exist simultaneously with an immovable object. An unstoppable force should, by definition, be able to move any object, and an immovable object, by definition, should be immovable regardless of the force applied. Hence, the paradox. Regardless, the Ultrasphinx accepts Superman's answer (this is a comic book after all), and Lois Lane is saved.

When it comes to tariffs, President Trump has been a bit of an immovable object. Despite arguments to the contrary, and despite the negative economic consequences, the Trump administration has continued with round after round of tariffs, first on solar panels and washing machines, then on steel and aluminum, and lastly, more than once, on specific goods coming from China.

The problem is that Newton's Third Law is more than just a law, it's also an apt metaphor. For every action, there is an equal and opposite reaction. China, India, and Canada have all retaliated by imposing tariffs on U.S. goods. Donald Trump, as immovable as he may be at times, exists in a world with other immovable objects. Or maybe they're unstoppable forces?

Of course, if an unstoppable force really were to meet an immovable object, the resulting collision would likely create a lot of collateral damage, much like Lois Lane was nearly collateral damage in Superman's meeting with the Ultrasphinx. Actually, come to think of it, there has been plenty of collateral damage as a result of the ongoing trade war, such as American soybean farmers, American manufacturers with global supply chains, and American consumers who buy products that are more expensive as a result of tariffs. That's why, in response to then-candidate Trump's trade rhetoric, the Hoover Institution published a 2016 article titled, "In a Trade War, No One Wins."

> "China, India, and Canada have all retaliated by imposing tariffs on U.S. goods."

A tariff is a tax on imports, meaning that the importing company pays the tax. Therefore, if a U.S. company imports a tariffed good from a Chinese manufacturer, the U.S. company bears the cost of the tariff. The question then becomes, can the importer pass these costs along to others or must they absorb the cost and make do with lower profit margins?

In some cases, an importer might be able to pressure their supplier for a discounted price, to help offset the cost of the tariff. In other cases, an importer might be able to switch suppliers and purchase from a domestic supplier or a supplier located in a country not subject to tariffs. These would be "best case" scenarios, the types hoped for by tariff supporters. Yet, these solutions are easier said than done. Much depends on the relative bargaining power between the importer and its suppliers, and it can be both costly and complex for a company to make sudden changes to its supply chain.

25 Years

Deighan Wealth Advisors
1994-2019

Absent these options, an importer has few other positive choices when faced with increased tariffs. An importer might choose to cut costs elsewhere, to offset the cost of the tariff and maintain profit margins. However, this can have a rippling effect, as the importer now either employs fewer people or purchases fewer goods and services across the rest of its business.

Alternatively, an importer could choose to pass the cost of the tariff along to customers and raise prices for end users. But, there's only so much price increase that customers will tolerate before they switch to a competing product or a substitute product. Price increases can also become a net drag on the overall economy, as consumers end up using discretionary income to indirectly pay for the tariff tax rather than buying more goods or services.

Caterpillar, Inc., for example, has seen its production costs increase by more than $100 million as a result of higher tariffs on the metals and Chinese parts it uses in its products. As a result, the company has increased its prices, passing the tax along to end users. Deere & Co., another heavy equipment manufacturer, has faced similar cost increases and has chosen to both raise prices and cut costs.

According to the Congressional Research Service, tariffs have led to as much as a 12% increase in the price of washing machines, and, according to the Peterson Institute for International Economics, steel and aluminum tariffs have increased the price of steel products by nearly 9%. Soybean farmers have been particularly hard hit, as Chinese demand for American soybeans has significantly declined in the face of China's retaliatory tariffs. Chinese importers have switched to buying Brazilian soybeans, causing U.S. stockpiles to hit record highs this past year.

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Therefore, well-intended or not, tariffs have been a drag on an already slowing global economy. A majority of Purchasing Managers' Indexes published at the start of July were equal to or lower than their prior readings. Germany, the United Kingdom, France, Italy, Russia, and India all saw declines. In the United States, reports were mixed. The Markit U.S. Manufacturing PMI reading increased from 50.1 to 50.6 month-over-month, while the ISM Manufacturing PMI reading decreased from 52.1 to 51.7. In its June report, ISM noted continued and expanding business strength, but at soft levels. June was the third month in a row with slowing PMI expansion, and demand expansion ended while consumption continued to expand. For reference, 50.0 marks the point between expansion and contraction.

According to Timothy Fiore, Chair of the ISM Manufacturing Business Survey Committee, "Respondents expressed concern about U.S.–China trade turbulence, potential Mexico trade actions, and the global economy." A sampling of survey responses shows that the impact of tariffs has been very real:

- "China tariffs and pending Mexico tariffs are wreaking havoc with supply chains and costs. The situation is crazy, driving a huge amount of work and costs, as well as potential supply disruptions." (A Computer and Electronics Executive)
- "Tariffs are causing an increase in cost of goods, meaning U.S. consumers are paying more for products." (A Chemical Products Executive)
- "We shifted shipments to China from our U.S. plants to our Canadian and European plants because of tariffs." (A Food, Beverage, and Tobacco Products Executive)
- "Tariffs continue to adversely impact decisions and forecasting. Our increasing fear is that current trends will weaken the global economy, influencing our ability to grow in 2020 and beyond." (A Fabricated Metal Products Executive)

This sentiment hasn't gone entirely unnoticed by the Federal Open Market Committee (FOMC). Despite voting to keep the federal funds target range at 2.25% to 2.50%, the FOMC sounded a more cautious tone in its June statement, saying that uncertainties around its outlook had increased. The FOMC plans to "monitor the economic outlook" and "act as appropriate" to sustain the expansion. This is Fed-speak for "an interest rate cut is on the table."

While there is some debate as to whether a rate cut is warranted given that the labor market remains strong and household spending has picked up, markets seem to be pricing in a near-term rate cut. Currently, based on transactions in futures, options, and swaps markets, there is a near 100% implied probability that the Fed will cut rates this year. The bond market seems to agree, as the treasury yield curve remains inverted, with the 3-month rate slightly higher than the 10-year rate. And much of the FOMC itself seems to agree, with eight of the committee's seventeen members projecting a rate cut of 0.25% to 0.50% between now and the end of the year.

So, we're back to Sir Isaac Newton and his Third Law of Motion: What goes up must come down. After raising rates rather methodically since 2015, the FOMC is considering a rate cut. This is rather remarkable, considering that rates are already low in a historical context. At their current level, rates are less than half of what they were at the peak of the last market cycle in 2007 (5.25% on the upper bound). In fact, at 2.50% (this cycle's peak), rates are lower today than they were during the trough (3.00%) coming out of the recession in the early 1990's.

It's hard to interpret what this means. On one hand, the economy continues to expand in certain areas, and unemployment is historically low. On the other hand, policymakers don't seem to think the economy can handle today's modest rates, which would imply the economy isn't, in fact, all that healthy. It's as though there's still some large, gravitational pull from the 2008 financial crisis weighing heavily on markets and the global economy, and the force of this pull is distorting traditional measures of economic health. Like the Ultrasphinx, the financial crisis has moved through space and time and remains with us even today.

To its credit, the stock market has largely shrugged off this negative force and continued on its upward trajectory.

Year-to-date through the end of the second quarter, the S&P 500 Index was up a staggering 18.54%, rewarding our conviction to remain fully invested despite an inverted yield curve and a slowing economy.

However, the stock market isn't the economy, and we agree with the FOMC that now is the time to "closely monitor the implications of incoming information…and act as appropriate." While the economy might be partially based on steel production, it is not indestructible like the Man of Steel. We're seeing a few more cracks in the armor than we saw three months ago.

The good news is that, coming out of the G20 summit at the end of June, President Trump and China's President, Xi Jinping, announced a renewed commitment to trade talks, which had previously stalled. The news initially sent the S&P 500 Index to an all-time intraday high of 2,977.86 on Monday, July 1st. Perhaps like Superman and the Ultrasphinx, Trump and Xi will surrender to one another. Our hope is that a reduction in trade tensions coupled with a reduction in interest rates might be enough to prolong the current economic expansion, giving stocks further room to run.

That said, we can't rely on hope alone when building portfolios. In the past quarter, we prepared to take profits from a number of positions with significant China exposure, to hedge against any potential souring of relations. And we continue to allocate to bonds and other portfolio diversifiers in the event that stocks reverse course like they did at the end of 2018. Our goal is to build durable, if not indestructible, portfolios that can weather a variety of situations.

As always, we're happy to answer any questions you might have. Until next time, we hope that you and yours have a wonderful summer.

PLANNING CORNER

Charitable Giving in a New Tax Landscape – DAFs and QCDs

The Tax Cuts and Jobs Act of 2017 increased the standard deduction to $12,000 for single filers and to $24,000 for married joint filers. This change has had a significant effect on charitable giving. Donors are now looking for charitable giving vehicles to preserve charitable deductions. Where many donors have lost their itemized deductions, methods of giving to maximize tax benefits still remain for savvy donors.

Donor Advised Funds

In a Donor Advised Fund (DAF), donors contribute to their own fund, held by a sponsor (such as the Maine Community Foundation or Schwab Charitable). At any time, donors can direct distributions to their selected charities from their respective funds. The sponsor is a 501(c)(3) organization and retains legal control over the assets upon contribution. The donor may retain an advisory role over investment decisions, and retains control over how the funds are distributed. The DAF is effectively a charitable middle man, providing the tax breaks for donors with no corresponding benefit for charities until the distribution is made.

What can go into a DAF? Just about anything, which is great for disposition of perhaps otherwise unwieldy assets. DAFs accept cash, however, they are most useful with contributions of appreciated securities, even real estate, helpful for charities that may otherwise not accept complex assets, or to parse complex assets out among multiple charities.

Advantages of the DAF include an immediate charitable income tax deduction in the year of the donation. Funds can be amassed to create a legacy plan for generational philanthropy. A DAF is an effective way to eliminate an unexpected significant capital gain in a tax year, a benefit not available for QCDs. DAFs also grow tax free. Typically, DAFs have low contribution minimums of $5-25K, and are easy and low cost to establish.

There are some disadvantages to DAFs. Donations are subject to charitable deduction limitations. Donors cede all legal control over the assets at the time of contribution to the fund. While theoretically the donor "controls" the account, the sponsoring fund has final say over the money, including the right to use the donated funds as it determines, such as for fees and costs incurred by the sponsoring fund.

Qualified Charitable Distributions

The Qualified Charitable Distribution (QCD) is increasingly popular as a tax-savvy charitable giving tool. In the QCD, the required minimum distribution from a retirement asset is made directly to charity.

SOUNDBYTES

Jen Eastman successfully completed the Series 65, an exam and securities license required by most U.S. states for individuals who act as investment advisors. Formally known as the Uniform Investment Adviser Law Examination, the Series 65 covers laws, regulations, ethics, and topics such as retirement planning, portfolio management, and fiduciary responsibilities. Congratulations, Jen!

Lucie Estabrook served as a judge for the Husson University Sales and Marketing Association's Second Annual Marketing Plan Competition. The competition is open to all undergraduate and graduate students currently enrolled in Husson University courses. This year's cases were Bangor International Airport, Portland Sea Dogs, and Husson University's new College of Business facility.

In April we were delighted to host a Producers Circle Reception for the American Folk Festival. We're looking forward to another amazing musical line-up at the AFF in August!

Jen Eastman and Lucie Estabrook attended the Envestnet Advisor Summit in Austin, Texas, in May. This annual event keeps us current with our ever expanding trading and reporting platform.

Jean was a guest speaker at the Olympia Snowe Women's Leadership Institute year-end celebration and graduation. She shared a bit of her history and the circuitous route to becoming a financial advisor.

It never "hits" the hands of the donor, and so is not considered income to the donor and not subject to income tax. No charitable deduction is available, as there is no income from the RMD to offset.

What qualifies for a QCD? Almost any retirement account except a 401K. IRAs are typically used for QCDs, but SEPs and SIMPLE IRAs can be used as long as they are considered "inactive." QCDs work for rollover and inherited IRAs as well. A Roth IRA could be used for a QCD, but would bear no tax benefit for the donor.

There are some rules regarding QCDs. While not subject to the AGI limitations on charitable deductions, there are annual limitations on gift amounts. Donations must be to a public charity – QCDs cannot be contributed to DAFs, private foundations, or charitable trusts. Donors must be over age 70.5 to make QCDs, in accordance with the rules on RMD.

Reduction of income is a primary advantage of the QCD. Taxable income will not reflect the distribution. This has the effect of lowering AGI and maximizing other AGI dependent limitations, including non-taxability of social security benefits, increasing 2% limitation deductions, and preserving other phase-out deduction limitations. QCDs can be made on top of charitable contribution limits since the QCD is never reported as a deduction at all.

Donors control the amount of the donation from the RMD. These dollars can be divided among various charities. The full RMD amount does not need to go to charity. Careful calculation could maximize the tax benefit to the donor, keeping one under certain income thresholds, while still providing for charity. In this way, QCDs add to the standard deduction. Where a direct donation or a DAF contribution will yield a benefit only over the standard deduction, the QCD provides the tax savings without need to beat the standard deduction.

QCDs are not perfect, however. There is no carryforward of the $100K contribution limit. There is no flexibility in the timing of the gift. Donors wishing to use QCDs should be thoughtful in planning well in advance of the end of the year.

Economists predicted that the rise in the standard deduction would decrease charitable giving because of the loss of tax savings, one estimating a drop of $13-21B per year. Such losses could be devastating for nonprofit organizations. It is more likely that people will continue to give; it is our nature to be charitable. Recognizing a benefit in a new tax landscape yields a win-win for donors and charities alike.

WE WELCOME DONNA BUSHEY!

Please join us in welcoming Donna Bushey as the newest member of the Deighan Wealth Advisors Team! Donna will be working as an operations assistant and client relations specialist, providing broad support to our group. Donna has worked as a legal assistant since 1996, and brings vast experience in high level client service to our firm. We asked Donna to tell us a little bit about herself.

Why did you want to join us at Deighan Wealth Advisors?
I decided to take the opportunity of working here at Deighan Wealth Advisors to do something very different. I am excited to work at Deighan Wealth Advisors, because their goal is providing the best service for client needs by working closely with them as individuals. I have seen just how dedicated this office is to accomplishing that in the short time I have been here. Everyone works together as a team here and I have felt so welcomed by everyone. I believe I have made a very good choice and look forward to being part of their team.

What is your favorite thing to do in Maine?
I like taking a ride through the Camden area and visiting some of the shops.

What is your favorite summer meal?
My favorite meal is a cheeseburger on the grill with a potato salad and watermelon.

Do you have any fur-friends?
I do not have any pets myself, but my son has two cats, of which he regularly shares pictures with me.

Donna, we are happy to have you on board!

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