ALBION FINANCIAL GROUP

October 26, 2018

As we head into the fourth quarter of 2018 we are thinking about how time flies. It seems like just yesterday we were watching the Philadelphia Eagles win the Super Bowl, South Korea host the Winter Olympics and Barbara Streisand reveal that she cloned her dog…twice. In this edition of our quarterly letter our President, John Bird, observes in “Prerequisite: The Attention Span of a Gnat” how the headlines of today quickly fade from the front page as we move onto the new and the next before truly understanding the facts of each assertion and event.

There is certainly no shortage of attention grabbing headlines when it comes to the financial markets, but we attempt to break through the noise with facts and thoughtful analysis in our Markets and Economy section. As the end of the year approaches a common topic of conversation is charitable gifting. In Planners’ Corner, we delve into thinking about charitable donations differently in 2018. And, last but not least, we share what’s happening in our world in Albion Community.

We hope all is well in your world and we encourage all our readers to vote on Election Day (Tuesday, November 6th).

Sincerely,

The Albion Team

Prerequisite: The Attention Span of a Gnat

Last year I attended the inaugural season of the Wasatch Speaker Series, a string of seven lectures over seven months in downtown Salt Lake City. Speakers ranged from Jane Goodall to Joe Biden and offered a broad array of perspectives. At the final lecture last spring the 2018-2019 speaker line-up was announced and on the list was James Comey. Remember him? Last spring he was all over the headlines having recently been fired as head of the FBI yet now, if mentioned at all, it’s many lines down from the top of the newsfeed.

Such is the nature of this time in our history. Subsequent to Mr.Comey’s moment in the limelight we’ve had a long cast of characters with their flash above the fold. A very abbreviated list includes Paul Manafort, Stormy Daniels, Michael Cohen, Brett Kavanaugh and Christine Blasey Ford. There are scores of others.

How is one to keep up and what is one to make of the parade of individuals dominating at least some portion of the national discussion? Perhaps the best approach is to hear what is said but take a moment to reflect rather than react. Clarity rarely comes with the first tsunami of information. But often, after the story has retreated to the second or third page, more nuanced and carefully vetted analyses appear that help put it all in context. Further, if you have the time and inclination, look across a variety of news sources. It’s remarkable the range of perspectives you’ll find on what is allegedly a common fact set. If you still have time follow through further using fact checking tools to see who may be closest to the truth.

Investing is no different. We are bombarded with opinions every day from myriad perspectives ranging from those who think the good times will roll on to those who are certain catastrophe is imminent. Rather than react we stop and think, assessing the various points of

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view and looking for confirming data. Rarely is the story as good, or as bad, as the initial headlines would have you believe.

Our success over the last thirty-six years has been based on taking in as much information as possible, screening it to sort out what is relevant and what is noise, then taking the time to think both analytically and creatively in an effort to understand how it should impact the decisions we make on behalf of our clients.

It has been nearly six months since James Comey was under the scrutiny of both our President and the Washington press corps. While it would have been fascinating to hear his perspective when he was in the spotlight it will likely be far more illuminating to hear his perspective after he's had nearly nine months to reflect upon the events that ended his tenure with the FBI.

We will continue to put in the time and effort to tease out the meaning behind the events we see in the investment world and make decisions based on a reasoned analysis rather than reflexively reacting to the events themselves.

Economy & Markets

Broad measures of the economy in the third quarter showed a durable expansion still underway. We have a healthy job market, aggregate consumption is strong, and overall confidence remains vigorous. Meanwhile core inflation is well-balanced and appears in check. This backdrop has helped push corporate revenues and profits higher. In the most recent reporting period profit growth expanded, yet again, at a pace nothing short of remarkable. Even so, we will repeat this until we are blue in the face: this stride of profit growth simply cannot be sustained over the long-run. At some point it will surely revert to the mean, which probably looks more like a mid-to-upper single digit pace. Sure, tax cuts should continue to provide some boost. But ultimately their effect will level off. We say this not to sound alarmist. Rather it's a simple recognition of facts in the context of both history and economic reality, shared in an attempt to more properly align investor expectations.

Looking abroad, the global economy by in large continues to grow, although at a slower pace. A worldwide expansion is undeniably good for business and for stocks. And yet perhaps ironically the biggest threat to these good times is the prospect of a trade war upending this coordinated upturn. As we've previously stated, we claim no edge in prediction on this critical issue. However we take some solace in data that indicates that to date the various trade skirmishes have had little impact on the U.S. economy or company profits. Unfortunately though, trade is one of those areas that can seem docile, even amid deteriorating rhetoric, until it suddenly isn't. As a result we remain attentive in our assessment of developments on this front.

In September the Federal Reserve raised interest rates for the third time this year. Financial markets are currently contending with the question of whether or not we will get another rate increase before year end. Many are also now looking toward 2019 in an attempt to divine how many additional rate hikes we get next year. We don't know what the Fed's going to do. But what we continue to assert is that for now rates, especially *real* rates (after inflation), are low within the context of history. This is good for the economy and for stocks. That said it is worth noting that a rising rate environment can create a more volatile (i.e., less smooth) ride for stocks. This doesn't mean that stocks cannot go up as rates rise. In fact, quite the contrary if decades of history are any guide. Too, lifting yields also help provide more income for cash instruments as well as shorter duration fixed income securities. So we think it's sensible to celebrate a normalizing interest rate environment as long as it's gradual and in accordance with improving economic fundamentals.

Ignore the bubble-watchers. Valuation on the stock market remains reasonable. At approximately 16x forward S&P 500 earnings with a growing economy and profits, amidst fairly low interest rates, and unassertive inflation, stocks continue to offer an attractive place to put long-term money seeking higher returns. Besides, bull markets don't end simply on subjective assessments of valuation. They typically end as the result of economic recession or policy errors borne from aggressive Fed tightening. And while we realize any forecast risks creating a false sense of security we don't anticipate either scenario any time soon given the body of current evidence.

When adding up the pluses and minuses of the Albion four pillars (Economic & Earnings Growth, Inflation, Interest Rates, and Valuation) we are encouraged about the present state of the stock market. We persist in our core philosophy that owning great *businesses* through long-term investment in U.S. stocks is a smart proposition.

Planners Corner

About this time last year Congress was working to pass the Tax Cuts and Jobs Act which was signed into law on December 22, 2017. The new legislation introduced many changes to both the individual and corporate tax structure, one of which is the change to the standard deduction. There is no longer both a standard deduction and personal exemption. Starting in 2018 all tax filers will have just a standard deduction of $12,000 per person or $24,000 for a married couple filing jointly. Why is this a big deal? As tax filers, if our deductions such as mortgage interest, property taxes and charitable contributions don't exceed our standard deduction amount, we don't get to use them. Some surveys project that as many as 90% of households will no longer itemize deductions at all. A potential unintended consequence of this change is that people won't give as much to charities because they won't be able to use the tax deduction. It is clear that people give to charities for more than just tax savings, but there are ways you can retain the tax benefit of your charitable contributions even with the higher standard deduction.

One tool is a donor-advised fund (DAF). DAFs aren't new – they've been around for decades and are essentially investment accounts specifically designed for charitable giving. When you make a gift to a DAF it is treated as a gift to a registered 501(c)3 public charity which means the gift qualifies for a charitable deduction. You can gift different types of assets to DAFs; most notably cash and stocks.

Although DAFs have been around for many years they are increasingly popular since the Tax Cuts and Jobs Act was passed because they allow donors to lump charitable deductions.

What is lumping deductions and why is it beneficial? Lumping charitable deductions means that you donate several years, let's say 3-5 years, of charitable contributions into one year. By lumping several years of donations into one year there is a greater likelihood that your itemized deductions will exceed the standard deduction in that year allowing you to take advantage of the tax benefit charitable gifting provides. By utilizing a DAF you can still control the timing and amount of money given to specific charities as you gift from the DAF to each charitable organization.

Albion is well versed in utilizing donor-advised funds to maximize the benefit of your charitable intent. Please let us know if you have any questions or wish to explore your own gifting options before the end of the year.

Albion Community

The Albion team is always looking for ways we can support our community. On October 26th we hosted our second annual blood drive in partnership with ARUP. Walks-ins were welcome and we had a great turn out. Thank you to everyone who donated their time and their blood. You're somebody's type!

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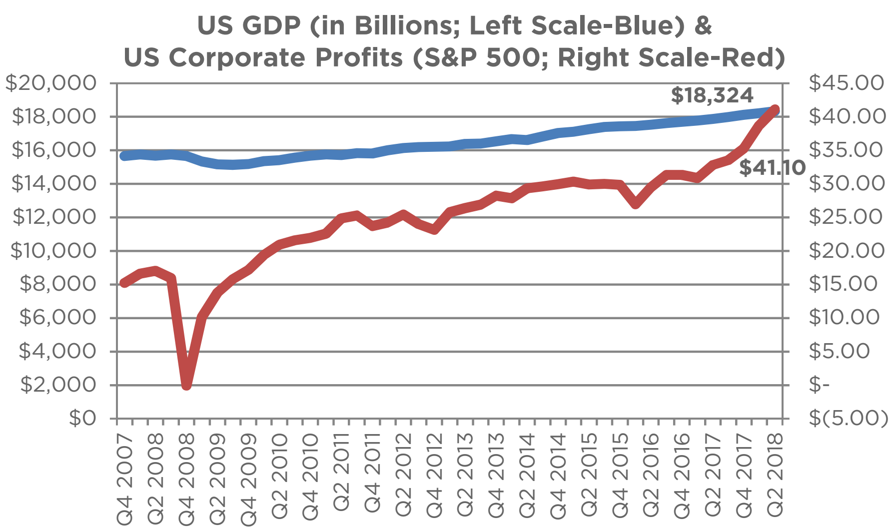
October was a busy month. In addition to our blood drive, the Women of Albion hosted a Health and Wealth book club event. In this day and age it's hard to have one without the other. We appreciate all the support from our clients, friends, and colleagues who joined us in sharing their stories and ideas for maintaining both their physical and fiscal health.

UNITED STATES GDP ANNUAL GROWTH RATE

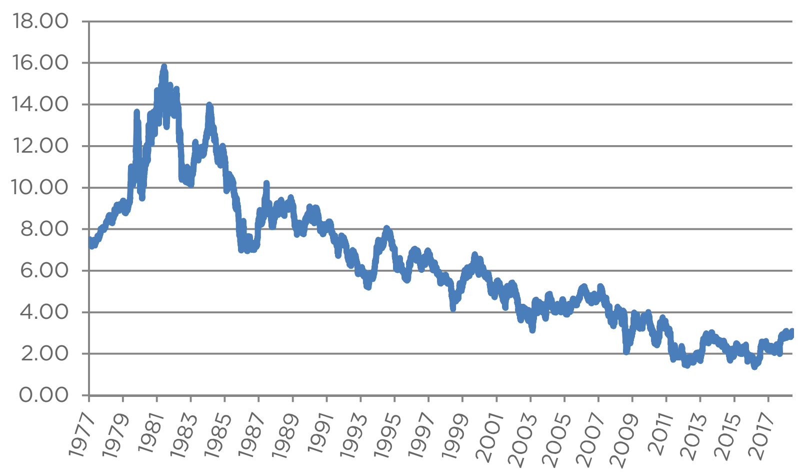


The economic expansion has picked up some recently and corporate profits continue to swell. Broad-based earnings hit yet another record high in the most recent reporting period. Meanwhile, the general economic data – output, jobs, private sector balance sheets, and aggregate consumption – suggest a well-balanced economy. While recent tax cuts have added an ephemeral boost, growing trade tensions with China could ultimately be an offset and harmful to economic growth.

UNITED STATES INFLATION RATE

Using the Fed's preferred measure, core inflation remains restrained with the most recent data showing a pace just at the Fed's 2% target. Additional measures like CPI have ticked higher, while various other inflation-oriented information warrant attention. We continue to carefully monitor the pace of inflation. For now, our assessment remains that general price growth is unlikely to run 'hot' anytime soon.

UNITED STATES 10 YEAR TREASURY YIELD



FORWARD 12M P/E RATIO: 10 YEAR

In September the Fed hiked their target rate an additional 0.25%, the eighth such hike since the Fed began raising rates nearly 3 years ago. The Fed also continues to reduce the size of their large balance sheet allowing mature Treasury bonds to "run off" without replacing them. Our thinking has been, and continues to be, that this behavior should – all things equal – result in longer-term yields gradually rising. Indeed, with the 10-year Treasury yield now firmly over 3% we are in fact seeing this to some degree. Despite the rise, interest rates remain low, particularly in real terms, which is a positive for both stocks and the economy.

Amid the recent sell-off juxtaposed with still-expanding corporate earnings the S&P 500 is now priced at approximately 15.5x forward earnings, the lowest valuation since 2015/16 timeframe and below its 5-year average. At these levels we reason that the P/E on the stock market is likely undervalued relative to the above-described fundamentals.