ALBION FINANCIAL GROUP

October 23, 2019

Welcome to the fourth quarter of 2019! This quarter we highlight the utility of using dividend paying common stocks for income generation, review the counterintuitive strategy of accelerating the recognition of capital gains, and offer an assessment of the current market and economic environment. Additionally we'd like to highlight two significant capacities of Albion of which some of you might not be aware.

For years we have been active in researching and investing in the ESG space. ESG is an acronym for environmental, social, and governance and is a lens we use to screen for companies that engage in a process of continuous improvement in each of these three areas. In addition to supporting companies that are working to make our world a better place we also find that forward looking corporate cultures typically lead to more successful companies. Several of our clients have asked us to include an ESG allocation in their investment account.

Albion is unique in many ways, one being the preponderance of women among our Senior Wealth Advisor team. For several years our Women of Albion group has focused on the sensibilities of working with women clients. Our group holds women specific events, provides continuing education for other professionals, and most importantly brings a women-centric focus to bear on behalf of our clients.

Please do not hesitate to reach out if you'd like to discuss ESG or Women of Albion with us.

Where in the world do you go to earn a return on your cash these days?

We hear this question, or something similar, nearly every day. And it's a good one. U.S. Treasuries yield from 1.58% on two-year debt, to 1.66% and 2.11% on the ten and thirty-year bonds respectively. But what does that actually mean to someone contemplating living off earned interest in retirement? It means those who have diligently saved are getting hammered: One million dollars invested in the ten-year bond pays only $16,600 in interest each year. Ouch. And as paltry as that is it compares favorably with the sovereign debt of other developed countries. Following are a few select examples:

	Two Year Treasury	Ten Year Treasury	Thirty Year Treasury
Germany	-0.78%	-0.56%	-0.05%
Japan	-0.30%	-0.16%	0.39%
Australia	0.67%	0.97%	1.18%
U.K.	0.33%	0.48%	0.98%
U.S Treasury	1.58%	1.66%	2.11%

*Source – Bloomberg

Notice the negative interest rates above. Yes, that's not a typo. Over fifteen trillion dollars in sovereign debt currently has a negative interest rate. That's up from $6 trillion one year ago and none seven years ago. Yes, that means investors holding over fifteen trillion dollars pay for the privilege of lending money. Taking our hypothetical retiree with a million dollars above, were they to invest it in the ten-year German government bond they would pay $5,600 each year for the privilege. Putting on our rose-colored glasses we can see we are $20,300 a year better off by investing in U.S. Treasuries rather than German Treasury debt.

We have discussed at length in previous missives to clients and quarterly letters the factors that have led to the current state of global interest rates but that's not the prime topic here. Back to the core question - Where in the world do you go to earn a return on your cash these days?

Willingness to take on more risk will set you up to earn 6.87% on ten-year Mexican debt and 6.66% on the same maturity in India. Stretching even further Turkey pays 13.44% and Argentina offers 25.90%! Of course the higher rates come with a big chance that inflation will destroy the value of the bond and also brings a more than moderate risk of default. Don't want to go there.

One of the tools we use to increase yields while also offering the potential to outpace inflation is a dividend stock allocation. Companies in this allocation, in aggregate, generate dividend income of about 3.3% per year. This compares favorably to Treasury Bonds. Our hypothetical retiree with $1,000,000 would receive $33,000/year in dividend income - which has the added benefit of being tax advantaged relative to Treasury Bond interest. However, the real power of the dividend stock allocation in our clients' accounts is the inflation beating power of annual dividend increases.

Just this year McDonalds increased their dividend by 8%, J.P. Morgan increased by 12.5%, while Clorox is paying us 14.3% more than last year. In aggregate our dividend stock portfolio has seen an 7.2% increase in dividends over the last year and an 8.2% average annual increase over the last five years. Our $1,000,000 hypothetical investor has seen their cash return grow by 7.2% over the last year and by 48.3% over the last five years. Their $33,000 in dividend income a year ago is now $35,376 while those who implemented a $1,000,000 dividend portfolio five years ago have seen their income grow to nearly $49,000.

Note that these are not buy and forget investments – there are myriad examples of apparently solid, durable firms – Kodak, General Motors, Sears, Worldcom, General Electric - that went from leaders in their industry to struggling for survival in a short time period. Take Lehman Brothers. In 1995 Lehman paid a $0.05 per share annual dividend which they grew consistently until 2008 when they were rewarding shareholders with a $0.68 per share payout. Then suddenly this iconic Wall Street firm was bankrupt. This was pretty darn painful for non-diversified investors with Lehman dominated portfolios.

The Lehman example highlights why the companies in a dividend stock allocation, like all companies in which we invest, must be monitored and evaluated on an ongoing basis for financial security. It also highlights why the dividend allocation needs to be a portfolio of securities, not one or two stocks. An investor in this space must expect to see more price volatility than what they'd experience in Treasury bonds. And that is the tradeoff adding an Albion dividend stock allocation; more price volatility and a greater need for an ongoing evaluation of financial strength than a U.S. Treasury Bond portfolio, in exchange for a greater current yield and a very high probability that dividend income will increase over time.

This is just one of the tools we use to build and maintain diversified income generating portfolios on behalf of our clients. Please reach out to our team if you'd like to discuss this further.

Volatility is the price we pay for better returns.

Economy & Markets

The U.S. economy continues to expand, even if at a modest stride. While there's little question that it has slowed from the tax cut-induced lift in 2018, this fact alone does not necessarily mean recession is imminent. Indeed, we have experienced several slowdowns since the economic recovery began back in June of 2009. In each instance the "R word" was thrown around by many as if it were inevitable. And yet in every episode a recession never developed. Our best guess is that this time around will be no different. Instead our analysis proposes that the ~2% (real) GDP trend growth rate of the previous ten years is a suitable pace for this economy, primarily due to declining demographics and poor productivity. This should not be taken with alarm however for it's a well-balanced trajectory supporting full employment and healthy general conditions.

To be clear this isn't to suggest that an economic contraction cannot occur at any time, or that we won't have one again. Quite the contrary. Recession is unavoidable – at some point down the road it will rear its ugly head. Yet our present take is that the probability we are currently in one, or that it's upon our doorstep remains fairly low. This view is reinforced by our objective examination across a variety of information – including several key leading indicators that have historically been insightful tells on the direction of the economy. Astute data from the jobs market, aggregate demand, LEI (leading economic indicators), building permits, sentiment, and credit market vitals all point to a steady economic environment.

That's the good news. The bad, however, is that after roughly 20 months bogged down in a needless trade war there appears to be no end in sight. One week we're purportedly nearing a deal; the next we're slapping on fresh tariffs. It's a fast and erratic two-step that even the great Fred Astaire would struggle to master. Unfortunately it also represents the single biggest threat. While it is true that to-date the trade war(s) have not had a material impact on overall growth, it is also true that the longer they last and the more they escalate the higher the odds that this placidity will not hold. Best estimates thus far suggest that perhaps ~0.5% of GDP has been lopped off America's growth rate as a result of the increased uncertainty and reduced business investment (e.g., hiring and spending). Over five or six quarters that isn't dramatic. But unless we see improvement, we reason that things could deteriorate further – as we've seen more acutely in fresh manufacturing data. Worse-still, if the trade war were to truly spiral out of control a measurable downturn may result. Unsurprisingly, we remain ardent watchers of developments on this front.

Turning our view further afield, the global expansion has also decelerated. As we have described before, world (real) GDP growth of near 4% logged in 2017 and 2018 has moderated to near 3% in 2019. The recipe for this braking is likely one part a natural derivative of slowing U.S. growth (tax cuts fading); two parts negative trade war effects; and one part European woes, including fears of a 'Hard Brexit'. Unfortunately we cannot handicap the outcome in the U.K. – especially given the newly elected leadership – nor can we precisely predict what happens with trade. But happily we don't have to in order to establish appropriate asset allocations and build high quality investment portfolios for our clients in service to your long-term needs, goals and aspirations.

In past missives we described each step of the "Fed pivot" as it was unfolding. Specifically, in our last quarterly letter we posited readers to "expect a rate cut soon, perhaps as early as July." Consistent with this prognosis the Powell Fed has now achieved a full monetary policy 180 (not to be confused with a 'Full Monty', mind you), and in under seven months' time! Put another way, the Fed went from largely auto-tightening at the end of 2018 to beginning a full-on rate cutting cycle by July. There is little question that this dovish slant has helped send bond yields lower, especially at the short end of the

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curve, and stocks higher. In short, the Fed stands ready to support the economic expansion as needed and seems more focused on the potential "downside risks" in the economy.

By third-quarter's end the stock market broadly speaking was trading around 16.7x expected forward company earnings. This is not expensive nor is it cheap as it sits right around the 5-year mean (17x), and just above its 10-year (15x). And when you consider that bond yields and inflation have fallen yet again, this furthers the case that stocks are not richly valued in today's environment. To be sure, with the 10-year U.S. Treasury now yielding ~1.6% it's hard to argue that stocks are exuberant or bubbly. Quite simply we just don't see much in the way of excesses, which is unequivocally a good thing.

Our north star 'four pillars' framework of the economy & earnings, inflation, interest rates, and valuation continue their job in informing us as to present conditions for stocks. Save for an abrupt recession we think stocks can tolerate inherent volatility borne from what's typically little more than changing market mood. Keep in mind that periodically prices can and will decouple from fundamentals. But don't lose sight of the fact that the reason(s) for this chasm are rooted in investor psychology and the overall attitude of the crowd, not a corrosion of economic progress. We acknowledge this and therefore do not attempt to foresee these whims. And as of this writing all four pillars remain encouraging.

Thus, our central philosophy of finding and owning slices of fantastic American businesses via long-term investment in stocks endures as an intelligent approach when striving to grow wealth in the years to come.

Planner's Corner

There are several strategies available to investors that can help reduce their overall tax burden. One little-known (but potentially powerful!) tax planning tool is the process of tax gain harvesting.

Many investors are familiar with the tax loss harvesting strategy in which the investor sells an investment that has lost value since its initial purchase. By realizing the resulting loss, the investor receives a tax deduction in the form of a capital loss, which can be used to offset capital gains in the same year. If capital losses exceed capital gains in the applicable year, the remaining losses can be carried forward to offset gains in future years, or to offset other income (e.g. ordinary income) by up to $3,000 each year.

Tax gain harvesting flips the concept of loss harvesting on its head. Rather than selling an investment at a loss, gain harvesting involves selling an investment that has increased in value. The same investment can then be immediately repurchased, which increases the cost basis from the original purchase price to the current market value, resulting in smaller future gains (or larger future losses). Conveniently, the wash sale rule, which does not allow for repurchase of the same security within 30 days of selling the asset at a loss (without forfeiting the capital loss deduction), does not apply to assets sold at a gain.

It is important to note that the gain on the sale is still reported at current tax rates. Thus, the strategy is most effective for clients with low taxable income due to the taxation of the resulting capital gains. If the sold asset was held for over a year, the long-term capital gains tax bracket applies. Below, you'll see the percentage of taxes due listed on the left with the corresponding taxable income on the right. The 0% capital gains tax rate applies to the bottom two ordinary income (or short-term capital gains) tax brackets.

2019 Long Term Capital Gains Tax Brackets			
Tax Bracket/Rate	Single/Married Filing Separately	Married Filing Jointly	Head of Household
0%	$0 - $39,375	$0 - $78,750	$0 - $52,750
15%	$39,376 - $434,550	$78,751 - $488,850	$52,751 - $461,700
20%	$434,551+	$488,851+	$461,701+

If coordinated properly, the transaction results in a free step-up in basis, as the tax due falls within the 0% long term capital gains tax bracket, and the cost basis gets stepped up to the current market value. The strategy can be implemented by investors who have low to moderate income, potentially due to some of the following reasons:

- lower income in early stages of a career
- ownership of modest portfolios that generate little taxable income
- being in the post-retirement phase, having not yet started receiving social security benefits or required minimum distributions from tax-deferred retirement portfolios.

It may seem as though harvesting capital gains at the 0% long-term capital gains tax rate is a no-brainer; however, there are instances in which it may be unfavorable. While long-term gains are taxed at 0% until the corresponding bottom two tax bracket thresholds are exceeded, the gains generated from the sale of appreciated assets still counts as income itself, and therefore increases the investor's total income in that year. Although this does not create additional tax implications based on ordinary income tax rates, it could potentially impact other income-level related benefits (certain deductions and/or tax credits), income-based health insurance coverage and the taxation of current social security benefits. State taxes, if applicable, would also be due on the resulting gains/income. Thus, it is important to closely consider if tax gain harvesting would inadvertently make you ineligible for certain credits such as the Savers Credit and the Earned Income Tax Credit, as well as if the increased income could increase (non-employer based) health insurance premiums or social security taxes. Additionally, if the investor intends to hold onto the investment until death, the step up in basis resulting from the gain harvest is unnecessary, as current tax law already allows for a step up in basis upon the death of the account owner.

Successful execution of tax harvesting requires an intimate understanding of your current year tax situation. At Albion, we work with our clients to understand their overall financial picture and help determine effective tax planning strategies. We then work in conjunction with our clients and their CPAs to ensure success. Please contact us if you have any questions or would like to discuss tax saving opportunities that may be available to you.

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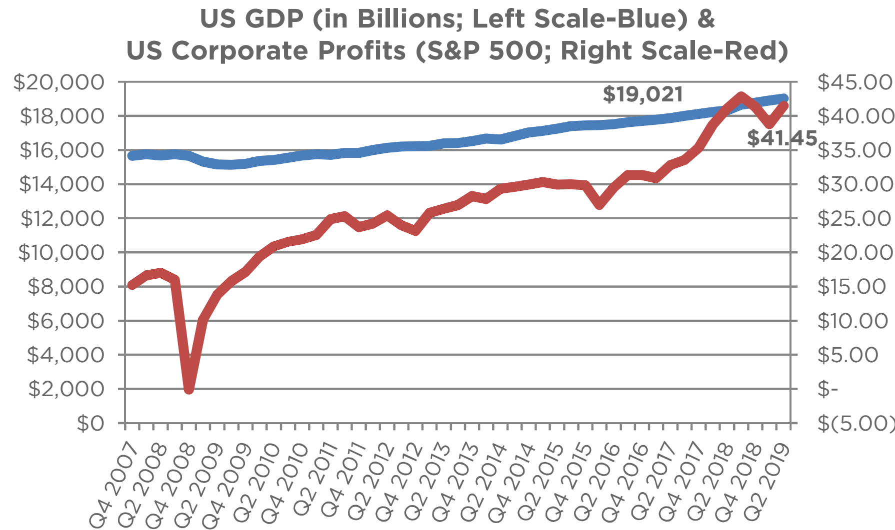
UNITED STATES GDP ANNUAL GROWTH RATE



Recent U.S. economic data shows continued growth at a rate in line with the 2.0% to 2.25% trend of this now ten year cycle. It has slowed from last year as the “sugar high” spike of recent tax cuts is now in the rear view mirror. We observe continued job creation, wage increases, strength in consumption and consumer confidence and low inflation. Trade tensions remain unresolved and assessing their current and potential impact continues to be a focus of our work.

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UNITED STATES INFLATION RATE

Using the Fed’s preferred measure core inflation remains in-check with the most recent data showing a pace just below the Fed’s 2% target. Additional measures like CPI and “5-year” and “5-year forward” data also reflect steady, benign price growth. We continue to carefully monitor the pace of inflation. For now, despite rising wage growth our view remains that inflation is unlikely to run ‘hot’ anytime soon.

Macroeconomic Highlights from the Third Quarter

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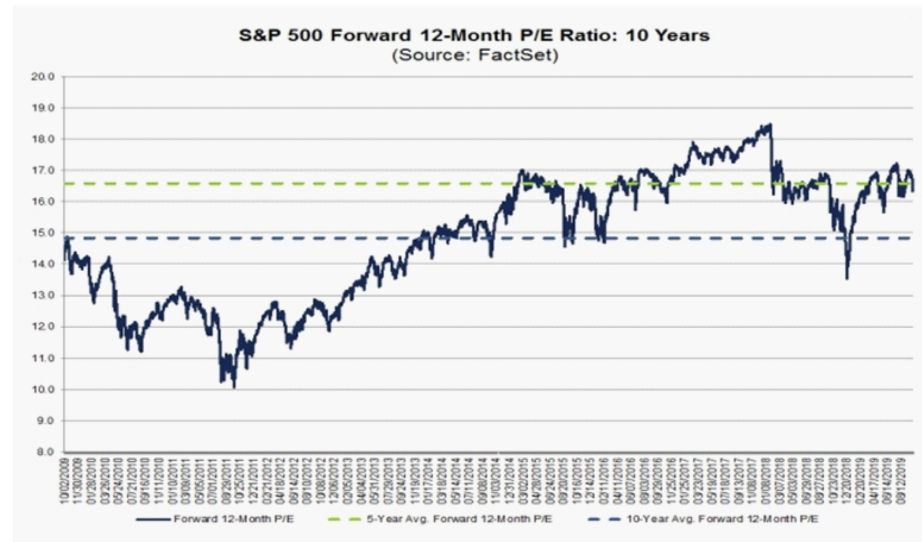
UNITED STATES 10 YEAR TREASURY YIELD

Consistent with our prognosis of the last few quarters the Powell Fed has achieved a full monetary policy reversal. The Fed went from a nearly automated rate rising stance at the end of 2018 to a full-on rate cutting approach by July. This dovish stance has helped send bond yields lower, especially for shorter maturities. It is clear the Fed stands ready to support the economic expansion and seems focused primarily on mitigating further economic slowdowns.

TRAILING 12M P/E RATIO: 10 YEAR



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