Financial Advisory Service, Inc.

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FAS Monthly Economic & Market Update

February 2017

As of January 31, 2017

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Economic Conditions

The US economy grew at an annual rate of 2.6% in the fourth quarter of 2017 according to the advance estimate from the US Department of Commerce. This is lower than the two previous quarters in 2017 in which GDP growth was over 3%, but above the average growth we've seen throughout this eight year expansion since the financial crisis in 2008. Assuming no major economic downturn comes between now and May, the current expansion is set to become the second longest in post-WWII history, albeit one of the slowest. With corporate earnings coming in mostly above expectations as well as the tailwinds generated by the passage of the tax reform bill late last year, we don't particularly see any warning signs that this expansion is coming to an end. So far half of the companies in the S&P 500 have reported earnings and of those, nearly 80% have beaten revenue expectations according to the Wall Street Journal which is the highest percentage since the third quarter of 2008. As the economy continues to pick up steam, rising inflation expectations, and as a byproduct of that, increases in interest rates, are bound to follow; both of which have been large factors contributing to the losses we've seen in early February. It's not surprising that after a 30%+ rise in the markets since the 2016 election we've seen markets cool off a bit.

Market Conditions

The markets continued their rallies from 2017 into the new year as all three major US indices were up over 5% in January. The Dow and the S&P 500 were up 5.73% and 5.79% for the month respectively, while tech again led the rally lifting the NASDAQ to a new record high and ending the month up 7.36%. With unemployment reaching its lowest levels in 17 years and with jobs added and hourly wage increases coming in better than expected, the markets seemed to pay heed to the potential for rising inflation. The 10-year treasury rate, which started the year at 2.46%, has increased nearly 40 basis points (0.40%) since the start of the year. This drove the Barclays US Bond Aggregate down by almost 1% in January. The index has continued its plunge into February. The markets have translated the inflation indicators to mean that the Fed could increase the rate at which they hike short-term interest rates – a negative for markets if they raise by too much or too quickly. More than anything, the recent pullback seems more like a breather for the markets after a long rally. While we don't see recent events as a signal of a long-term reversal, we do believe that investors will be keeping a close eye on how new Fed chair Jerome (Jay) Powell will steer the massive ship that has driven financial markets over the past eight years.

Index Returns

	Jan '17	YTD
S&P 500	5.73%	5.73%
DJIA	5.79%	5.79%
NASDAQ	7.36%	7.36%
MSCI EAFE	4.99%	4.99%
Barclays Aggregate	(0.95%)	(0.95%)

The Tax Cuts and Jobs Act

In November of last year, we wrote about the proposed changes detailed in the tax reform bill, titled the Tax Cut and Jobs Act. As usual, bills that get passed rarely look the same as ones that were originally proposed. This bill was no different and several changes were made from when it was originally passed through the House and when it was finally placed on the President's desk for his signature. This month we wanted to review some of the key changes that were made in the tax laws that will affect our clients for future tax years, beginning with 2018.

Personal Income Brackets

While the original House bill had proposed cutting the number of tax brackets down to four, the final bill kept the current number of tax brackets, but lowered the tax rates and increased the thresholds for each. Additionally, the new tax bill eliminates all personal exemptions and increases the standard deduction from $6,350 and $12,700 for single filers and married filers to $12,000 and $24,000, respectively. Please refer to the graph on the next page which details the changes in the tax brackets.

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The Tax Cuts and Jobs Act

As you can see from the graph to the right, all tax brackets aside from the lowest bracket have been lowered, while several thresholds within each bracket have increased. One of the most noticeable changes can be seen in the middle tax bracket where under the previous tax law anyone with taxable income above $233,000 would have fallen into the 33% tax bracket. Under the new tax law, any married couple with taxable income up to $315,000 will fall into the 24% tax bracket. Additionally, changes were made to the alternative minimum tax (AMT). While the two AMT rates have not changed and the thresholds for each did not rise by much, the AMT exemption increased as did the threshold for the phaseout of the exemption, meaning that tax payers will be more protected against being exposed to AMT.

Current (2017)		New (2018)	
10%	$0 - 9,325 $0 - $18,650	10%	$0 - 9,525 $0 - $19,050
15%	$9,326 - $37,950 $18,651 - $75,900	12%	$9,521 - $38,700 $19,051 - $77,400
25%	$37,951 - $91,900 $75,901 - $153,100	22%	$38,701 - $82,500 $77,401 - $165,000
28%	$91,901 - $191,650 $153,101 - $233,350	24%	$82,501 - $157,500 $165,001 - $315,000
33%	$191,651 - $416,700 $233,351 - $416,700	32%	$157,501 - 200,000 $315,001 - $400,000
35%	$416,701 - $418,400 $416,701 - $470,700	35%	$200,001 - $500,000 $400,001 - $600,000
39.6%	$418,401+ $470,701+	37.0%	$500,000+ $600,001+
Standard Deduction	$6,350 $12,700	Standard Deduction	$12,000 $24,000
Personal Exemption	$4,050 $8,100	Personal Exemption	N/A N/A

AMT Current (2017)		AMT New (2018)	
26%	$0 - $187,800 $0 - $93,900	26%	$0 - $191,500 $0 - 95,750
28%	$187,800+ $93,900+	28%	$191,501+ $95,750+
AMT Exemption	$54,300 $84,500	AMT Exemption	$70,300 $109,400
AMT Exemption Phaseout	$120,700 $160,900	AMT Exemption Phaseout	$500,000 $1,000,000

Filing Single
Married Filing Jointly

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Child-Tax Credit

Under the previous tax law single and joint filers were eligible for a $1,000 child-tax credit per child with phaseouts beginning at $75,000 and $110,000, respectively. Under the new tax law that credit will be increased to $2,000 and the phaseout levels will increase to $200,000 and $400,000 for single and joint filers, respectively. Additionally, there will be a temporary $500 credit for other qualifying dependents (i.e. adults).

On the topic of dependents, another notable change in the tax law that pertains to children is the change to how dollars in 529 college savings plans can be spent. Historically, money in 529 plans could only be used for qualifying college expenses. If distributions were used for any expenses other than post-secondary education they would be subject to taxes and a penalty. The new tax law will expand the qualified distribution rules to include elementary and high school education costs as well. Certain states allow for state tax deductions for 529 contributions and could help tax payers save even more when paying for their kids' education.

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Deductions

One of the more controversial changes in the tax law has been the limit on state and local tax deductions. The new tax law only allows up to $10,000 to be deducted for state and local taxes in taxpayers' itemized deductions. The increased standard deduction may offset some of the costs that taxpayers could face, but this will most likely have a greater affect on taxpayers in states with high tax rates. Additionally, the deduction for mortgage interest will be allowed for interest on up to $750,000 in mortgage debt. This is down from $1M under the previous law. However, this only applies to new mortgages underwritten after December 14, 2017. All mortgages taken out prior to that date have been grandfathered in and can still take an interest deduction on up to $1M of mortgage balance. After some pushback against the proposed bill, another major deduction that will be adjusted is the medical expense deduction. For tax years 2017 and 2018, filers can deduct all medical expenses that exceed 7.5% of adjusted gross income (AGI). Beginning on Jan 1, 2019, the threshold goes back up to 10% of AGI.

All of the changes to the tax code that we've listed are set to expire after 2025, as opposed to the corporate tax changes that are permanent. That's not to say that congress and the President at that

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time will not extend the tax cuts like President Obama did with most of the Bush tax cuts. Regardless of the timeframe, these changes in the tax code should be a positive for most taxpayers as well as for the economy. We haven't covered all of the changes in this update so if you have any questions regarding how these changes affect you personally we would be happy to have a conversation with you. As always, please do not hesitate to reach out to an FAS advisor with any questions or concerns.

Disclosures & Index Definitions

Under style performance boxes, indexes referenced in the equities section for large, mid and small reference the Russell 1000, Russell MidCap and Russell 2000 stock indices, respectively. The Barclays US Government, Barclays Credit and Barclays High Yield fixed income indices refer to Gov't, Corp, and HY, respectively. Short, Intermediate and Long refer to the time frame of the investments and their positions on the yield curve.

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All dates are as of January 31, 2017 unless stated otherwise.

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Index Definitions

The **S&P 500 Index** is based on the market capitalizations of 500 large companies whose stocks are listed on the NYSE and NASDAQ. This is widely regarded as the single best gauge of large cap US Equities.

The **Dow Jones Industrial Average** is a price-weighted average of 30 actively traded blue-chip stocks, primarily industrials. It is used as a barometer of how shares if the largest US companies are performing.

The **NASDAQ** is a market capitalization weighted index of the more than 3000 common equities listed on the NASDAQ Stock Exchange. These securities include American Depository Receipts, common stocks, real estate investment trusts, and tracking stocks.

The **MSCI EAFE (Europe, Australasia, Far East) Net Index** is recognized as the pre-eminent benchmark in the US to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America, Europe, Australia, and the Far East.

The **MSCI Emerging Markets Index** captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 822 countries, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **Barclays US Aggregate Index** is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS, ABS, and CMBS.

All index information has been gathered from public sources who are assumed to be reliable, although we cannot guarantee the accuracy or completeness of those public sources.