McCarthy Asset Management, Inc.
Personalized Wealth Management

February 2018 Monthly Commentary

Mar. 1, 2018

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Stock Market & Portfolio Performance

February 2018: U.S. and international stocks suffered a 10% correction during the month, with a partial recovery by month-end. Bonds also fell as interest rates rose.

	Feb 2018	YTD 2018	Description:
Without Dividends:			
S&P 500	-3.9%	1.5%	500 Largest Public U.S. Companies
Russell 2000	-4.0%	-1.5%	2000 of the smallest U.S. stocks
MSCI EAFE	-4.7%	0.1%	international stock index
U.S. Aggr Bond	-1.0%	-2.1%	index of U.S. bonds
With Dividends, after all fees:			
MAM portfolios	-3.0%	0.7%	non-very conservative MAM portfolios
MAM Conserv	-2.3%	0.0%	portfolios with 50%+ bond allocation

The returns showed above are unaudited. Past performance is not indicative of future results. Returns for McCarthy Asset Management Portfolios ("MAM Portfolios") are net of management fees and transaction costs, and reflect the reinvestment of dividends. Results represent a composite of clients using a similar investment strategy, individual results will vary.

Returns for the indices are provided solely as a general indication of current market conditions. MAM Portfolios are not invested in a style substantially similar to any index. Indices do not reflect the deduction of management fees or transaction costs or the reinvestment of dividends. Performance for the indices would be lower if these costs were reflected.

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What's Next After the 10% Correction?

We don't think the stock market decline last month is the start of a bear market. History shows that corrections in bull markets are common, especially during the last few years of the economic cycle when two or three 5% to 10% corrections per year are not unusual. Unfortunately, there aren't simple rules to follow to signal the end of a correction.

We don't try to market time short-term corrections. As I wrote in my February 6th email regarding this market downturn: "Technical factors and investor sentiment tend to drive stocks over **short-term horizons of one-to-two months**. These factors can cause stock prices to gyrate sharply. This is now the case with the return of volatility and reduced investor confidence. While easier said than done, investors are better off ignoring these gyrations rather than reacting to them." Despite a 10% drop in stock prices last month, I am very pleased that MAM clients have taken it in stride. I heard from only one who was concerned with the drop.

Also as discussed in my February 6th email, we are most focused on business cycle developments and financial conditions, which drive stock prices over **horizons of one to two years**. Currently, these conditions remain very favorable:

- There are virtually no signs of the U.S. economy slipping into a recession any time soon. This is significant as most bear markets are accompanied by an economic recession.

- Corporate earnings continue to be very strong. With more than 80% of S&P 500 companies reporting results, earnings per share for the fourth quarter of 2017 are up about 15% year-over-year and sales are up in the high single-digits. At this point, 81% of companies are beating earnings expectation, the highest in eight years. Meanwhile, the new tax law won't benefit earnings until 2018, but analysts have increased their 2018 estimates for the S&P 500 profits by $10 per share (nearly 7%) since January 1st.

- Consumer and business confidence remain high, as personal spending and capital investment are both likely to get a boost from the new tax law.

- Inflation and interest rates are rising, but remain relatively low compared to historical averages.

- Technical Analysis: Meanwhile, internal measures of the stock market are strong with market breadth remaining healthy. Lowry's, a stock market timing service we follow, has remained positive during this correction. In a recent commentary, it wrote, "major market tops don't suddenly appear but are the result of prolonged process of deteriorating strength. Over our 92 year history of bull and bear markets, this deterioration has been most prominently displayed in the balance of Supply and Demand and in market breath." The commentary went on to say that the current conditions of the stock market are not showing any of the early warning signs of deterioration.

What Will End This Bull Market? We think most likely it will be inflation fears motivating the Fed to raise interest rates high enough that an economic recession is triggered. This could occur as soon as late 2019 or early 2020. We are monitoring this to see if and when we should take defensive measures to protect portfolios in advance of the next bear market.

New IRS Withholding Tables– Insufficient Withholding for Some Taxpayers

The IRS has released new withholding tables that employers were supposed to start using no later than with payrolls issued on or after February 15th. Without any change in the number of exemptions claimed, it is estimated that 90% of wage earners will see an increase in their paychecks due to a new lower level of Federal income tax withholding. While this may feel like a tax cut, it may cause an under-withholding issue for those taxpayers whose Federal taxes will increase as a result of the new law. For some, this may be particularly significant because the new optional flat rate for supplemental wage payments (bonuses, RSUs, etc.) is 22% (down from 25%) for the first $1 million in income.

Once we complete a client's 2017 tax returns, using the client's 2017 income and deductions, our tax software generates a report comparing the 2017 Federal tax to what the tax would be based on 2018 tax law. While I have been pleased to see that most clients are seeing a modest reduction in taxes from the tax law changes, some are seeing a tax increase. Depending on their expected 2018 income, these clients should either increase the Federal tax withholding or increase their Federal estimated payments. Taxpayers that are likely to see an increase in their taxes include those with:

- High property taxes on their primary residence
- High state income taxes
- Large miscellaneous itemized deductions

For those tax clients who we think will owe higher Federal taxes resulting from the tax law changes, we are providing specific recommendations for increasing their Federal withholding or Federal estimated payments.

New Tax Law Regarding Pass-Through Income

The tax law passed in December created a new deduction of up to 20% of net income for many pass-through business owners. Lawmakers made the change as a boon to firms that won't benefit from the cut in the top corporate rate to 21% from 35%. **This deduction for Qualified Business Income (QBI) is created in the new Section 199A (and thus may be referred to as either the "Section 199A deduction" or the "QBI deduction").**

This portion of the new law contains very complex details, some of which remain to be sorted out once the U.S. Treasury issues regulations. Furthermore, there are limitations on which businesses will qualify for the deduction. The purpose of this article is to provide an overview of this potentially significant tax break.

What is a pass-through entity? It is a business that passes its income through to its owner's tax returns, and is taxed at the owner's individual rate. Most private businesses in the U.S. are structured as pass-throughs. Types include:

- Sole proprietorships (no separate entity; reported on individual's Schedule C)
- Real estate investors (no separate entity; reported on the individual's Schedule E)
- Limited liability companies
- S Corporations
- Partnerships
- Trusts and estates, REITs and MLPs

New Tax Law Regarding Pass-Through Income– Con't

Income Limitation:

- Pass-through owners can claim the full 20% deduction if their taxable income (line 43 of Form 1040) is under $315,000 for joint filers or $157,500 for single filers.
- Taxpayers can claim a reduced deduction if their taxable income is between $315,000 and $415,000 for joint filers and between $157,500 and $207,500 for single filers.
- For taxpayers with taxable income above $415,000 for joint filers and $207,500 for single filers, the deduction, based on a complex calculation, will only be available to non-services business.

Service Businesses: Owners of the following businesses will benefit only if their income is below the income limits stated above:

- Service professions such as doctors, attorneys, accountants, actuaries and consultants.
- Anyone who works in the financial services or brokerage industry.
- Performing artists
- Athletes
- And the catch-all: "Any trade or business where the principal asset is the reputation of skill of the owner."

So for services businesses, if the taxpayer's income is above $415,000 for joint filers or $207,500 for single filers, there is no QBI/Section 199A deduction.

Non-Service Businesses: Like service business owners, non-service businesses qualify for at least a partial 20% deduction if their taxable income is below $415,000 for joint filers and $207,500 for single filers. If their income is above these levels, they can still get a deduction, the amount of which is dependent on the level of wages paid to employees and depreciable assets used in the business.

What About Rental Property Owners? Most rental property owners should qualify for at least a partial QBI deduction (although it is unclear whether owners with "triple net leases" would qualify). The amount of the deduction will be dependent on the taxpayer's taxable income:

- Below $315,000 for joint filers or $157,500 for single filers, the deduction will be 20% of the rental profit.
- Between $315,000 and $415,000 for joint filers or $157,500 and $207,500 for single filers, the deduction will be reduced.
- Above $415,000 for joint filers or $207,500 for single filers, the deduction will be the lesser of 20% of the rental profit or, assuming there are no W-2 wages paid for the rental business, 2.5% of the original purchase price of the depreciable long-term property (i.e. excluding land and assuming the property is not yet fully depreciated).

Other Comments:

- The 20% QBI deduction is available whether the taxpayer itemizes their deductions or takes the standard deduction.
- The calculation is done on an entity-by-entity basis. For example, an individual with two different rental properties must calculate the exclusions separately—their income can't be combined.
- These rules are in effect for the 2018 tax year, but are scheduled to end after 2025.

Sincerely,

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Our Services

McCarthy Asset Management, Inc. (MAM) is an independent, privately owned Registered Investment Advisor firm. We provide clients with the peace of mind that comes from knowing professionals are managing their financial affairs. The services we offer include:

Investment Management Services:

- **MAM creates and manages customized investment portfolios based on each client's investment objectives, timeframe and risk tolerance.**

Financial Planning Services:

- **The Net Worth Analysis (NWA) tracks the accumulation of Invested Assets for pre-retirees and the retention of Invested Assets for retirees. Updated annually.**
- **"Retirement Analysis" a comprehensive analysis of your retirement goals, which produces easy-to-read, interactive working plan, stored in the cloud. Updated as needed for life events.**
- **Social Security Planning is an analysis of the best strategy for when and how to start claiming Social Security benefits.**

Tax Services: Clients have the option of utilizing the income tax services provided through the firm Stephen P. McCarthy, CPA. These services are offered at an hourly rate and may include:

- **Tax Return Preparation**
- **Income Tax Projections**
- **Tax Minimization Ideas**
- **Tax Authority Representation**

Other Services: MAM has retained outside experts, whose services are available at no cost to our clients:

- **Long Term Care Planning– Allen Hamm of Superior LTC Planning Services, Inc.**
- **Medicare Advisory Program (MAP) - Eileen Hamm**

Reminders/Updates

ADV Part II: You were provided a copy of our ADV Part II when you became a MAM client. As a Registered Investment Advisor, we file this document with the Securities and Exchange Commission. Along with other items, it contains information regarding our fees and our educational backgrounds. Each year, the SEC requires us to offer clients the opportunity to receive a copy of our most recent ADV Part II. Please let us know if you would like to receive a copy.