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To Our Clients, Partners, and Friends –

To quote the boxer Mike Tyson, "everyone has a plan until they get punched in the mouth." The recent volatility in the stock market has come as a shock, the tax overhaul has made landmark changes to the law, and foreign policy decisions threaten to alter the way the global economy functions. 2018 has so far been a year of punches.

Certain Uncertainty

After U.S. stocks dropped roughly 10% in ten trading days[1], it's more important than ever for individuals to understand what it means, and what it takes, to be a long-term investor. Buy and hold isn't always a perfect strategy. If you had decided in Fall 2007 that this was the right way to invest, your portfolio would crash by nearly 60% over the following sixteen months. However, if you stuck to your guns, the next ten years would provide an average annual return of 7.5%[2]. It turns out that the past decade has been good for investors, even though it hasn't always been easy.

The challenge is likely to continue as the market is in transition from one of low volatility to one of higher, daily volatility. This is not the result of Trump's tweets, Facebook privacy concerns, or the "headline du jour"—volatility in today's market is the result of a simple mathematical function.

The easiest way to think about this is to start with the bond market. Academics typically classify an investor's total return as the result of a risk-free return plus a risk premium. "Risk-free" is considered a short-term loan to the government, otherwise known as a U.S. Treasury Bill. The 10-year Treasury yield has increased from 2.4% to 2.9% in Q1 2018[3]. In other words, a 0.5% higher total return is necessary, assuming the same risk premium, from an already overvalued equity market. This is starting to spook some investors as the spread between riskless and risky appears to be shrinking.

Reactions to market movements are not understandable or predictable. They are the function of an amalgamation of functions, each with their own unique set of consequences. As the legendary investor Howard Marks once said, "people who rely heavily on forecasts seem to think there's only one possibility, meaning risk can be eliminated if they just figure out which one it is. The rest of us know many possibilities exist today, and it's not knowable which of them will occur. Further, things are subject

[1] Jason Zweig, "When Investing in Stocks Makes You Feel Like Throwing Up," *WSJ MoneyBeat*, February 9, 2018
[2] Michael Batnick, "Sometimes This Sucks," *The Irrelevant Investor*, March 27, 2018
[3] The Economist, "Why Low Returns Are Inevitable," *Buttonwood's Notebook*, February 21, 2018

to change, meaning there will be new possibilities tomorrow. This uncertainty as to which of the possibilities will occur is the source of risk in investing."

If there were a fundamental law to which we could adhere, we would all be following it. What it takes to be a long-term investor is keeping a big picture perspective on the market and maintaining patience in the short-term. As interest rates and stock prices continue to stoke the flames of volatility, remember that a change in the character of the market should not prompt a change in your character.

So Much for Simplicity

At a Pennsylvania town-hall event in April 2011, then-President Obama remarked, "what you pay in taxes should not depend on how good your lawyer is or how good your accountant is." This is one area where President Trump agrees with his predecessor—the tax code should be made simpler.

Tax law changes have become so embroiled in politics that most people only know them by their nicknames. The Tax Reform Act of 1986 is better known as "Reaganomics," the Economic Growth and Tax Relief Reconciliation Act is referred to as "The Bush Tax Cuts," and the Affordable Care Act is universally called "Obamacare."

Trump's version is the Tax Cuts and Jobs Act. For 27 million Americans, POTUS kept his promise of simplifying the tax code. A higher standard deduction should result in an estimated 10% of taxpayers itemizing their deductions in 2018 versus 30% in 2017[4]. But don't let those numbers fool you; below are just a few examples of new tax complexities resulting from this act –

- Capital gains tax brackets are no longer aligned with income tax brackets
- Changes to individual provisions create paycheck withholding discrepancies
- Sunset provision in 2025 makes long-term tax planning difficult
- SALT limitation punishes high-tax states such as New Jersey and New York
- Qualified business income (QBI) is not just a new deduction category, but a completely new classification of income with its own set of rules, calculations, and phase-outs

1, 2, 3, 4…I Declare a Trade War

War, what is it good for? Most economists would say, "absolutely nothing," especially when it comes to trade. Longer supply chains and globalization encourage economies of scale to continue growing. In fact, global companies making up the MSCI World Index earn more than half their sales from international trade[5]. Most experts agree that the recent spat between the U.S. and China is unlikely to escalate into a "war," but it is troubling nonetheless—tariffs tend to follow the law of unintended consequences.

In 1929, the U.S. economy was healthy and growing. Unemployment was low and there were no signs of a recession in sight. However, the Dust Bowl had ravaged farmers and the agricultural industry was not

[4] Howard Gleckman, "How Changes to SALT Will Affect Itemizers," *Tax Policy Center*, December 21, 2017
[5] Schwab Market Perspective, "Navigating the Changing Market Environment," *Charles Schwab*, March 30, 2018

doing well. Senator Reed Smoot and Representative Willis Hawley took it upon themselves to write a tariff bill to protect farmers. Once the bill started picking up steam, lawmakers were all trying to get something for their district. Congress ended up raising over 800 tariffs on over 20,000 imported goods when all was said and done[6].

The Smoot-Hawley Tariff Act sparked a wave of protectionism around the globe as countries levied counter-tariffs and formed trade blocks. Downstream products became more expensive for consumers and global trade plummeted. The consensus among economists is that this act was a significant contributor to both the inception and the depth of The Great Depression.

Trump's proposed tariffs are nowhere near as comprehensive, the U.S. and other major economies have shifted from manufacturing to service-based, and the World Trade Organization now helps the flow of global trade. The trade conflict as it stands today appears much less dire, but appearances can be deceiving. Here is how the market reacted to the Smoot-Hawley bill, just after hitting a record high[7]:

- May 28, 1929: Smoot-Hawley passes the House and stock prices drop to 191 points
- June 19, 1929: Senate Republicans revise bill; market rallies to its peak of 216 on September 3rd
- October 21, 1929: Senate adds tariffs to non-farm imports; Black Thursday stock market crash
- October 31, 1929: Hoover supports bill and foreigners start withdrawing capital
- March 24, 1930: Senate passes the bill and stocks fall sharply
- June 17, 1930: Hoover signs the bill into law and stocks drop to 140 by July

The recent volatility for stocks should come as no shock when we consider this wave of protectionism, the controversial new tax law, and an ever-shrinking risk premium in an overvalued market. We will continue to roll with the punches heading into the second quarter.

We hope you enjoyed our comments. If you have any questions, please do not hesitate to contact us. We welcome the opportunity to discuss our thoughts in greater detail. Thank you for your continued confidence in Planning Capital Management.

Sincerely,

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[6] Sally Helm, "Smoot-Hawley Tariff Act: A Classic Economics Horror Story," *NPR Morning Edition*, April 5, 2018
[7] Kimberly Amadeo, "What the Smoot Hawley Act Can Teach Protectionists," *The Balance*, December 18, 2017