Fear of Missing Out
Tax Cut and Jobs Act
Opening Thoughts

It is hard to find anything wrong with the picture. Low inflation, low unemployment, good wage growth, good corporate earnings growth. Maybe we are just too negative, but the lack of warning signs gives us an uneasy feeling. We are always leaning toward caution, particularly when it comes to managing other people’s money. Then again, when we are fully invested, as we have been for some time now, we are always looking for the iceberg in the distance that might put an unexpected dent in our hull.

Equities had a good run in 2017 and a great start to 2018. Global growth is picking up after languishing since 2008. The global economy started to finally recover in earnest back in 2014 only to get blindsided by the complete meltdown in commodity prices in general and energy prices in particular. It is hard to overstate the depression that the energy sector went into from the end of 2014 and is still emerging from today. In September 2014 the energy sector was responsible for more than 12% of the earnings on the S&P 500. In the fourth quarter of 2017, the energy sector was responsible for merely 4% of earnings for the index. This is after “recovery”. For many emerging countries, energy is most of their GDP.

Our point is that the strength in the equity markets are due more to accelerating global economic growth than anything else. There is a feeling that certain stocks have come a bit too far too fast, but the rally has solid footing. GDP growth is accelerating and forecasts are being revised up. Revenue growth has been picking up and earnings along with it. There is always plenty that could go wrong and we are certainly on the lookout, but for now equities is the place to be.

If we had to pick any one concern, it would be inflation. For the moment it is not a factor but it should be watched closely. In the mean time, we will make the most of the positive outlook.

As always, please reach out to either of us if you have any questions, comments or concerns.

GKV Capital Management is an independent registered investment advisor. For more information about us please call (805) 497-2616 or visit gkvcapital.com
In 2017 the S&P 500 Index surged nearly 20% and the Dow Jones Industrial Average grew by approximately 25%. These gains were in response to about a 17% gain in earnings per share growth for the companies comprising the S&P 500 Index. Earnings per share growth should continue to show above average momentum in 2018 compared to the tepid results of 2014-2016. Earnings per share for the S&P 500 Index ended 2016 at about $107 per share. At the end of 2017 it was $124 per share. For 2018 the consensus forecast for S&P 500 Index earnings per share was $145.37 at the close of December and has been subsequently increased to $150.57 to incorporate the lower corporate tax consequences of the recently passed Tax Cut and Jobs Act. Most importantly, the growth in earnings is not coming solely from lower taxes, share buybacks, or even increasing profit margins. Companies are experiencing revenue growth greater than 7% annually.

Stock prices are primarily a function of expected cash flows: corporate earnings and dividends. A confluence of positive factors is all pushing the justification for equity valuations higher. Namely, deregulation of American industry, the repatriation of approximately $1.5 trillion dollars by U.S. corporations to the U.S., the existence of abnormally low interest rates rendering bonds since 2008 a poor alternative to stocks, the prospects of massive infrastructure spending, accelerating wage increases, low inflation, a benign Federal Reserve, increased capital spending and potentially larger stock dividends coupled with an increase in stock repurchases and mergers and acquisitions have all caused investors to expect further solid investment returns in 2018. Investor confidence, due to these factors, continues to grow. For those not fully invested, there is now less a fear of investment risk than a fear of missing out. Sentiment and emotion magnify the fundamental factors and the FOMO will push prices further that an efficient market should allow.

We anticipate further gains in 2018, but our expectations based on fundamentals alone are more tempered. We believe that the positive catalysts driv-
ing the stock market are well recognized, but potentially negative factors which could derail the year of euphoria may materialize faster than expected. Rising interest rates and inflation are the two primary contingencies which currently appear most likely. Although wolf has been cried annually since 2010 regarding both factors, 2018 might be the year to heed the cries. Interest rate increases and increases in inflation may be modest in 2018 but crossing the threshold of 3% for both this year may alter investors’ perceptions of market gains for 2019. The growth in corporate earnings for 2018 will not be punished by either of these economic events but price/earnings ratios, the measure of euphoria within stock prices, may be revised downward. Economically a modest rise in interest rates and inflation, if it occurs, will not derail in 2018 or 2019 the very strong synchronized growth of the world economy, but it will increase investor awareness of a potentially worsening environment from its almost perfect position presently.

Although the outlook is positive for further stock market gains in 2018, we project smaller percentage increases versus 2017 unless FOMO takes valuations to truly unsustainable levels. Recognizing that the S&P 500 Index has risen 4% in the first 3 weeks of 2018, we believe almost half of our forecast for the year has already been realized. This puts us on Ralph Waldo Emerson’s thin ice. Our safety is to react with speed, but this is always easy to say and hard to do. If interest rates and inflation remain benign in 2018 and external geopolitical risks stay small, then price/earnings ratios could expand making 2018 another high growth year for stock prices.

Some more cautious stock market pundits believe general price gains this year will only be modest because all the good news is known. Also, cash levels among institutional investors is very low by historical standards. Furthermore, we are no longer in the era of monetary stimulus. An era of less liquidity has begun. However, we expect investor sentiment to stay positive during at least the first six months of this year in response to stellar corporate earnings and universal economic growth among almost all countries. At the present time Wall Street analysts are raising their corporate earnings estimates. This event will continue to support the FOMO mentality at least through the first quarter. The position of stock market prices at that point will help determine investment strategy going forward. The condition of the ice will have to be reassessed. But entering 2018 the world is in a pretty good place.

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<tr>
<th>Rate</th>
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<th>Tax Owed</th>
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<tbody>
<tr>
<td>10%</td>
<td>$0-$9,525</td>
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<td>$9,525-$38,700</td>
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**Tax Brackets Under TCJA and Prior**

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<tr>
<td>New Rates</td>
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**Source:** TCJA of 2017
In December 2017 Congress passed and Trump signed into law the most comprehensive changes in the U.S. Tax code since the Reagan era. These changes affect every aspect of American life from businesses, to individuals, to charities, to university tuitions. Although broad in its scope, the changes in the tax code were to simplify it and make it more equitable. In both cases it failed, but it will reduce the income tax burden for individuals and corporations for the next eight years or more which was its primary goal. The new tax code is more complicated than the old law and it has more loopholes for the wealthy and is of dubious benefit to the middle class but it will add stimulus to the U.S. economy and should create further job and wage growth. The negative offset is that the federal deficit is expected to rise significantly but in the short-term the tax legislation should benefit the general economy.

Although the reduction in the corporate tax rate from 35% to 21% is the most dramatic provision in the new tax legislation, individuals, as expected, are more focused on what it does for them.

Of the total benefits derived from the tax cuts for individuals, about 23% will go to middle-income families, for a total of $61 billion. In 2026 the reduction in taxes for middle-income families will terminate and these same households will see a net increase in their taxes by 2027. According to the Joint Congressional Committee on Taxation the middle income families receiving 23% of the tax saving benefits represent nearly half of all U.S. tax filers. Middle income families are classified as those earning between $20,000 and $100,000 per year.

The most affluent households in the U.S., which consist of those earning more than $500,000 per year, will also receive about $61 billion in tax savings. This group, however, equals only 1% of tax filers. Although less after 2027, this high income group will still receive tax savings of about $12 billion.

The middle-income and affluent class tax-saving benefits includes income earned by pass-through businesses such as partnerships and S-corporations which are taxed as individuals.

The new tax law favors higher income earning tax payers versus lower-income earning households. The higher affluent household category will see the biggest cuts in average tax rates. The reductions in tax rates from those in existence prior to the end of 2017 will terminate for all income categories by 2027. The top 20% of households by income will receive almost two-thirds of the tax savings between 2018 and 2025.

Most of the tax savings from the recently passed tax legislation will accrue to corporations. This reduction in the corporate tax rate is permanent, not temporary as for individuals. The new tax law is a major gift to U.S. corporations but of mixed benefit for individuals. Under the new law the mining industry will receive the most benefit in tax savings, equaling an estimated 60%, while the utility industry will actually see an estimated increase in taxes.

The table on the opposite page shows the changes in tax rates and income brackets for individuals before 2018 and under the new law.

The new tax code maintains the seven tax brackets just like the old tax code. But the top rate falls from 39.6% to 37%.

Almost all tax payers will receive some tax savings in the short term. After 2026 the lower tax rates expire and revert to the tax rates in existence in 2017.

In an effort to reduce the number of tax filers itemizing deductions the standard deduction was increased from $6,350 for singles to $12,000 and to $24,000 from $12,700 for married couples filing jointly.

The personal exemption of $4,050 per person was eliminated. Whether or not the increase in the standard deduction and child tax credit offsets the loss of the personal exemption depends on family size, itemized deductions, and filing status.

The per child tax credit will double from $2,000 to $4,000 and will apply to tax payers with income levels up to $200,000 for singles and $400,000 for couples. This is an improvement from the old levels of $75,000 for singles and $110,000 for couples filing jointly. There is also a new credit of $500 for non-child
dependents such as an elderly parent or adult child with a disability.

Although Congress did not eliminate the Alternative Minimum Tax (AMT) as originally proposed in an early version of the legislation, it did provide some relief. The AMT exemption for singles was raised to $70,300 from $54,300 and it was increased to $109,400 for couples from $84,500. Also importantly, there was an increase legislated in the amount of income taxpayers can have before the AMT exemption gets reduced. It was raised to $500,000 for singles from $120,700 and to $1 million for couples from $160,900. The actual AMT rate of 28% was not changed. The corporate AMT was repealed.

The estate tax exemption was doubled to about $11 million for singles and $22 million for couples. However, it reverts back to the exemption levels of 2017 by 2026.

The new tax bill also assumes a lower rate of inflation in the future versus the old tax code. Consequently, exemptions and tax thresholds will be indexed to a lower inflation rate which will slightly erode the value of the tax benefits each year. This change is permanent and does not expire in 2026.

As mentioned, corporations are the major beneficiary of the tax law changes. The drop in the corporate rate from 35% to 21% will greatly assist U.S. multinational corporations to be competitive with foreign companies. Owners of pass-through entities such as S corporations will have to do the complicated math to see if converting to a C corporation offers more benefits than remaining as an S corporation or pass-through entity. The new C corporate tax rate is 21% and the top rate for pass-through entities such as LLCs and S corporations is 29.6% if they receive the 20% deduction on income. Otherwise the top rate for pass-through entities is 37%. Since most pass through entities are owned by wealthy taxpayers, this could amount to a large tax break for the wealthy, but the advantage of this 20% deduction has to be measured against the new 37% tax bracket for pass-through entities versus the 21% for C corporations.

Capital gains rates remain the same in the new law as compared to the old law. The maximum capital gains rate is still 20%. The mortgage interest deduction has been reduced in the new tax law. The mortgage interest deduction is allowed on total mortgages up to $750,000 for a first or second home purchased after December 14, 2017. Total mortgages up to $1,000,000 on a first or second home which are already in place before December 15, 2017 are grandfathered under the $1,000,000 limit. There will no longer be an interest deduction on home equity credit lines whether new or old under the new tax law. The exclusion on the gain of a principal residence remains the same as in the old law. The exclusion is $250,000 for a single person and $500,000 for married couples.

Charitable cash contributions limits are increased under the new law to 60% of adjusted gross income.

The tax code remains the same for the sale of securities. Common stock purchased at different times and at different costs can be selected by the individual as to which stock to sell first. The stepped up cost basis on assets held at the time of death remains the same under the new law as stipulated in the old law. The cost basis, as before, will become the fair market value at the time of death.

The provisions of the new tax code versus the old tax code as outlined herein are summaries and are not all inclusive. There are numerous details pertaining to many of the tax code terms which a taxpayer should discuss with a qualified tax expert when preparing his/her future tax strategies.

Some observations about the new tax legislation:

- It is very possible that the effect on real estate values in states like California and New York will be a modest negative since property tax deductions and mortgage interest deductions are restricted.
- The slower inflation adjustments in the future in the new tax code will gradually increase the level of an individual’s taxable income in many circumstances.
- By 2026 the more generous federal estate tax exemption granted under the new law will expire but it is expected that gifts made prior to 2026 for estate planning purposes will not be “clawed back” by the IRS if the grantor of the gifts dies after 2026 when the estate tax exemption reverts back to the old tax legislation. The increase in the federal estate tax exemption offers individuals an exceptional opportunity to plan and implement substantial advantageous changes to estate planning strategies before 2026.
- The new tax code clearly favors the wealthy and will provide very modest tax relief to the middle and lower middle classes.
- As mentioned earlier in this Quarterly Report, the lower corporate tax rate to 21% should prove to be a strong stimulant to the U.S. economy for several years to come. In our opinion, it will also be a stimulant to further in-
creases in stock prices as cash dividends are increased by companies, stock buybacks are enlarged and the rate of mergers and acquisitions increases. The changes in the tax code, which primarily benefits corporations, should help foster and sustain low unemployment and wage increases.

The major negative to the recently passed tax law is that it will substantially increase the federal deficit. It is very possible that the growth in the federal deficit will again require major changes in the tax code to address the unsustainable gap between the government’s income generated and expenses paid.

It is possible that the major fiscal stimulus caused by the new tax law will gradually reignite inflation above 3% and push interest rates on 10 year U.S. Treasury bonds above 3%. These events may significantly alter the attractiveness of stock market valuations and bring an end to the long bull market, but we emphasize that a return to what was once called the “normal” world of pre 2007 does not have to have negative implications for the capital markets. They are simply variables to watch and analyze early.

The new tax law will affect universities and colleges differently regarding their endowment funds. Liberal arts colleges will be hit the hardest. Schools with sizeable endowments but smaller student enrollment will be taxed on the income from their endowment funds. This could result in adversely affecting tuitions and grants.

Corporations will pay one-time tax on the repatriations of overseas profits held in cash equal to 15.5%. They will also lose their ability to deduct past losses against future profits. These items will result in immediate non-cash changes to their fourth and first quarter earnings results but they will benefit greatly in the future from the lower corporate tax rate of 21%. These one-time write offs due to changes in the tax code and the repatriation of overseas cash will not have an impact on stock prices. Investor focus is on the lower favorable tax rate of 21%.

The new tax law allows “independent” workers to deduct 20% of their income before paying the new, lower individual tax rates. This is the same deduction received by pass-through businesses. The net result for these individuals is a top effective tax rate of 29.6% instead of 39.6% before the new law. The exact number of independent contractors who will benefit from the new law is unknown since there are limits for tax payers making more than $157,500 if single, or $315,000 as a couple. Also, each individual taxpayer must qualify under the IRS definition of independent contractor. For example, an architect may qualify but an interior designer may not. A chef owning a restaurant may qualify but a celebrity chef may not.

The new tax law may exert a significant favorable impact on the U.S. Trade deficit. Multinational companies will no longer have the incentive to shift their profits overseas in an artificial way. It is estimated that the new tax legislation could reduce the annual U.S. trade deficit by almost $250 billion. This shift in the flow of funds would be an accounting entry rather than a change in actual business. This type of transfer pricing of foreign profits under the old law overstated our annual trade deficit and probably understated our GDP growth.

The new tax code regulations eliminate all miscellaneous itemized deductions that are subject to the 2% floor including accountant tax preparation fees and investment management fees. Also, the floor for medical expense deductions is reduced to 7.5% from 10% of adjusted gross income.

In the new law companies will get a tax deduction on $1 million of executive compensation for the 3 highest paid employees of a corporation, such as the CEO, CFO, COO from any source. This deduction includes all commissions and performance based compensation which was formerly exempt.

The new tax law will have a significant effect on individuals and businesses. For individuals it favors the wealthy but appears to have some varying benefit for almost everyone. The new tax law is clearly a big plus for corporations. We would expect the new tax bill to further stimulate U.S. economic growth and add to the rate of corporate earnings growth in the next two years. This should translate into continuing support, if not stimulus, for stock market prices. Longer term the new tax provisions may create a dangerous growth in the U.S. government deficit, in inflation and in interest rates.

All of the tax analysis presented in this report is deemed to come from reliable, expert sources. You should consult your CPA for information regarding tax decisions applicable to your personal situation.
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