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FIRST QUARTER 2019

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Q4 Market Update

(values as of 12/31/2018; % changes for Q4, not YTD)

U.S. Stock Indices

S&P 500	2,507 (-13.97%)
Dow Jones	23,327 (-11.83%)
Nasdaq	6,635 (-17.54%)
Russell 2000	1,349 (-20.51%)

Global Stock Indices

FTSE (London)	6,728 (-10.41%)
DAX (Germany)	10,559 (-13.78%)
CAC (France)	4,731 (-13.89%)
Nikkei (Japan)	20,015 (-17.02%)
Emerging Mkts	965.67 (-7.85%)

Bond Indices (Bloomberg)

U.S. Gov't.	2,217.70 (+2.57%)
U.S. Corporate	2,829.02 (-0.18%)
U.S. Hi-Yield	1,909.36 (-4.53%)
Eurozone	255.32 (+1.47%)
Emerging Mkts	1,069.11 (-0.18%)

Commodities

Gold (per oz)	1,282 (+7.56%)
Silver (per oz)	15.44 (+5.70%)
Oil (WTI, barrel)	45.15 (-38.29%)

Fixed Income Yields

U.S. 2-Year Treasury	2.52%
U.S. 10-Year Treasury	2.72%
U.S. 30-Year Treasury	3.04%
U.S. High-Yield Index	7.89%

Currency Exchange Rates

Euro/Dollar	1.15
Pound/Dollar	1.28
Dollar/Yen	109.58

Investing in the O-Zone Layer?

By most metrics, the U.S. economy has fully recovered from the 2008 financial crisis and recession: housing prices have exceeded their pre-crisis peak, the stock market remains at stratospheric levels (even after its late-year stumble), and unemployment measures stand at multi-decade lows. However, the recovery has been extremely uneven, with the gains concentrated in increasingly few hands. Many areas of the country remain mired in a decades-long economic malaise, and even the affluent urban centers like New York, Los Angeles, and San Francisco have seen a dramatic expansion in income inequality, with some neighborhoods left completely behind.

While the Tax Cuts and Jobs Act of 2017 has been criticized for helping to exacerbate those inequalities, there is one largely overlooked item in the tax reform act that aims to correct at least some of that growing imbalance. In an attempt to spur investment in underdeveloped areas, Congress created a new program that may have tax and investment implications for a wide range of investors. We'll explain the mechanics of the program, the potential benefits and drawbacks, and help to determine whether or not average investors should be taking notice.

What are Opportunity Zones?

Initially conceived of by a diverse group of billionaires and politicians—stemming from both sides of the political aisle—so-called "Qualified Opportunity Zones" (also known as QOZs or "O-zones") offer investors a new and innovative tax incentive for investing in specific underprivileged areas. First discussed in earnest during the leadup to the 2016 election, the O-zone concept eventually evolved into a somewhat unlikely add-on to the 2017 tax reform law.

Mechanically, the concept is fairly simple, relying on a trio of attractive new tax breaks: investors who sell appreciated assets (real estate, stocks, or other securities) with embedded capital gains can, within 180 days of the sale, reinvest the capital gains portion of their sale into an approved Qualified Opportunity Fund (QOF). The reinvestment in the QOF will allow the investor to defer tax on the realized capital gains, which is the first level of tax incentive.

Then, depending on the investor's holding period, additional tax breaks can accrue: investors who remain in a QOF for at least 5 years can reduce the tax bill on their initial capital gain by 10%, while those who hold for at least 7 years qualify for a 15% reduction. Finally, investors who remain in a QOF for 10 years or longer will enjoy fully tax-free growth on any gains stemming from the QOF investment. In a sense, then, any funds invested in a QOF essentially become a special-purpose Roth IRA, allowing tax-free investment growth for the investor.

For the long-term investor, the benefits from the various tax incentives can be massive, especially if the QOF investment performs well. Of course, like most tax incentive programs, the benefits are greatest for the wealthiest investors—not only are they the ones most likely to have large capital gain assets in the first place, but their marginal tax rates are also the highest, increasing the value of the tax benefits.

In many ways, the QOZ concept is similar to existing tax-free exchanges (like 1031 exchanges for rental properties, or 1035 exchanges for insurance policies), but supercharged to allow for tax reduction. However, the application is also much more limited. In order for a specific census tract to qualify as an O-zone, it must have a poverty rate of 20% or higher, or a median household income that is less than 80% of the surrounding area. Per the final IRS list issued in 2018, there are more than 8,700 approved zones, spread across the 50 states (and 6 U.S. territories).

There are limitations on what kinds of investments will qualify, but for the most part, the opportunity set is broad. QOFs must ultimately hold 90% of their assets in projects located within O-zones, but they will have a relatively long time to deploy their investments (30 months, per proposed IRS guidelines).

Not surprisingly, banks and other funds have already begun scrambling to attract capital from investors, even before the rules surrounding QOZs have been finalized (and with the IRS currently severely understaffed due to the government shutdown, "final" guidance may still be a while coming).

The drawbacks

Of course, with great opportunity often comes great risk, as well. For one, the QOZ opportunity simply won't be appropriate for many (or most) individuals or families. Many individuals have no retirement savings or investments outside of IRAs or 401(k) plans, and those vehicles are incompatible with QOFs. Only investors with accumulated capital gains in taxable accounts (or other non-retirement assets) are eligible, thus limiting the pool of potential investors.

And as with most new and poorly-understood opportunities, there are bound to be abuses and bad actors. Enhanced due diligence of any and all opportunities is paramount, in order to avoid chasing a bad investment simply in search of a potentially illusory tax benefit.

Even the best-vetted O-zone investments will likely come with higher risk. New Jersey Senator Cory Booker, a vocal proponent of the QOZ program, has referred to O-zones as "domestic emerging markets", and it's not just a euphemism: nearly 10% of the 8,700 designated zones are in Puerto Rico, which is, in fact, an emerging market economy.

The O-Zone "Triple Tax Benefit"

1. Tax deferral on "initial gain"

Appreciated asset can be sold (and removed from portfolio) without generating any current-year capital gains tax

2. Tax reduction on "initial gain"

Tax on initial gain is reduced by 10% if O-zone investment is held for 5 years; by 15% if O-Zone investment is held for 7 years

3. Tax exclusion on new investment gain

If O-zone investment is held for 10 years, any new capital gain on that investment is *fully exempt* from tax (excluded from income)

Meanwhile, future changes in the tax code could mute or eliminate the tax benefits that QOF investors expect to receive. A complete repeal of the O-zone program is unlikely given its broad bipartisan support, but if the program proves to be less successful (or more expensive) than anticipated, that support could erode quickly.

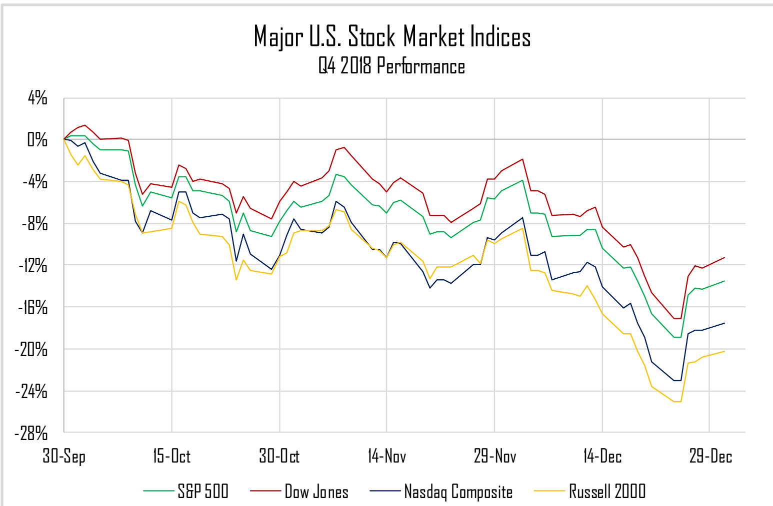
No matter what, realizing the full benefits of an O-zone investment will require a very long-term investment, with significant limits on liquidity. Any funds committed to a QOF, then, should be funds that the investor does not expect to need for at least a decade. That may be an appropriate trade to make for a younger investor with decades to go until retirement, but less suitable for a retiree.

Given the potentially large benefits of O-zone investments, the program definitely seems to deserve more attention than it has received so far. However, given the vast uncertainties (and limited applicability), we recommend that all individuals proceed with caution. As usual, it's rarely wise to let the tax tail wag the investment dog.

ALMOST EVERY GLOBAL ASSET CLASS POSTED NEGATIVE RETURNS IN 2018

Equity Overview – 2018 Year In Review

Three years ago, in our Q1 2016 newsletter, we quoted a Bloomberg article in referring to the 2015 market year as "The Year That Nothing Worked". We noted then that for the first time this millennium, no major asset class was able to manage a return of greater than 5%, leading a diversified portfolio to experience its first loss since the 2008 financial crisis.



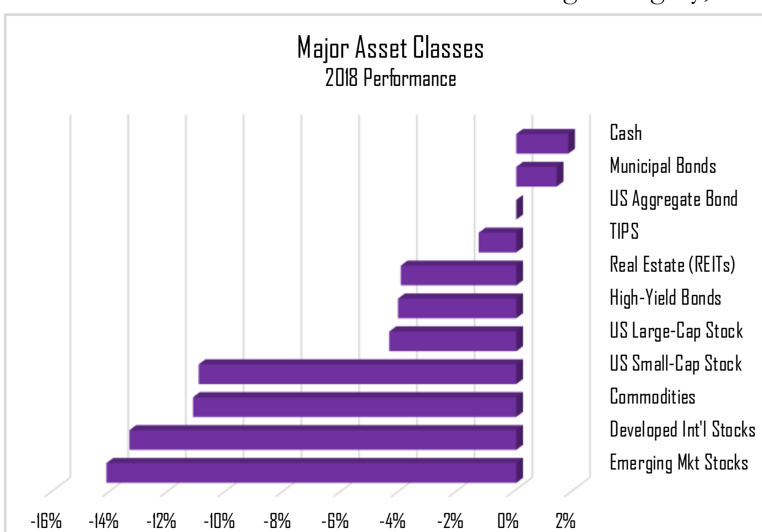
As it turns out, 2015 was a mere prelude to the real "Year That Nothing Worked", which arrived in 2018. Indeed, according to Deutsche Bank research, 93% of global asset classes finished the year in negative territory, marking the highest loss rate on record, dating back to the early 1900s. Domestically, only municipal bonds and cash were able to eke out a positive return, as rising bond yields put pressure on both fixed income and equity markets.

For most of the year, the U.S. stock market was actually able to buck the trend, remaining in positive territory—and shaking off a swift correction in February—even as bonds, real estate investments, and international stocks all began to slide. But as Q3 drew to a close with markets once again marking new all-time highs, some important divergences were beginning to develop. We noted developing weakness under the surface in the U.S. stock market, with more NYSE stocks marking 52-week lows than 52-week highs, an unusual dynamic for a bull market making new highs.

That weakness soon revealed itself via wide cracks in the broader market; a quick 7% loss in October seemed to stabilize after November's midterm elections, but the end of the year brought a rapid acceleration of the downtrend, with stocks shedding more than 9% for the month of December to end the year in negative territory for the first time this decade.

The decline was swift and relentless, with the week before Christmas marking the worst one-week return since the peak of the financial crisis in October 2008, leading the market briefly into official "bear market" territory (20% below its recent highs). The last few days of the year did see some small recovery, but the damage to the market—and to investor psyches—could take some time to repair.

For investors in diversified portfolios, 2018 provided little comfort, since there was seemingly nowhere to hide. However, some context is in order; after all, 2017 saw a record number of asset classes posting *positive* returns, so some normalization was seemingly inevitable. And in the silver linings category, the decline in bond prices in 2018 means more attractive yields for fixed income investors going forward, which is a welcome change after years of near-zero interest rates. Investor fear remains palpable as 2019 dawns, but as in all market corrections, opportunities abound for patient long-term investors.



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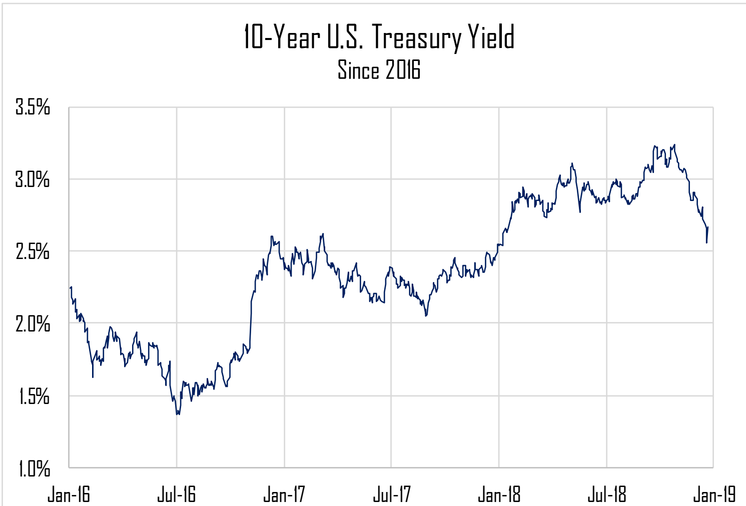
AFTER RISING ALL YEAR, BOND YIELDS CONTRACTED SWIFTLY IN DECEMBER

As Stocks Slide, Treasury Bonds Begin to Recover – Fixed Income

One of the apparent causes of the stock market weakness that developed in Q4 was the persistently rising interest rate environment, which threatened to derail the economic recovery. But in an ironic twist, as stocks rapidly lost ground in December, Treasury bonds suddenly (and noticeably) reclaimed their "safe haven" status, as investor fund flows out of stocks and into bonds stemmed the rise in rates, causing bond yields to swiftly correct lower.



For most of 2018, it looked as though the 10-year Treasury yield was determined to break above the psychologically important 3% level—each time it did, stocks reacted negatively, punctuated by December's plunge. But the safe-haven flows caused yields to reverse course well below 3%, a trend change that could spell relief for equity markets (and the economy) as we enter 2019.

The delicate interrelationship between bond rates and equity prices has rarely been demonstrated as clearly as in 2018; low yields are generally good for risk-asset performance, but too much of a good thing can generate imbalances. The Federal Reserve's attempts to normalize interest rates are important for long-run economic stability, but for investors in equity markets, the ride may continue to be bumpy at times.

Tax-Related Changes for 2019 – General Finance

Compared to the tidal wave of tax changes in 2018 stemming from the Tax Cuts and Jobs Act of 2017, 2019 will be a relatively tame year as far as tax changes are concerned. The major change to keep an eye on is the official elimination of the "individual mandate" penalty for taxpayers who do not have eligible health insurance coverage. For tax years up to and including 2018, a "Shared Responsibility Payment" of either $695 per adult ($347.50 per child) or 2.5% of household income was charged as a penalty for noncompliance with the individual mandate. Beginning with the 2019 tax year, that penalty has been eliminated.

Aside from that change (which ultimately impacted somewhere around 5% of taxpayers), the only updates to the tax codes are the usual inflation adjustments to contribution limits and income thresholds. Perhaps most notable is the increase in the IRA contribution limit, which has increased to $6,000 per person per year, after several years stuck at $5,500. Individuals who are covered by employer-based retirement plans will see similar increases to their contribution limits: the 401(k) limit increases to $19,000 (from $18,500), the SIMPLE IRA limit increases to $13,000 (from $12,500), and the SEP IRA/Solo 401(k) total contribution limit increases to $56,000 (from $55,000).

Finally, the tax reform bill also enacted major changes that impact alimony payments in divorce settlements, which will take effect beginning in 2019. Previously, alimony was tax-deductible for the payer, and was treated as taxable income for the recipient (child support payments, though, were not). This treatment led to some creative structuring of divorce settlements in order to take advantage of the deduction, but such structuring will no longer be valuable. Pre-2018 settlements will not be affected, so those currently paying alimony need not worry.