KMS
Client Quarterly
Fall 2018

Compliments of

Published September 2018 by KMS Financial Services, Inc.
2001 Sixth Ave., Suite 2801 • Seattle, WA 98121 • *www.KMS.com*
Member: Financial Industry Regulatory Authority • Securities Investor Protection Corporation

The Drive to *Drafta* New NAFTA

Spoiler alert: This article does *not* opine on whether the North American Free Trade Agreement should be cheered, changed, or chucked. Now for the context.

Nations' trade policies are a swirl of economic, political, and cultural pressure points. NAFTA is notable for the size and extent of integration across three nations' economies and for President Trump's amplifying of the debate. The ebb and flow of trade issues with China and the European Union also can move markets on any given day.

Investors could get the idea that world trade is in crisis, but the numbers suggest otherwise. In July, *total* U.S. trade climbed to a new record. For the first seven months of 2018, U.S. exports rose by 8.6%, annualizing at nearly $2.4 *trillion*, while imports grew 8.3% to $2.8 trillion annualized. Those numbers do not indicate a slowdown, but they do point up the stakes involved.

At this writing, Mexico and the U.S. appear to have worked out changes to their 25-year-old agreement. But NAFTA is a *three*-nation pact, and a push by negotiators heading into the Labor Day weekend failed to bring Canada aboard.

The Montreal-based BCA Research firm followed with a multifactor review of ramifications if the parties ultimately fail to reach an acceptable NAFTA rewrite or extension. BCA examined the potential impact from the standpoint of international supply chains, respective foreign revenue and input costs, and predictive economic models.

Those supply chains are a key focus, as much of the trade potentially affected is in *intermediate* goods. NAFTA has promoted highly favorable treatment for components crossing the countries' shared borders. Auto components might cross those borders up to eight times before installation at a final assembly plant. Higher tariffs on each crossing could represent a major disruption of this ecosystem. Motor vehicles, machinery, and petroleum products appear to be most vulnerable on this front, but telecom equipment, food products, and other industries would also be affected.

Detailed breakouts of foreign-sourced revenue are harder to come by, but BCA notes 15 major sectors in which U.S. companies average 40-80% of income from outside the country. Canada and Mexico likely represent a meaningful share.

Some 21 U.S. industries look comparably exposed to significantly higher input costs in the event of a broad upshift in tariffs. A degree of counter-leverage derives from the fact that trade with the U.S. is a much greater share of both Canada's and Mexico's economies.

Economic models try to assess the overall impact of higher tariffs, reduced business investment due to uncertainties over market access, and the drag of non-tariff barriers on cross-border services. Most economic models suggest that *all three* countries would sacrifice a small slice of growth at the margin.

The prospect of all parties losing a little points up a basic dilemma. Economists may proclaim the blessings of liberalized trade. However, those benefits tend to be broad and diffuse, while losses and dislocation from stiff global competition are often more focused and visible.

It is not unusual for countries to spread some costs across the many in order to mitigate acute pain for the few. Fortunately, politicians also like the optics of a handshake and a chance to declare victory. ■

Social Security's Long-tailed Reform

Discussions of the federal budget often founder on the issue of entitlements. This fiscal year, Social Security, Medicare, and Medicaid together will account for more than half of all federal spending. Those mandatory outlays plus interest on federal debt will drive 75% of fiscal 2018's overall spending *increase*.

The prevailing media narrative is that politicians *never do anything* about entitlements. But about 35 years ago they did address Social Security, and the effects are still playing out today. The need for action was clear. From 1968 to 1983, Social Security spending had climbed from 2.6% to 4.8% of the nation's gross domestic product (GDP).

The reform package enacted back then bumped payroll tax rates and programmed an annual rise in the income base subject to the tax. It bent down the curve in benefits relative to payroll taxes, and it further tilted the program in favor of lower income earners. It initiated taxation of benefits for retirees with other income, and it phased in higher eligibility ages for full benefits.

Some have called for Social Security to be "means-tested," but most of the provisions noted above do exactly that. Those changes, plus a couple decades of more favorable demographics, helped contain Social Security spending below 4.5% of GDP for 25 years. It has edged above that level since 2008.

On the revenue side, reform ushered in a 25-year run (1985-2009) that saw Social Security's dedicated taxes *exceed* benefits paid by a cumulative $900 billion – tapping the baby boomers across their prime earning years against the day

continued at bottom of page 4 ►

Nothing contained herein shall constitute an offer to sell or solicitation of an offer to buy any security. Securities are offered through KMS Financial Services, Inc. Material in this publication is original or from published sources and is believed to be accurate. Readers are cautioned to consult their own tax and investment professionals with regard to their specific situations.

The Dynamics of Crisis, a Decade Out

Ten years ago, investors stood on the threshold of one of the most traumatic market environments of modern times. From the end of August 2008, through March 9, 2009, the Standard & Poor's 500 Index declined by 47%. An erosion of confidence in U.S. mortgage-backed securities became a full-blown global financial crisis revealing an unsettling fragility across debt markets, money market funds, major money center banks and brokerage firms.

That lookback prompts two salient observations. First, events can turn markets in dramatic ways with little warning. Second, selling out ten years ago would have looked real smart for a while, but only if one had the intestinal fortitude to reenter the market relatively early in the subsequent recovery, while the memory of financial crisis and market panic was still fresh.

After all, the ten-year numbers in the accompanying table *include* that sickening six-month sell-off noted above. As is often the case, the early stages of recovery were most dynamic. The S&P 500 rallied 66% from that March low to the end of 2009. That big bounce turned out to have remarkable legs, eventually becoming the longest-running bull market in U.S. history at more than 3,550 days and counting.

For most of that period, and certainly in terms of overall performance, U.S. listed stocks have commanded the spotlight. A broad blend of foreign equities has lagged badly, barely managing to beat the 10-year results for a globally diversified bond portfolio.

Meanwhile, this year's strength in the dollar and a laundry list of country-specific crises have contributed to a deeper swoon for Emerging Market (EM) stocks. That recurring scenario has challenged the long-touted premise that dynamic EM growth will eventually translate into a level of multi-year market returns that would justify the risk.

Exactly when these trends might shift is anyone's guess. We do know that it *can* pay to redeploy a few dollars from one's winners into the relative laggards. But that is not *always* a risk-reducing strategy. ■

Investment Performance Review	**TOTAL RETURN *** (dividends and capital gains reinvested)			
Selected Mutual Fund Categories *	**--- Annualized through Sept. 7, 2018 ---**			
	1 yr.	***3 yr.***	***5 yr.***	***10 yr.***
Large-Cap Stocks (Blend)	17.0 %	14.5 %	12.1 %	10.0 %
Mid-Cap Stocks (Blend)	16.1	12.0	10.4	9.8
Small-Cap Stocks (Blend) †	20.7	14.2	10.8	10.1
Foreign Stocks (Large Blend) †	- 0.4	7.3	4.2	3.9
Diversified Emerging Markets †	- 6.3	9.5	2.9	3.6
Specialty Natural Resources †	5.5	10.1	1.4	2.2
Specialty Real Estate †	3.7	9.4	9.5	7.2
Cons. Allocation (30-50% Equity)	3.3	5.9	5.0	5.5
Long-Term Bond	- 2.3	4.1	5.9	6.4
World Bond †	- 2.6	2.3	1.4	3.1
High Yield Taxable Bond †	2.3	5.4	4.4	6.8
Long-Term Municipal Bond	0.0	2.7	4.5	4.1

* Source: Morningstar. **Past performance is NOT indicative of future results.**

† Small-cap stocks, high-yield (lower rated) bonds, and sector-specific funds may exhibit greater price volatility than the stocks of larger, established companies and/or more broadly diversified funds. Securities of companies based outside the U.S. may be affected by currency fluctuation and/or greater political or social instability.

Fretting Over a Flatter Yield Curve

Everyone knows the world is not flat. Interest rates are another story. At this writing, the spread between the yield on two-year Treasury notes and ten-year T-bonds is a scant 24 basis points (0.24 percentage points), the narrowest margin in more than a decade.

A narrowing of this "term spread" worries some economic and market prognosticators who point out that an *inverted* yield curve (short-term yields rising above long-term) has preceded all nine U.S. recessions since 1955. By the way, those recessions also were preceded by spring, summer, winter, and fall.

Researchers with the Federal Reserve Bank of San Francisco recently noted that "while the current environment appears unique compared with recent economic history, statistical evidence suggests that the signal in the term spread is not diminished." It remains an open question as to whether a flatter yield curve *causes* recession or is simply a common feature of the late stage of economic expansions.

The business cycle probably has not been repealed. When the next recession settles in, it will be seen, in retrospect, to have been presaged by an array of "obvious" indicators. However, such predictions based on any *single* indicator are quite tricky. As a practical consideration, a positively sloped yield curve – long rates higher than short – is more common, so the current environment is probably transitional... but for how long?

For now, investors are paid a bit more to keep powder dry in money market funds and short-term instruments as the Federal Reserve draws back from years of unusually accommodative monetary policy. As that plays out, advisors might watch for opportunities to redeploy and further diversify some of that dry powder if stocks stage a correction and/or long-term quality bond yields push higher. If your time horizon is truly long-term, your timing need not be perfect. ■

Nothing contained herein shall constitute an offer to sell or solicitation of an offer to buy any security. Securities are offered through KMS Financial Services, Inc. Material in this publication is original or from published sources and is believed to be accurate. Readers are cautioned to consult their own tax and investment professionals with regard to their specific situations.

Prioritizing Your Tax-advantaged Savings Options

They say there's more than one way to skin a cat, but not every approach is optimally efficient and effective. U.S. tax law includes a grab bag of vehicles offering some combination of tax deductibility, tax deferral, and/or tax-free withdrawals. How do you deploy those vehicles to best advantage?

Assuming you already maintain a healthy cushion of liquid reserves for emergencies and near-term special expenses, a common first turn would be to individual retirement accounts (IRA) and/or your employer's 401(k) plan. But first, a brief detour to consider a **Health Savings Account (HSA)**.

HSAs offer an unusual *triple* tax play: up-front deductibility, whether or not you itemize; ongoing tax-deferral on investment earnings; and tax-free withdrawals for qualified medical expenses. That includes a range of direct costs and premiums we are all bound to incur over time.

To contribute to an HSA, you must be in a qualified, high-deductible health plan, which *may* provide premium savings to help fund HSA contributions. The 2018 contribution limit is just $3,450 for an individual or $6,900 for a family, but that triple tax preference is too attractive to just ignore.

If you can carve out more savings, **a workplace 401(k)** can be critical, especially if your employer matches some portion of your elective contributions. Failing to contribute at least enough to secure that match is just turning down free money. The annual limit for individual elective contributions is $18,500, *plus* $6,000 if you are over 50.

If you can't access a 401(k), or your savings capacity exceeds those limits, **Individual Retirement Accounts (IRAs)** are another staple, albeit with lower contribution limits than a 401(k) and some complexity regarding deductibility.

IRAs and many 401(k) plans offer **two distinct flavors**: "Traditional" accounts offering an up-front deduction but eventual tax on withdrawals; and "Roth" accounts for which contributions are *not* deductible but withdrawals can be *tax-free*. Much has been written about the relative merits of those two approaches, but the key consideration is probably this: Does an up-front deduction help you commit more capital for long-term savings? If so, the Traditional approach may be the proverbial "bird in hand" (the deduction) versus the "two in the bush" (tax-free withdrawals) that might be captured via the Roth.

If you hit the contribution limits on the vehicles outlined above, **non-qualified deferred annuities** offer tax-deferral on investment earnings as well as opportunities for tax-managing your retirement income. Contributions to **"529" college savings plans** also enjoy tax-deferred build-up with tax-free withdrawal to meet a beneficiary's college expenses.

Then there are strategic opportunities with a **donor-advised fund** (DAF), as featured in the Summer *Client Quarterly*. DAF contributions are deductible if you itemize. Once made, those gifts are no longer your personal assets, but they do build an investment in sustaining your charitable interests and legacy.

The pecking order outlined above certainly is not rigid. It should flex with your financial circumstances and personal objectives. Your investment and tax professionals are bound to have a few constructive ideas on the subject. ■

Advice You Probably Could Have Figured Out for Yourself

A team of neuroscientists recently used electromagnetic brain scans and heart rate monitors for more clues on the things that make people happier and healthier. Near the top of that list is interacting with one's grandchildren.

An Australian study showed better cognitive test results for grandmothers who spent time watching their grandchildren than for those who did not. Another 20-year study (1985-2004) found fewer symptoms of depression among grandparents who had close, positive relationships with their grandchildren. A simple Internet search (try "Benefits of Grandparenting") can link you to plenty of studies extolling grandparent-grandchild relationships.

That's all useful ammunition if you're trying to nudge your adult children to start producing the little happiness boosters. If you are already so blessed, experts are ready to help you be the best grandparent you can be. The following suggestions may seem obvious, but remember... they come from experts.

Get active: Grandchildren want someone to play with them, i.e., run, jump, lift, get down on the floor and be able to get back up. For a battery of playtime possibilities with the youngsters, direct your Internet browser to *HuffingtonPost.com* for its "101 Boredom-Busting Ideas."

Offer encouragement: A positive, supportive attitude can help build long-term relationships with children and foster their future success... according to experts.

Remember the parents: After all, your adult children are people too, not just a grandchild delivery system. They and their respective spouses may not be perfect, but they are the ultimate gatekeepers to your more perfect grandchildren.

Stay connected: Proximity certainly can make a difference, but distance is much less of a barrier than it was even a generation ago in the *Pre-FaceTime* era.

Keep pitching: We are not all naturals at engaging babies and toddlers, but something should click. As one savvy couple explained, "We have a way with the grandkids...It's *expensive*, but it's a way." ■

Nothing contained herein shall constitute an offer to sell or solicitation of an offer to buy any security. Securities are offered through KMS Financial Services, Inc. Material in this publication is original or from published sources and is believed to be accurate. Readers are cautioned to consult their own tax and investment professionals with regard to their specific situations.

Of Scattered Clouds and Silver Linings

You may have heard recently about a *critical* shortage of truck drivers. Or did you read it in these pages six years ago? Back then, the recovery was still finding its footing, but trucking managers were already struggling to staff their fleets fully. Meanwhile, the Bureau of Labor Statistics was reporting a marked recovery in traditionally attractive alternatives to trucking such as construction and manufacturing.

Back in the present, the American Trucking Association pegs the nation's driver shortage at 50,000. In a strong economy, that affects a wide range of businesses and flows through to consumers. Citing higher shipping costs as a *prime* driver, Amazon recently hiked its Prime membership from $99 to $119 a year. Is this hitting closer to home?

But that's all to the good, right? The Labor Department reports that hourly earnings in August were up 2.9% from a year earlier, their biggest jump since June of 2009. Labor also recently reported that job openings have run ahead of the number of unemployed workers for the first time since the Department started gathering that data in 2000.

Now the professional worriers can shift their focus to higher labor costs and shortages of skilled workers in construction, manufacturing, and technology. And so it goes. Growth and progress create new problems requiring innovative solutions that drive more progress and new problems. As with trucking, the ride can be bumpy. ■

► ***cont'd from page 1*** / *Social Security's Long-tailed Reform*

when their retirement benefits would start to squeeze the system. That turning point came in 2010, and retirement benefits exceeded dedicated taxes by a cumulative $500 billion from 2010 through 2017.

Social Security reform carried real costs. Those shifting benefits formulae trimmed relative buying power and income replacement levels. The advocacy group Senior Citizens League says the effective value of benefits has slipped by a third just since 2000, based on an analysis weighted to goods and services that have greater impact on retirees' living costs.

For information on our services, please contact:

In 1993, the *Client Quarterly* noted that, for the first time, some *new* retirees could expect to receive less in total benefits, assuming normal life expectancy, than the cumulative Social Security payroll taxes paid on their behalf. That represented a marked reduction relative to the same calculation for those who had entered retirement less than a decade earlier.

Whether Congress did *enough* all those years ago is open to debate, but it wasn't *nothing*. Again, as these pages noted back in 1993, "Social Security's evolution simply raises the premium on *individual* efforts to build sufficient retirement savings." ■

Nothing contained herein shall constitute an offer to sell or solicitation of an offer to buy any security. Securities are offered through KMS Financial Services, Inc. Material in this publication is original or from published sources and is believed to be accurate. Readers are cautioned to consult their own tax and investment professionals with regard to their specific situations.