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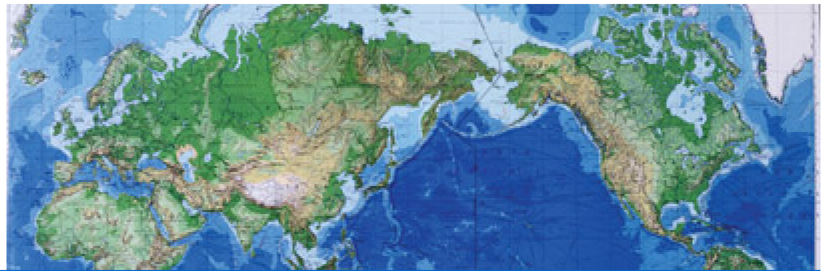

WEEKLY ECONOMIC COMMENTARY

This Week's Economic Review and Outlook

January 2018

Laura Mossakowski
Laura Mossakowski, LLC
2555 Continental Court, Suite 4
Green Bay, WI 54311
920-321-0327
Laura@LauraMossakowski.com
www.LauraMossakowski.com

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INVESTMENT IMPLICATIONS OF THE NEW TAX LAW: ECONOMY AT A GLANCE

KEY TAKEAWAYS

- The new law is intended to boost economic activity and simplify the U.S. tax code.
- Given clarity on the new tax law, we are raising estimates for U.S. GDP and S&P 500 operating earnings for 2018.

After more than a year of political posturing and investor anticipation, Congress finally approved a $1.5 trillion tax cut, the most sweeping U.S. fiscal overhaul since 1986. The 2017 Tax Cuts and Jobs Act was signed into law by President Trump on December 22, 2017, meeting his pledge to deliver tax reform before Christmas. The complex 1,000-page bill features changes that are intended to spur economic activity through a reduction in both individual and corporate tax rates, and simplify the tax code by eliminating or trimming a variety of deductions and exemptions. In this week's commentaries, we look at the likely impact of the final bill on the economy, monetary policy, and the financial markets in the coming years.

As we wrote in our *Outlook 2018: Return of the Business Cycle* publication, we believe the combination of improved business fundamentals and fiscal legislation should sustain momentum in the economy and equity markets in the coming year and potentially beyond. After years of depending on the largess of monetary policymakers, investors can now focus on fiscal levers that we believe will support consumption and spur new business investment over the next few years. The law has important implications for major corporations, small businesses, and individual taxpayers **[Figure 1]**, and may shift the trajectory for economic growth, the federal budget, monetary policy, and perhaps most critically for investors -- corporate profits.

1 **SUMMARY: 2017 TAX CUTS AND JOBS ACT**

		Current Law	Final Bill
INDIVIDUAL	Top individual tax rate	39.6%	37% (until 2025)
	Individual tax brackets and rates	10%: $0; 15%: $18,650; 25%: $75,900; 28%: 153K; 33%: $233K; 35%: 417K; 39.6%: $471K	10%: $0; 12%: $19,051; 22%: $77,401; 24%: 165K; 32%: $315K; 35%: 400K; 37%: $600K
	Estate tax exemption	$5.5MM/person	$11MM/person
	State and local tax (SALT)	Deductible	Mostly eliminates; caps property tax/income up to $10,000
	Mortgage interest deduction	Deductible up to $1MM mortgage + $100,000 home equity	Deductible up to $750,000 of new mortgages; no home equity
	Student loan interest deduction	Deductible	No change
	Personal exemption	$4,150/person	Eliminates
	Standard deduction	$6,500 single; $13,000 married	$12,000 single; $24,000 married
	Individual alternative minimum tax (AMT)	Includes a $86,200 exemption + $164,000 phase-out	Increases exemption to $109,000 + phase-out to $1MM
	Child tax credit	$1,000/child	$2,000/child; refundable up to $1,400
	Obamacare individual mandate	Penalty of $695 or 2.5% income for no health insurance	Repeals
	Requires first in, first out (FIFO) upon sale	Flexibility to optimize tax harvesting	No change (i.e., no FIFO requirement)
	Municipal interest tax exemption	Muni interest exempt from federal taxes	No change
	Municipal private activity bonds	Tax-exempt bonds for specific public/private projects	No change
	Advanced refunding bonds	Allowable	Eliminates
	Capital gains	Long term: 0/15/20% (income dependent); short term: taxed as ordinary income	No change
CORPORATE	Corporate tax rate	35%	21% (permanent)
	Corporate tax rate starts	Not applicable	2018
	Top pass-through rate	39.6%	20% deduction for certain income until 2025 (with caveats)
	Corporate AMT	20% tax to broadly defined alternative income	Repeals
	Expensing	50% expensing through 2020	100% expensing through 2023
	Interest expense deductibility	No limit	Limits to 30% EBITDA until 2021; 30% EBIT thereafter
	Net operating losses	Allows carry backs 2 years; carry forwards up to 20 years	Eliminates carry backs; indefinite carry forwards (with caveats)
	Taxation of foreign income	Worldwide (though only taxable when repatriated)	Territorial; 100% exemption
	Deemed one-time repatriation tax	Not applicable	15.5%; 8% illiquid
	Carried interest	1-year holding period (minimum)	3-year holding period (minimum)
	Minimum taxes from income	Not applicable	10% tax on high-return income; increase to 12.5% in 2025

Source: LPL Research, Joint Committee on Taxation, Senate Finance Committee, House Ways and Means Committee, PIMCO 12/26/17

ECONOMY & THE FEDERAL RESERVE

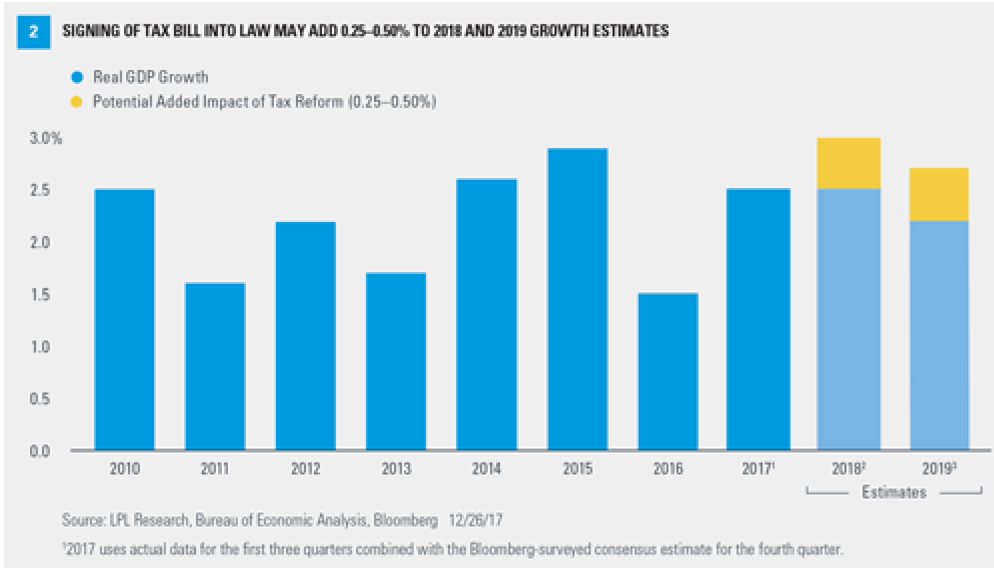
Though much of the political posturing over the past year was a result of the reduction in corporate tax rates, the legislation offers a larger than expected boost to individuals. While higher income earners should experience the largest benefit, the breadth of the individual tax rate reduction may lead to higher levels of consumer spending over the next few years. For example, in 2018, the net tax cut is set to exceed $100 billion, and as the effects of the alternative minimum tax (AMT) changes settle out in 2019, the consumer windfall could eclipse $200 billion, or approximately 1.0% of gross domestic product (GDP). Of course, the goal of lawmakers is that the increase in consumption will have a positive feedback loop, generating increases in output, employment, income, and ultimately, tax receipts. Alas, without an increase in productivity, the gains in personal spending are unlikely to be permanent, which is another reason leadership in Washington, D.C. included incentives for business investment as part of the tax package.

Indeed, the corporate tax rate has been lowered from 35% to 21%, bringing the United States more in-line with the rates charged to businesses in other developed nations (compared to the average of 22% for OECD member countries, which includes most major developed economies). Assuming the net benefit to corporations averages approximately $80 billion per year over the next four years, the logical next question would be what we expect them to do with the additional income.

Ideally, the majority would take advantage of the 100% expensing provision for investments in property, plant, and equipment, as highlighted in our *Outlook 2018*, yet economic growth below the long-term trend suggests not all business leaders will be confident enough to take these "economic" steps. Instead, it is likely that many companies (we estimate up to one-half) may still choose the path of least resistance and choose "financial" steps, using the cash to buy back shares or increase dividend payouts. The other $40 to $50 billion or so, we estimate, may be used for the "economic" steps of capital expenditures, further propelling business investment and restoring investment to its more central role in driving the business cycle.

GDP and Interest Rates

We believe the combination of improved personal consumption and capital spending from the tax legislation could add anywhere from +0.25% to +0.50% to our original forecast of +2.5% in U.S. real GDP growth in 2018 compared to the 2.2% average during the expansion [Figure 2]. To be sure, the U.S. economy is entering 2018 with a fair amount of momentum, led by consumption and employment. Though housing in high-priced states may flatten, recent Institute for Supply Management (ISM) readings on manufacturing and services have displayed some of the best levels in more than a dozen years. Moreover, the weaker dollar in 2017 may support export growth, although dollar strength in 2018 may limit the effect. In addition, government spending, particularly on defense, is poised to potentially accelerate.



Considering the fiscal incentives and an already solid economy, the Federal Reserve (Fed) may feel the need to raise rates more frequently than our projected three hikes in the coming year. If the best case projections of the tax changes are realized in the next two years, readings on GDP, employment, and inflation could exceed current consensus forecasts. We believe wage growth should prove the key determinant for policymakers in 2018, though, as inflation has thus far failed to reach the central bank's target rate this cycle. It should be emphasized that wage growth is only up about 2.5% year-over-year and well below the greater than 4.0% pace that has historically caused the Fed to raise interest rates aggressively to get ahead of the imminent inflationary threat.

Other factors monetary policymakers may consider include dollar strength, inflation expectations, the geopolitical environment, financial conditions, and financial market behavior in the coming year. While these items are not part of the Fed's official mandates of full employment and low inflation, we believe the scope of the central bank's considerations have widened heading into 2018, particularly since the financial markets typically "test" new Fed chairs, and midterm election years in the past have shown increases in financial market volatility, which could give policymakers reason to pause. We continue to believe the Fed's path for balance sheet reduction of approximately $300 billion in the coming year will remain unchanged.

Federal Deficit

At the conclusion of its fiscal year 2017, the U.S. government ran a deficit of $666 billion -- devilishly high and an ongoing concern. This shortfall registered at 3.4% of U.S. GDP and brought the total debt held by the public up to $14.7 trillion, or 76.5% of GDP, according to the Congressional Budget Office (CBO). A static scoring analysis by the Joint Committee on Taxation (JCT) and the CBO suggests the new tax law will reduce revenue by ~$1.65 trillion and decrease outlays by ~$195 billion from 2018 to 2027, leading to an increase in the deficit of ~$1.45 trillion over the next 10 years, while dynamic scoring (which adjusts for added growth) puts that level closer to $1 trillion. Proponents of the fiscal legislation see prospects of a greater offset due to improvements in economic output, incomes, profits, and ultimately, tax revenue, which could serve to reduce the longer-term deficit figures further.

CONCLUSION

It's been our view since the election that the combination of a Republican president with a Republican Congress had a high chance of passing some form of tax relief, whether it be in the form of tax cuts or more comprehensive tax reform. Early legislative setbacks led us to push back our timeline, but we remained confident that a tax bill would find its way to the president's desk. While the accelerated legislative process that led to the president being able to sign the bill into law on December 22, 2017 was a surprise to us, it does not substantially change our views.

The biggest impact of the accelerated timeline is decreased uncertainty, allowing individuals and businesses the opportunity to begin planning around the changes and pulling forward the new law's impact. As a result, we have upgraded our economic growth path to 2.75 - 3.0%, maintained our bond market view though we see greater risk to the upside for rates, and upgraded our S&P 500 target to align with our view of the law's expected impact on corporate earnings. Our upgraded S&P 500 target keeps our broad return expectations for 2018 at approximately 10% including dividends. While the new law should help provide fiscal support for the economy as monetary support is withdrawn and helps decrease the chance of recession in 2018 and even in 2019, we still expect to see market volatility increase from the extraordinarily low levels that persisted in 2017. But nevertheless, for markets and the economy, we believe the new law provides a firmer launching point as we enter the new year.

Please see the *Outlook 2018: Return of the Business Cycle* publication for additional descriptions and disclosures.

DEFINITION

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.