Demming
Financial Services Corp.

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Special Notes…

As a friendly reminder, for your protection, it is now our policy that any **requests** for funds sent to us via email **will also be confirmed by phone**.

Please be sure to let us know if there are any changes to your contact information (**Address, Phone number, E-mail, Etc.**)

Don't forget to send us a copy of your 2016 tax returns!

Also, please be sure to check out our website at www.demmingfinancial.com!

The economic myth-destroyer gets his

Imagine a person who always, in every circumstance, makes rational decisions with his money. He saves when he ought to and spends exactly as he should spend, in order to maximize the "utility" of whatever wealth he happens to possess. He defers gratification with ease. When he invests, he has instant and total access to all possible information related to every item in his, including the details of every company's financials and any impactful world events, even if they haven't reached the news media yet. If he found a $100 bill on the sidewalk, he would immediately go out and invest it in a steel mill.

"ALL YOU'RE EVER INTERESTED IN ARE GET-RICH-QUICK SCHEMES. WHAT'S YOUR HURRY?"

Most of us have never met a person like that, but this is how most economists, when they build their models, assume that normal humans behave. All of us—and especially professional financial planners—know that these assumptions are far from what we see in the real world, which makes us question whatever economists tell us about group behavior like the financial and economic markets, laws and regulation, or what consumers will do next.

All of this is why a silent cheer went up around the professional investing world when University of Chicago economist Richard Thaler was awarded the 2017 Nobel Prize in Economics by the Royal Swedish Academy of Sciences. Thaler spent his entire career exploring the differences between these unrealistically idealized economic assumptions and actual human behavior. He demonstrated that people take mental short-cuts—called "heuristics"—when they make what they believe to be logical decisions. He showed that in the real world, their decisions are often impulsive, and self-control is more of an aspiration than a reality.

Thaler also developed a theory of "mental accounting," which explained how people make financial decisions by creating separate accounts in their minds—one for college funding, say, and another for retirement, and still another for vacations or a new car. He explored those mental short-cuts and found that people tend to expect more in the future of what they've recently experienced and uncomfortably often they believe themselves to have more knowledge about their decisions than they do.

An experiment with a lost ticket uncovered the "sunk cost" effect. Thaler found that if people purchased a $100 opera ticket and lost it on the way to the show, they would be unlikely to buy another ticket, reasoning that $200 was too much to pay. But if we were perfectly logical, the only choice upon approaching the ticket counter should be whether it was worth $100 to hear the opera, and we had already made that decision when we bought the first ticket.

This is actually the second time that the Nobel Prize in Economics has been awarded to behavioral theorists who strayed from the economic party line. Daniel Kahneman won the prize in 2002 for his work with fellow psychologist Amos Tversky on human behavioral biases and systematic irrational behaviors.

In the models that economists produced out of their assumptions of perfectly rational, all-knowing investors and consumers, we could never have market bubbles or market crashes, since every market price is right and fair at every moment. In that strange world, nobody would ever pay more than anybody else for a product or service. Thaler's prize—and Kahneman's before him—suggest that the world of economics is starting to catch on to the messy decision-making that goes on in the real world.

Tax Reform–or Not?

You can be forgiven if you're skeptical that Congress will be able to completely overhaul our tax system after failing to overhaul our health care system, but professional advisors are studying the newly-released nine-page proposal closely nonetheless. We only have the bare outlines of what the initial plan might look like before it goes through the Congressional sausage grinder:

We would see the current seven tax brackets for individuals reduced to three — a 12%, rate for lower-income people (up from 10% currently), 25% in the middle and a top bracket of 35%. The proposal doesn't include the income cutoffs for the three brackets, but if they end up as suggested in President Trump's tax plan from the campaign, the 25% rate would start at $75,000 (for married couples), and joint filers would start paying 35% at $225,000 of income.

The dreaded alternative minimum tax, which was created to ensure that upper-income Americans would not be able to finesse away their tax obligations altogether, would be eliminated under the proposal. But there is a mysterious notation that Congress might impose an additional rate for the highest-income taxpayers, to ensure that wealthier Americans don't contribute a lower share than they pay today.

The initial proposal would nearly double the standard deduction to $12,000 for individuals and $24,000 for married couples, and increase the child tax credit, now set at $1,000 per child under age 17. (No actual figure was given.)

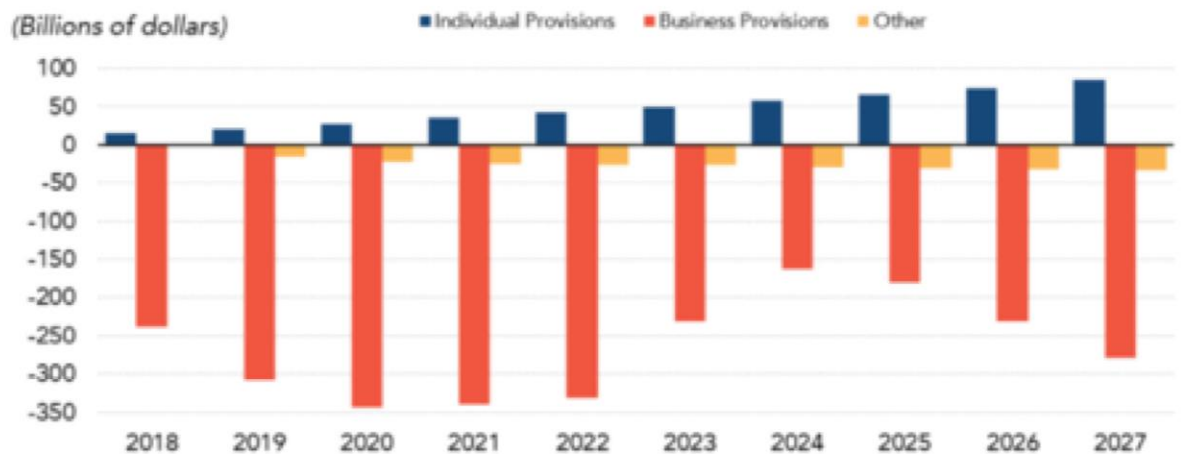
At the same time, the new tax plan promises to eliminate many itemized deductions, without telling us which ones other than a promise to keep deductions for home mortgage interest and charitable contributions. The plan mentions tax benefits that would encourage work, higher education and retirement savings, but gives no details of what might change in these areas.

The most interesting part of the proposal is a full repeal of the estate tax and generation-skipping estate tax, which affects only a small percentage of the population but results in an enormous amount of planning and calculations for those who ARE affected.

The plan would also limit the maximum tax rate for pass-through business entities like partnerships and LLCs to 25%, which might allow high-income business owners to take their gains through the entity rather than as income and avoid the highest personal brackets.

Finally, the tax plan would lower America's maximum corporate (C-Corp) tax rate from the current 35% to 20%. To encourage companies to repatriate profits held overseas, the proposal would introduce a 100% exemption for dividends from foreign subsidiaries in which the U.S. parent owns at least a 10% stake, and imposes a one-time "low" (not specified) tax rate on wealth already accumulated overseas.

What are the implications of this bare-bones proposal? The most obvious, and most remarked-upon, is the drop that many high-income taxpayers would experience, from the current 39.6% top tax rate to 35%. That, plus the elimination of the estate tax, plus the lowering of the corporate tax (leading to higher dividends) has been described as a huge relief for upper-income American investors, which could fuel the notion that the entire exercise is a big giveaway to large donors. But the mysterious "surcharge" on wealthier taxpayers might take away what the rest of the plan giveth.



But many Americans with S corporations, LLCs or partnership entities would potentially receive a much greater windfall, if they could choose to pay taxes on their corporate earnings at 25% rather than nearly 40%. (Note: The Trump organization is a pass-through entity.)

A huge unknown is which deductions would be eliminated in return for the higher standard deduction. Would the plan eliminate the deduction for state and local taxes, which is especially valuable to people in high-tax states such as New York, New Jersey and California, and in general to higher-income taxpayers who pay state taxes at the highest rate?

Currently, about one-third of the 145 million households filing a tax return — or roughly 48 million filers — claim this deduction. Among households with income of $100,000 or more, the average deduction for state and local taxes is around $12,300. Some economists have speculated that people earning between $100,000 and around $300,000 might wind up paying more in taxes under the proposal than they do now. Taxpayers with incomes above $730,000 would hypothetically see their after-tax income increase an average of 8.5 percent.

Big picture, economists are in the early stages of debating how much the plan might add to America's soaring $20 trillion national debt. One back-of-the-envelope estimate by a Washington budget watchdog estimated that the tax cuts might add $5.8 trillion to the debt load over the next 10 years. According to the Committee for a Responsible Federal Budget analysis, Republican economists has identified about $3.6 trillion in offsetting revenues (mostly an assumption of increased economic growth), so by the most conservative calculation the tax plan would cost the federal deficit somewhere in the $2.2 trillion range over the next decade.

Others, notably the Brookings Tax Policy Center (see graph) see the new proposals actually raising tax revenues for individuals (blue bars), while mostly reducing the flow to Uncle Sam from corporations.

These cost estimates have huge political implications for whether a tax bill will ever be passed. Under a prior agreement, the Senate can pass tax cuts with a simple majority of 51 votes — avoiding a filibuster that might sink the effort — only if the bill adds no more than $1.5 trillion to the national debt during the next decade.

That means compromise. To get the impact on the national debt below $1.5 trillion, Congressional Republicans might decide on a smaller cut to the corporate rate, to something closer to 25-28%, while giving typical families a smaller 1-percentage point tax cut. Under that scenario, multi-national corporations might be able to bring back $1 trillion or more in profit at unusually low tax rates, and most families might see a modest tax cut that will put a few hundred extra bucks in their pockets.

Alternatively, Congress could pass tax cuts of more than $1.5 trillion if the Republicans could flip enough Democratic Senators to get to 60 votes. The Democrats would almost certainly demand large tax cuts for lower and middle earners, potentially lower taxes on corporations and higher taxes on the wealthy. Would you bet on that sort of compromise?

2017 Third Quarter Report

The last few years of a bull market are always a bit of a mystery to professional investors; the market rises faster than it did in the early, cautious years when nobody believed there WAS a bull market, even though there appear to be fewer fundamental or economic reasons for it. The current bull market churns on, even if nobody can explain it, and people who bail out in anticipation of a downturn do so at the risk of missing out on an untold number of months or years of (still somewhat inexplicable) gains.

A breakdown shows that just about everything gained at least modestly in value these last three months. The Wilshire 5000 Total Market Index—the broadest measure of U.S. stocks—rose 4.59% for the most recent quarter, finishing the first three fourths of the year up 13.72%.

Looking at large cap stocks, the Wilshire U.S. Large Cap index gained 4.50% in the third quarter, to stand at a 14.19% gain so far, this year. The widely-quoted S&P 500 index of large company stocks gained 3.96% for the quarter and is up 12.53% in calendar 2017.

As measured by the Wilshire U.S. Small-Cap index, investors in smaller companies posted a 5.39% gain over the third three months of the year, to stand at a 9.55% return for 2017 so far. The technology-heavy Nasdaq Composite Index rose 5.79% for the quarter and is up 20.67% in the first three quarters of the year.

As nice as the returns have been domestically, international stocks this year have been even kinder to investment portfolios. The broad-based EAFE index of companies in developed foreign economies gained 4.81% in the recent quarter, and is now up 17.21% in dollar terms for the first nine months of calendar 2017. In aggregate, European stocks have gone up 19.87% so far, this year, while EAFE's Far East Index has gained 12.31%. Emerging market stocks of less developed countries, as represented by the EAFE EM index, rose 7.02% in the third quarter, giving these very small components of most investment portfolios a remarkable 25.45% gain for the year so far.

Looking over the other investment categories, real estate, as measured by the Wilshire U.S. REIT index, posted a meager 0.61% gain during the year's third quarter, and is now up 2.44% for the year so far. The S&P GSCI index, which measures commodities returns, gained 7.22% for the quarter but is still down 3.76% for the year. By far the biggest component is the ever-unpredictable price of oil. Since the bottom on February 11, 2016, crude oil prices have risen by 50%, but the trajectory has been choppy and unpredictable.

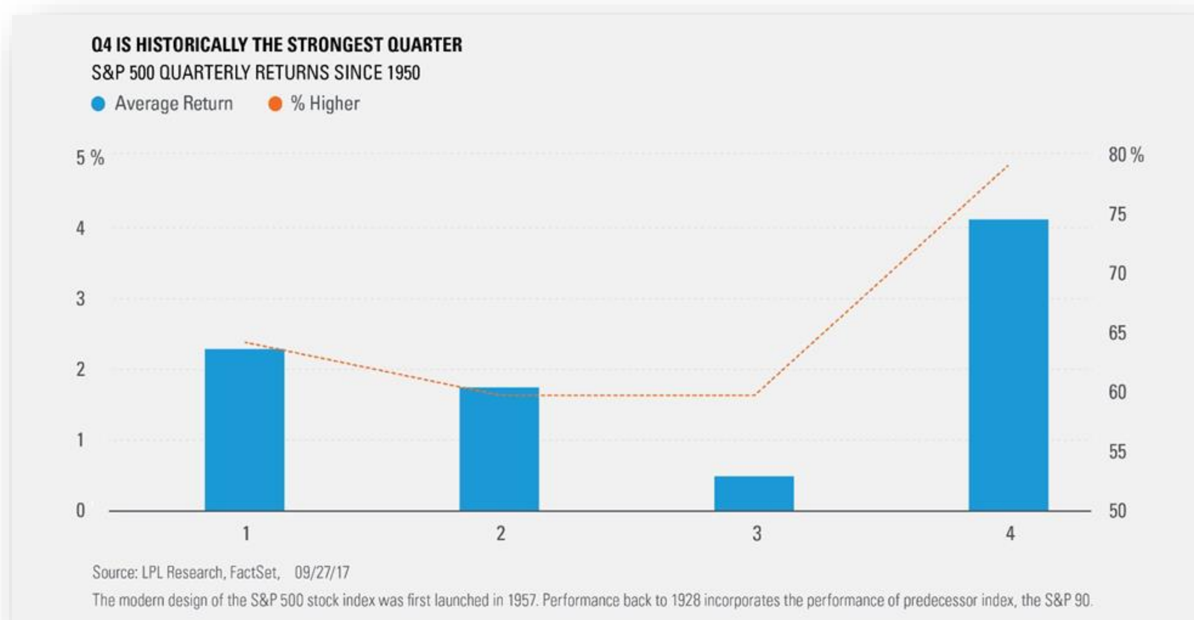
In the bond markets, you know the story: coupon rates on 10-year Treasury bonds have risen incrementally from 2.30% at this point three months ago to a roaring 2.33%, while 30-year government bond yields have also risen incrementally, from 2.83% to 2.86%.

One might imagine that the uncertainties around government policy and fundamental economic issues (failed attempts to repeal the Affordable Care Act and a new promise to write a new tax code, for example) would spook investors, and if those weren't scary enough, there's the nuclear sabre rattling sound coming from North Korea. Hurricanes have disrupted economic activity in Houston and large swaths of Florida, while Puerto Rico lies in ruins. Yet the bull market sails on unperturbed.

How can this be? Because if you look past the headlines, the underlying fundamentals of our economy are still remarkably solid this deep into our long, slow economic expansion. Corporations reported a better-than-expected second quarter earnings season, with adjusted pretax profits reaching an annualized $2.12 trillion—which means that American business is still on sound footing. Unemployment continues to trend slowly downward and wages even more slowly upward. The economy as a whole grew at a 3.1% annualized rate in the second quarter, which is at least a percentage point higher than the recent averages and marks the fastest quarterly growth in two years. There is hope that the new tax package will prove as business-friendly as the Trump Administration is promising.

Economists tell us that the multiple whack of hurricane damage will slow down economic growth figures for the third quarter, although the building boom fueled by the destruction will mitigate that somewhat. There are no economic indicators that would signal a recession on the near horizon, and one of the potential panic triggers—a Federal Reserve Board decision to recklessly raise interest rates—seems unlikely given the Fed's extremely cautious approach so far.

Meanwhile, as you can see from the accompanying chart, fourth quarters have historically been kind to investors—much kinder than third quarters.



There are still potential speed-bumps down the road. The Trump Administration has threatened multiple trade wars with America's major trading partners: the NAFTA members Canada and Mexico, and with China. Tight immigration rules could lead to limited labor supplies.

But it's hard to be pessimistic when your portfolio seems to grow incrementally every quarter. The current 12-year stretch of economic growth below 3% a year is America's longest on record. But if the U.S. charts a prudent economic course, it's possible that the current expansion could at least set new records for longevity. This current expansion just turned 99 months old. The all-time record is 120 months, from 1991 to 2001. We may have to wait two more years for the next great buying opportunity in U.S. stocks.

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The Staff at Demming Financial Services Corp. wishes you a safe and happy Holiday Season!