# Advisory Notes

June 2018


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## Second Quarter in Review

The second quarter equity markets have been riding a roller coaster of ebbs and flows of political jousting with our trading partners. The equity markets have remained positive on the heels of good earnings and future tax cuts, but the rise in short-term rates had a negative effect on the bond markets (see Market Table).

We are in the midst of the second longest economic expansion in U.S. history, albeit it has been the weakest as well, meaning many excesses that are normally built in fast expansions are not present yet in this expansion.

Currently, we have many tail winds in the overall markets to continue this expansion. Retail sales have been improving in 2018 through actions which build consumer confidence. Small business confidence remains high for now, as capital spending is rising over the next six months. Head winds that could slow growth is the rising interest rate environment at the Fed. Rates are still reasonably low for long-term rates, but off the bottom of the past recession lows. Inflation remains modest and wage pressures have filtered into the employment cost index at a modest rate.

Trade wars… More bark than bite? Protectionism and fair trade come into play in both head winds and tail winds. Short-term tariffs would provide short-term shocks to our exporters and long-term fair trade practices would benefit our companies for years to come. The shot gun approach hopefully is all bark and individual trade agreements should have some bite to them.

We hope you enjoy your summer of 2018 and, as always, we will manage your portfolios to meet your individual goals.

Joseph M. Valicenti
*President/CEO*

## Market Table

**Valicenti Advisory Services, Inc.**
**Comparative Index Period Returns**
**From 03-31-18 THROUGH 06-30-18**

| | DJIA | S&P 500 | NASDAQ | Russell 2000 Index | Lehman Muni Bond Index | Citi Corp Corporate Bond Index | U.S. Treasury Bill Index (90 day) |
|---|---|---|---|---|---|---|---|
| 03-31-18 to 04-30-18 | 0.34 | 0.38 | 0.04 | 0.81 | -0.39 | -0.91 | 0.13 |
| 04-30-18 to 05-31-18 | 1.41 | 2.41 | 5.32 | 5.95 | 1.25 | 0.63 | 0.16 |
| 05-31-18 to 06-30-18 | -0.49 | 0.62 | 0.92 | 0.58 | 0.09 | -0.72 | 0.13 |
| Cumulative Returns 03-31-18 to 06-30-18 | 1.26 | 3.43 | 6.33 | 7.43 | 0.95 | -1.00 | 0.41 |
| YTD Returns 12-31-17 to 06-30-18 | -0.73 | 2.65 | 8.79 | 7.00 | -0.27 | -3.24 | 0.79 |

## Director's Chair

First Half Review: Volatility made a significant comeback for the first six months of 2018 that could be seen in two mini 10% corrections causing the market to bottom on February 9 and to a lesser extent on April 2. By some measures, 2017 was the least volatile year since the VIX volatility gauge was invented in 1990. It was also a year that shrugged off the North Korean nuclear missile threat, a possible presidential impeachment and the failure to move forward the Republican agenda through the first eleven months in power. What has brought about instability in the market this year? To a lesser extent, higher interest rates have detracted from stock market returns, as fixed income securities such as the 10-year Treasury bond now yield 2.83% versus 2.23% a year ago, providing an alternative to income hungry investors who hid in dividend paying stocks during the aftermath of the Great Recession. A larger headwind is fear of trade wars as the administration has made good on campaign promises to use tariffs against our trading partners in an effort to renegotiate existing trade agreements. Canada, Mexico, China and the European Union impose tariffs well in excess of what the United States imposes for a multitude of goods to protect their domestic manufacturers. Possible trade wars hurt equity markets from fears of higher raw material costs that American producers would face if cheaper foreign sources were tariffed, leading to lower corporate earnings. Also, decreased demand for American exports could appear if our trade partners retaliate, leading to a global slowdown.

The first half has also brought us continued stock market returns with the market up 2.7% total return. The administration's efforts to reduce federal regulations eliminating 15% of Federal Rules in 2017 and the Republican Congress' use of power under the Congressional Review Act to invalidate new regulations enacted in the waning days of the prior administration, coupled with the Tax Reform Act of 2017, turbocharged total returns last year to an impressive 21.8% and continues to provide tailwinds thus far through this year. These efforts have provided gross domestic product growth that is eclipsing the sub-2% annual growth of the prior administration, as the Industrial Productivity Index recently hit an all-time high of 107.3 while the Capacity Utilization reading of 78 (with the exception of a brief period in 2014) is comparable to pre-Great Recession, 1990's and 1980's growth levels. Other signs of economic growth can be seen in the JOLT's (Job Opening and Labor Turnover) survey, which shows the number of job openings hitting new highs and also exceeding the number of available Americans looking for employment, coupled with new lows in layoffs and individuals quitting their current jobs for higher paying employment, nearing the previous all-time high from 1999.

Stronger industrial growth should eventually translate into stronger consumer wages as the Employment Cost Index, which measures wages and benefits, continues to inflect upward showing growth in a 2.5%-3% range.

What kind of ending will 2018 have? In the 2007 Steven King based horror movie *1408*, John Cusack plays an author who debunks supernatural occurrences. The worldwide movie release features a happy ending after Cusack's character confronts real "ghostly forces" and survives a fire he sets. If 2018 tailwinds from higher share buybacks and capital spending from corporations continue, coupled with stocks trading at cheaper multiples than they did at year-end 2017, then much like *1408*, we will have a decent first half that leads to a happy ending. However, if a true trade war, not the current squabbles the U.S. has had with Canada and the E.U., and/or overaggressive interest rate hikes from the Federal Reserve materialize, it will lead to the original version of the film, which was changed for being a downer. In the U.K. and Australian (original) release of *1408*, Cusack's character does not have a happy ending at all. Which ending the markets will have depends on, which "forces" are stronger, share buybacks and capital spending or interest rate hikes and slowdown in global trade.

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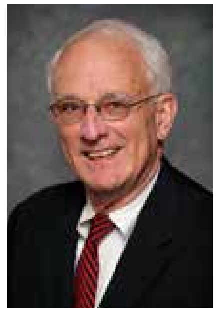
Louis F. Ruize
*Director of Research/Portfolio Manager*

## The Meaning of Bond Ratings



Bond ratings is the method by which the possibility of default by a bond issuer is evaluated. There are three main bond rating agencies: Fitch Ratings, Moody's Investors Services and Standard & Poor's that analyze the financial strength of each bond issuer, be it a corporation or a government body.

The following chart shows the ratings issued by each of these rating agencies:

| LEADING BOND RATING SERVICES | | | |
|---|---|---|---|
| | RATING SERVICE | | |
| Explanation of corporate/ municipal bond ratings | *Fitch* | *Moody's* | *Standard & Poor's* |
| Highest quality, "gilt edged"<br>High quality<br>Upper medium grade | AAA<br>AA<br>A | Aaa<br>Aa<br>A | AAA<br>AA<br>A |
| Medium grade<br>Predominantly speculative<br>Speculative, low grade | BBB<br>BB<br>B | Baa<br>Ba<br>B | BBB<br>BB<br>B |
| Poor to default<br>Highest speculation<br>Lowest quality, no interest | CCC<br>CC<br>C | Caa<br>Ca<br>C | CCC<br>CC<br>C |
| In default, in arrears,<br>questionable value | DDD<br>DD<br>D | | DDD<br>DD<br>D |

Fitch and Standard & Poor's may use + or – to modify some ratings. Moody's uses the numerical modifiers 1 (highest), 2 and 3 in the range from As1 through Ca3.

Higher rated bonds have a lower risk of default, but generally have lower yields, whereas, lower rated bonds have a higher yield depending on the risk tolerance. Bond ratings can help in finding bonds with no chance of default. If there is a need for a little more risk, these ratings can help construct a fixed income portfolio with an appropriate amount of risk.

Ralph H. Roberts, Jr.
*Vice President of Client Services*

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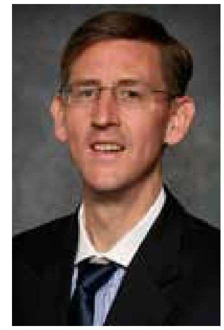
## Investment Strategy



The first half of 2018 has seen the U.S. equity markets and economy continue to forge ahead, despite a pickup in market volatility both at home and abroad. While head winds persist from areas such as the concern of further rate increases by the Federal Reserve, trade tariffs and geopolitical issues to name a few, we remain optimistic that calmer heads will prevail.

In the face of the head winds, there remain pockets of strength helping the U.S. economy and markets to climb the wall of worry. These areas range from continued strength in consumer confidence, improved business confidence, increased capital spending, and the U.S. labor market continuing to show strength.

With the second quarter earnings season just a few weeks away, we remain optimistic and focus on larger U.S. companies that continue to show positive earnings growth and improving balance sheets along with good cash flow. Our asset mix will vary based on client income needs, specific directives and risk levels. As such, our asset mix is flexible, with 25-35% in fixed income, 40-65% in equities and 5-15% in money markets.

Jeffrey S. Naylor
*Executive Vice President/CFO*

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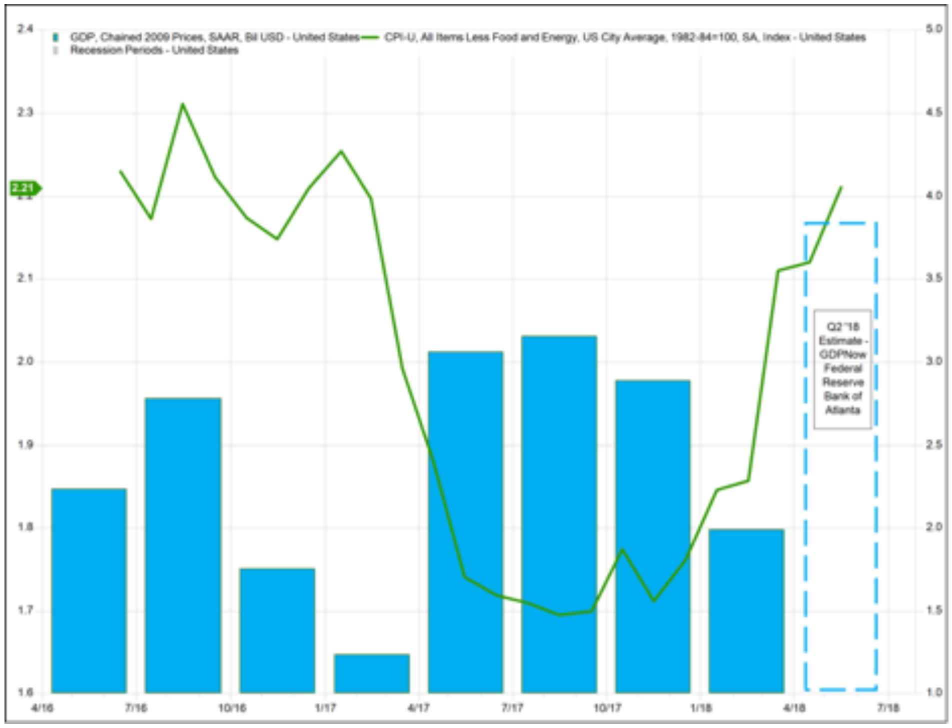
## Analyst Corner

After the first quarter (Q1) market price action resembled that of a roller coaster, the second quarter (Q2) equity markets delivered more of a linear equity uptrend. Inflation measures came in just a bit weaker than consensus expectations and some housing data mid-quarter turned in weaker results as well. This indicated that certain sectors have a limit to how quick and fast higher rates can be absorbed before growth is impeded. This served to temper forward rate expectations to some degree, which stabilized markets. From mid-May onward, the market narrative has been one of largely contained inflation combined with stronger growth which typically is a positive backdrop for risk assets. The S&P 500 in total returned 3.4% through the quarter and has returned 2.6% for the year. The bond market on the other hand stabilized in Q2, but it still is operating at a slight loss year-to-date. The Barclays U.S. Aggregate Corporate Credit Index was down nearly -1% through the quarter and is down -3.3% in 2018.

Market returns continue to be driven by pro-cyclical and innovative areas of the market, while the Energy sector participated as a turnaround sector and strong leader this quarter amid higher oil prices after the Trump administration withdrew from the Iran deal. Energy was up 12.7% quarter-to-date, followed by the Consumer Discretionary space up 7.8% and Information Technology up 6.8%. The lagging sectors for the quarter are Industrials down -3.7%, Financials down -3.6%, Consumer Staples down -2.3%, and Telecommunication Services down -2.3%, as the more defensive sectors are less favored amid robust growth.

Current market symmetry is generally balanced and the current uptrend for equities is intact. Late in the quarter, the slightly hawkish tone coming out of June's Federal Open Market Committee (FOMC) meeting and overall continued tightening posture, combined with trade retaliatory actions by China, softened the strength recently observed in markets.

| Positive Market Influences | Negative Market Influences |
|---|---|
| U.S. Real Gross Domestic Product (GDP) | Tariff and Trade Concerns |
| Target Level Inflation | June FOMC |






### Positive Market Influences:

- **U.S. Real GDP** – GDP is off to a good start in 2018 with Q1 GDP coming in at 2.2% and Q2 GDP currently estimated to be well north of 3%.
- **Target Level Inflation** – Core Consumer Price Index is manageable and running around 2.2% year-over-year as of May's reading and the Core Personal Consumption Expenditures Price Index, which is more a focus for the Fed, is running very near the target rate of 2% year-over-year.

### Negative Market Influences:

- **Tariff and Trade Concerns** – Following a 25% tariff applied to $50B on certain Chinese goods, the country is signaling it will retaliate with tariffs of its own applied to U.S. goods. Similar trade tensions relating to renegotiations with the North American Free Trade Agreement partners and with Europe remain sticky points for markets.
- **June FOMC** – Further tightening on the part of the Fed is being priced into the market and investors have digested a realization that there is an increase in the likelihood that there will be a total of four rate hike increases this year with the further possibility of repeating that trajectory in 2019.

Daniel P. Burchill
*Security Analyst*

## IRS Response to State Tax Workarounds

The IRS intends to propose regulations addressing the federal income tax treatment of certain payments made by taxpayers for which taxpayers receive a credit against their state and local taxes. "The Tax Cuts and Jobs Act" limits an individual's deduction under section 164 for the aggregate amount of state and local taxes paid during the calendar year to $10,000 ($5,000 in the case of a married individual filing a separate return). State and local tax payments in excess of those amounts are not deductible. This new limitation applies to taxable years beginning after December 31, 2017 and before January 1, 2026.

In response to this new limitation, some state legislatures are considering or have adopted legislative proposals that would allow taxpayers to make transfers to funds controlled by state or local governments, or other transferees specified by the state, in exchange for credits against the state or local taxes that the taxpayer is required to pay. The aim of these proposals is to allow taxpayers to characterize such transfers as fully deductible charitable contributions for federal income tax purposes, while using the same transfers to satisfy state or local tax liabilities.

Despite these state efforts to circumvent the new statutory limitation on state and local tax deductions, taxpayers should be mindful that federal law controls the proper characterization of payments for federal income tax purposes.

The Treasury Department and the IRS intend to propose regulations addressing the federal income tax treatment of transfers to funds controlled by state and local governments (or other state-specified transferees) that the transferor can treat in whole or in part as satisfying state and local tax obligations. The proposed regulations will make clear that the requirements of the Internal Revenue Code, informed by substance over form principles, govern the federal income tax treatment of such transfers. The proposed regulations will assist taxpayers in understanding the relationship between the federal charitable contribution deduction and the new statutory limitation on the deduction for state and local tax payments.

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Paul E. Hornbuckle, CPA
*Vice President of Tax and Business Services*

## Kiddie Tax - New Tax Law Changes

The kiddie tax is a special tax rate generally applied to children under the age of 19 (24 if a full-time student) who have unearned income in excess of $2,100. Unearned income includes interest, dividends or investment income.

Under the prior law, the unearned income is taxed at the parents' tax rate if the parents' tax rate is higher than the child's tax rate. Starting in 2018, the unearned income in excess of $2,100 will be taxed according to the tax brackets that apply to trusts and estates. Those 2018 tax brackets are as follows: up to $2,550 - 10%; $2,550 to $9,150 - 24%; $9,150 to $12,500 - 35%; over $12,500 - 37%. This provision expires after 2025.

Depending on the amount of income subject to the kiddie tax and the parents' tax bracket, the new rules may or may not benefit the taxpayer. For example, if the child's unearned income is over $12,500, under the new rules it will be taxed at 37%. If the parents' tax bracket is 24% (new tax rate schedule), the child taxpayer would be paying more in tax under the new rules. If the child's unearned income is $2,500 and the parents' tax bracket is 24%, the child taxpayer would be paying less in tax under the new rules. Every situation is different.

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Elizabeth A. Zarnoch, EA
*Tax and Accounting Manager*

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## A Few Tips for the College Bound

College is costly enough without the added cost of unexpected accidents or theft, not covered by your insurance policy. If you have a student heading away to school, below are a few tips to help you get the most out of your coverage.

**HOMEOWNERS (varies by state)**

- Personal Property: Most homeowners policies will cover personal property for up to 10% of your total policy while your child is residing at school (a $100,000 policy equals $10,000 in coverage). Not all types of damage are covered, so read your policy carefully. Some items such as jewelry or expensive electronics require special coverage. Renters insurance is strongly recommended, if your child resides off campus.
- Liability Coverage: General damage to a dorm room or apartment is not usually covered.
- Documentation: Creating an inventory of the items your child is taking to school is a good idea. Use photographs and keep receipts.

**AUTO (varies by state)**

- Car Stays Home: Keep your child listed on your auto policy if he/she will drive your car while at home during school breaks.
- Car at School: Make sure to notify us if your child will be taking a car to school. In most cases, if the car is registered to you and listed on your policy, it will be covered.
- Driving a Friend's Car: Students are generally covered if they are listed on their parent's policy and are not regularly using the vehicle. The coverage would be secondary. The insurance for the friend's vehicle would be the primary coverage.
- Discounts: A full-time student meeting certain academic requirements can qualify for a good student discount. Distant student discounts may also be available. Drivers under 21 who have completed driver's education may also receive a discount.

Before your child leaves for school, call Valicenti Insurance Services, Inc., at (607) 215-0242 or send us an email at info@valicentiins.com. We can walk you through the steps to ensure you have the right coverage. We're here to help!

Suzanne M. Valicenti
*President/CEO*

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Valicenti Insurance Services, Inc.

## For ALL Your Insurance Needs

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- Recreational Vehicles
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- Watercraft

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- Automobile
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- Life Insurance
- Disability Insurance
- Customized Benefit Insurance

*The mission of Valicenti Insurance Services, Inc. is to provide personalized insurance products and services with unparalleled customer service to protect the assets of individuals, families and businesses that we serve.*

## What is a Power of Attorney?

A power of attorney (POA) is a legal document that lets you appoint someone to handle financial and legal matters on your behalf. The person authorizing the other to act on his/her behalf is referred to as the principal, grantor or donor. The person authorized to act is the agent or attorney-in-fact. With a power of attorney, the person you appoint will be legally permitted to take care of important matters for you, including paying your bills and managing your investments, if you are unable to do so. A durable power of attorney (DPOA) serves the same function as a power of attorney; however, a durable power of attorney is effective even if you become incapacitated.

### DIFFERENT TYPES OF POA'S

**General Power of Attorney**

A general power of attorney gives broad powers to a person or organization (known as an agent or attorney-in-fact) to act on your behalf. These powers include handling financial and business transactions, settling claims, operating business interests, buying life insurance, making gifts and employing professional help, if needed. A general power of attorney is an effective tool if you need someone to handle certain matters or if you will be out of the country. A general power of attorney is often included in an estate plan to make sure someone can handle financial matters.

**Special Power of Attorney**

You can specify what powers an agent may exercise by signing a special power of attorney. This is often used when one cannot handle certain affairs due to health reasons or other commitments. Selling property, managing real estate, handling business transactions and collecting debts are some of the common matters specified in a special power of attorney document.

**Health Care Power of Attorney**

This document clearly outlines your preferences for the person who will act as your healthcare agent in the event that you are not able to make your own medical care decisions. You will appoint someone to the role of healthcare agent, allowing this person to make decisions on your behalf, to access your medical records as needed and to help enforce your wishes as outlined in your advance directive. This form makes a legal contract between you and your designated agent and allows one to act on your behalf.

**Durable Power of Attorney**

This is simply a general, special or health care POA that has a durability provision to keep the current power of attorney in effect. You might also sign a durable power of attorney to prepare for the possibility that you may become mentally incompetent due to illness or injury. Specify in the power of attorney that it cannot go into effect until a doctor certifies that you are mentally incompetent. You may name a specific licensed doctor who you wish to determine your competency or you may require that two licensed physicians agree on your mental state.

Who should have a POA? Everyone who is 18 or older should consider having a POA. It can be updated throughout your life when things change. A POA is automatically revoked at death.

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Melissa B. Mickley, FPQP®
*Administrative and Marketing Assistant*

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***Our Clients Come First***

## Contributions to a Roth IRA

Being eligible for a Roth IRA has nothing to do with whether you already have an employer's retirement plan such as a 401(k). In order to contribute to a Roth IRA, your income must be under a certain amount. If you are married and file a joint tax return, your adjusted gross income (AGI) must be $189,000 or less to make the maximum Roth IRA contribution, which for 2018 is $5,500 if you are under 50 or $6,500 if you are 50 or older. If your AGI is greater than $189,000, but less than $199,000, you may be able to make a partial Roth contribution. If your AGI is $199,000 or higher, you cannot contribute to a Roth IRA at all.

If your tax filing status is single, head of household or married filing separately and you did not live with your spouse, the thresholds are $120,000 for a full contribution and $135,000 for the complete phaseout. If you are married filing separately and you lived with your spouse at any point during the year, the thresholds drop to $0 and $10,000.

There may be tax consequences, so you should consult with your tax and/or your investment advisor before making a decision.

Melissa B. Mickley, FPQP®
*Administrative and Marketing Assistant*

## Buying Your First Home

The thrill of buying your first home is tempered by how you are going to finance it. Unless you have substantial liquid assets, more than likely you will need a mortgage, but you may also want to consider borrowing from an IRA or a Roth IRA.

In an effort to set the record straight, first time homebuyers can withdraw money from an IRA at any time, but you should understand what the IRS will allow without your paying the 10% early withdrawal penalty. The IRS defines a first time homebuyer as someone who has not owned a principal residence within the last two years. For first time homebuyers, there is an exemption of $10,000 penalty free withdrawal per individual and if you are married and your spouse also has a traditional IRA, he/she can take out $10,000 also. The withdrawals *will* be considered taxable income.

If you have Roth IRA(s), you can always withdraw your contributions tax and penalty free. You can withdraw up to $10,000 of your earnings under the first time home buyer exemption and they will be tax free, if your account(s) have been open more than five years.

Generally speaking, IRA withdrawals are not recommended.

Ralph H. Roberts, Jr.
*Vice President of Client Services*

## FYI - Invesco Acquired Guggenheim's ETF Business

In April 2018, Invesco expanded its ability to meet client needs by completing its acquisition of Guggenheim Investments' ETF business and retired the PowerShares brand. The acquisition strengthens Invesco's market-leading ETF capabilities as well as the firm's efforts to meet the needs of institutional and retail clients in the U.S. and across the globe, which will contribute further to the growth and long-term success of the business. All PowerShares funds will now be known as Invesco ETFs in order to strengthen brand recognition.

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