FERGUSONJOHNSON
WEALTH MANAGEMENT

July 12, 2019

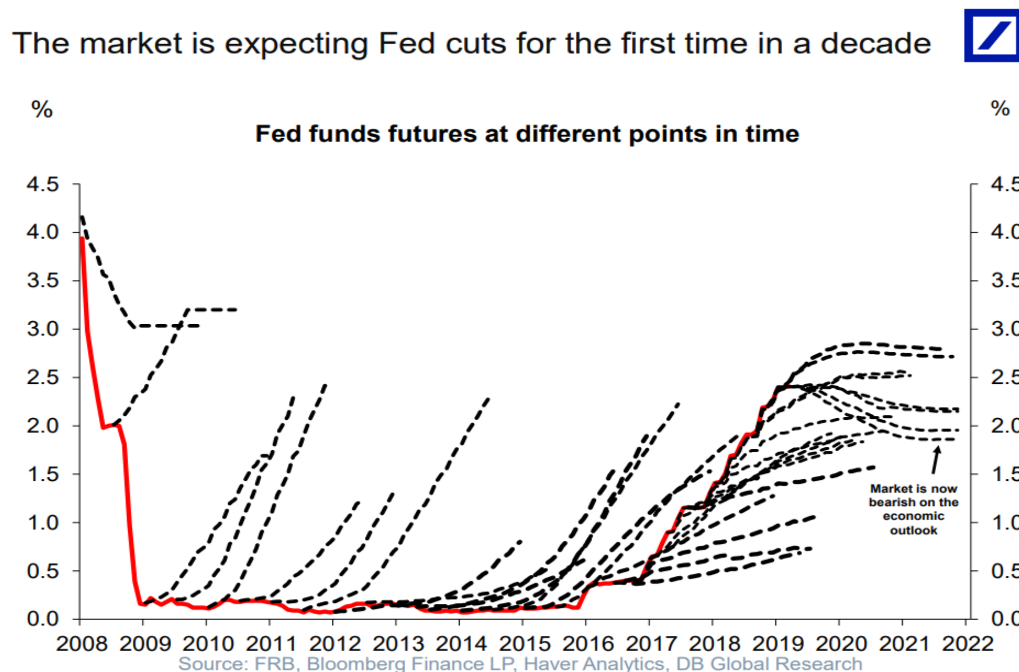
Untangling Interest Rates & Legislation

Q2 2019 was one of those particularly unremarkable quarters in the investing world (in a good way!). Markets went down a little bit, then they recovered and posted modest gains for the quarter. Headlines oscillated between impending doom from trade worries to relaxation from trade breakthroughs. There were concerns over the direction of interest rates, then there was some exuberance from news indicating potential rate cuts. In one particularly nonsensical day in the markets on June 7th, U.S. jobs numbers came in below expectations and markets rocketed *upward* at the news.

I've beaten the 'Headlines and financial news are a waste of time' drum in these commentaries a lot recently. So, I'll spare you the 400-or-so words about it and just say - Absolutely no one will remember or care about any of this in a few months.

In seriousness, I may be underselling the interest rate thing a little bit. There's a good chance that movements in interest rates in the coming weeks and months have the potential to drive markets (positively or negatively) quite a bit. In the short-term, markets have shown to react rather dramatically to The Federal Reserve's actions and guidance regarding interest rates. Here's the problem, no one knows what's going to happen with interest rates.

Below is a chart from Deutsche Bank that illustrates the actual federal funds rate (in red) and the economist consensus predictions for where interest rates are heading (dotted black lines).



Source: Deutsche Bank as of June 6, 2019.

They're basically always wrong! Through most of the last decade, people were *sure* that rates were going to rise – they didn't for almost eight years. At the beginning of this year, people were *sure* that rates were going to rise more after rate hikes in 2018 – they fell. Today, people are *sure* that rates will fall a little bit. The traders and money managers that use these forecasts to make investment decisions for themselves and clients are playing a fool's game.

As it turns out, maintaining broad diversification with rules-based, periodic rebalancing continues to be a very effective way to invest for most of our clients.

Legislation

A few weeks ago, the U.S. House passed a bill that would tweak how IRA distributions would operate called the SECURE Act of 2019. The bill comprises a number of new rules and changes that govern tax-deferred investment accounts. But, there are two parts to the legislation that stand out as of material importance to many of our clients:

1) Required Minimum Distributions would be delayed to age 72. Currently, required distributions must begin for the year an individual turns 70 ½. Obviously, the new change would be desirable as it would allow retirees to stave off unnecessary withdrawals and taxes a year or two longer. Clients and advisors, rejoice!

   But wait - Delaying RMDs for retirees that intend to pass on sizable IRA balances to their children may end up being a double-edged sword because of the second aspect of the proposed legislation:

2) Accelerated disposition of inherited IRAs. Currently, when a non-spouse beneficiary inherits an IRA (most commonly children inheriting a deceased parent's IRA), the recipients can choose to take distributions from the IRA over the rest of their lives. In most cases, this allows the heirs to take modest distributions over several decades providing them with pleasant, extra income with limited tax liability.

   The new legislation would mandate that an inherited IRA be distributed in full over a 10-year period.

   This could create an extraordinary tax burden for middle-to-high earning heirs. For example, consider a couple living in Maryland earning $150,000/year that has just inherited an IRA worth $1,000,000. Next year, they would be required to take a distribution from the inherited account of about $100,000, which is added on top of their other income for that year. Between federal, state, and local taxes, they could expect to pay about $33,000 in tax on that distribution.
   I would imagine, most retirees wouldn't like the idea of one-third of the wealth they worked to accumulate ultimately getting directed toward the tax coffers.

We'll be keeping an eye on the progress of this legislation. Currently, the bill is under contentious review in the Senate. In the event that it gets signed into law, this may potentially have large implications on long-term and posthumous income planning for retirees.

Potential Legislation

While the SECURE Act is real legislation that may actually see the light of day, I can understand why most people haven't heard of it. Over the past month, we have been inundated with financial policy hypotheticals from democratic presidential hopefuls and from President Trump himself.

> Trump re-proposed the often Republican-championed idea of indexing capital gains to inflation. The theory goes that the purchasing power of an *initial* investment made a number of years ago is worth less today than when it was made. As such, an investor should not be assessed taxes on the portion of any gain that was eroded by inflation. In practice, this is logical and would certainly represent a boon to the investor class. However, it's pretty transparently a tax-break aimed exclusively for the wealthy. With income-inequality rising to ever greater levels coupled with burgeoning federal deficits, I'm not sure how palatable or feasible a tax cut of this manner would be.
>
> Bernie Sanders and Elizabeth Warren each unveiled plans for addressing the student debt crisis. Sanders' plan proposes a tax levied on investment transactions of 1% on stock trades and 0.1% on bond trades. It's unclear how items such as mutual funds and ETFs would be included in the proposal. Warren proposes a 2% "wealth tax" on households with net worth over $50 million. It's unclear how the government would go about identifying and valuing assets for this idea. It's easy to value a share of stock in an investment portfolio. Valuing a piece of real estate or a stake in a privately held business (items that constitute the majority of the wealth for the targets of the tax) isn't quite as straightforward. In both candidates' case, there hasn't been mention of addressing the spiraling cost of higher education and the culpability of students, parents, and the universities themselves.

I wouldn't put a lot of stock in any of these ideas at this stage. Other than as a topic to argue about with your family at the dinner table, we don't think there's much substance here.

Housekeeping

We've decided to undertake a review of the reports that we send to clients each quarter (the very ones accompanying this letter). The goal is to cut down on the bloat of the report and provide more readily understandable information about accounts and their performance. If you have input on things you like or don't like with how the reports currently look or the information they contain, please let us know. Ultimately, we want this to be a valuable tool for our clients and not something that gets thrown away or tossed into a stack of old newspapers!

Stay cool (and unflooded) this summer!

Investment advisory services offered through Ferguson-Johnson Wealth Management, a registered investment adviser.

This newsletter contains general information that may not be suitable for everyone. The information contained herein should not be construed as personalized investment advice. Past performance is no guarantee of future results. There is no guarantee that the views and opinions expressed in this newsletter will come to pass. Investing in the stock market involves gains and losses and may not be suitable for all investors. Information presented herein is subject to change without notice and should not be considered as a solicitation to buy or sell any security.

Indices are unmanaged and investors cannot invest directly in an index. Unless otherwise noted, performance of indices do not account for any fees, commissions or other expenses that would be incurred. Returns do not include reinvested dividends. The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. It is a market value weighted index with each stock's weight in the index proportionate to its market value.

Derek Johnson is an Investment Advisory Representative of Ferguson-Johnson Wealth Management, a values-based investment management firm located in Maryland. Derek Johnson can be reached at (301)670-0994 or djohnson@mymoneymanager.com