The Quarterly Perspective

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ABOUT

Harman Wealth Management

At Harman Wealth Management, we provide private, advanced, independent planning and investment management to individuals, families, and institutional clients.

We value in-depth economic research, evidence-based investment methods, and rigorous risk management. We are committed to insightful, objective solutions, and always working solely for the best interest of our clients.

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Tax Cuts Offer Market Assistance in 2018

Real effects from the Tax Cut and Jobs Act adding to the positive trend.

In spite of recent market volatility, the U.S. economy has started off 2018 with solid economic trends. With the passage of the Tax Cuts and Jobs Act (TCJA) effective for 2018, the market will receive added support as the year unfolds.

Here are three tangible examples where the TCJA will show a benefit in 2018.

Three Real Impacts of the Tax Cut and Jobs Act

1. LIFTING REAL WAGES.

Since the signing of the TCJA on December 22nd, there has been a litany of announcements for major companies increasing pay and granting spot bonuses.

The typical household of 4 (making $73,000) will save

$2,059

per year on their taxes.

There's more though. Beginning in February, most wage-earning Americans saw a downward adjustment to their federal income tax withholding amount. For a median household earning $73,000 per year, they are expected to keep an estimated $2,059 in 2018 (Source: House Ways and Means Committee).

2. IMPROVED EARNINGS GROWTH.

Prior to the TCJA, Wall Street analysts were already forecasting 2018 to be an attractive year of earnings growth. At the end of December, initial expectations stood at +11.6%. But since that time companies have had a chance to assess the impact of corporate tax cuts into their future numbers. The latest assessment from FactSet shows the updated corporate earnings estimates growing by +18.4% in 2018.

3. INCREASED GDP GROWTH.

Increased incomes? Higher earnings? Yes, it naturally leads to higher national consumption. By keeping more money in the hands of the private sector, the expectation is for a consumption boom.

Early estimates suggest an added effect to GDP growth by 0.2% to 0.8% on top of the already anticipated growth rate of 2.5%. Regardless of the final number, it is safe to assume that the TCJA will add resiliency to U.S. growth for now.

Source: [1]Factset, Earnings Insight, January 25, 2018.

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Maintaining Perspective When Markets Decline

Three Guiding Rules to Help Investors Avoid Mistakes in a Running Market

Too often, investors fall into the trap of "recency bias." This is where they consider their most recent experience to be what's normal, and they often stand unprepared for change.

After the unusual circumstances of 2017, the caution against recency bias has become highly relevant again. Why so? It is because the market climb through 2017 was so smooth and untested, that many investors have forgotten what normal market declines feel like.

Consider the following facts about the trend in 2017 (Source: Yahoo! Finance):

- By the end of 2017, the S&P 500 climbed for eighteen months without a -5% decline. This is the longest such streak on record.
- By the end of 2017, the S&P 500 index has produced positive "up" months in 21 of the prior 22 months.
- The S&P 500 index went the entire year of 2017 without a -3% decline.
- The S&P 500 index produced positive "up" months for every month for the full calendar year in 2017, the first time to do so since the index's inception in 1957.

SO, WHAT'S NORMAL?

After such a long stretch where markets were able to dodge any noticeable decline, it is important for investors to re-ground their expectations. Overreacting to a return of normal behavior can lead to counter-productive moves and unwarranted nerves. So, what should investors expect from market behavior when it comes to declines?

The chart below provides some helpful context for investors.

Four Types of Market Declines

Category	Frequency Expectations	Degree of loss	Length from Peak to Trough	Market Decline Facts
Day-to-day Fluctuations	Daily	Usually less than 1%	N/A	From 1950 – 2013 Up Days: 53.7% Down Days: 46.3%
Intermediate Pullbacks	2-3 times per year	-5% to -10%	1 – 2 months	June '16 – Jan. '18 saw the longest stretch without a -5% pullback
Market Corrections/ Market Shocks	Idiosyncratic. No cyclical repetition	-10% to -19%	1 – 3 months	6 corrections since 1990 3 corrections since last recession of 2008
Recessionary Declines	Once per decade since 1982	-17% to - 56%	6 – 24 months	3 Recessions since 1990; 7 Recessions since 1970

Source: Yahoo! Finance, NBER, Alphalytics Research

Sources: [2]BEA, [3]NBER

Five Reasons Inflation May Finally Arrive

Inflation has been historically low for this stage of the Business Cycle.

One of the most surprising attributes of the economic expansion since 2009 is how sustainably low inflation has remained. However, this phenomenon may be poised to end soon. Circumstances now appear to be reaching a critical pivot, moving inflation back in the upward direction. Here's why:

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TIGHT LABOR MARKET

The unemployment rate presently measures at a lowly 4.1% - the lowest in 19 years (Source: BLS). In fact, the unemployment rate has gone lower only twice in the last 60 years. When unemployment reaches such low levels, it is known as a tight labor market whereby employers have a tougher time attracting and retaining skilled workers. Higher pay usually follows.

ADDED WAGE PRESSURE

In addition to the tight supply of labor, individual states have initiated raising minimum wage laws in their respective states. At present, twenty-nine states have a minimum wage higher than the Federal minimum wage. Additionally, eighteen states acted to raise minimum wages in 2018 (Source: Economic Policy Institute).

RISING INTEREST RATES

The federal reserve usually raises interest rates to tamp down inflation when the economy runs hot. However, there is an overlooked consequence to higher rates – it raises the cost to borrow. For business seeking to expand or leaning on lines of credit, this added expense eventually finds its way into the prices of the goods and services they sell.

INCREASED DEMAND FOLLOWING THE TAX CUTS

While the tax cut is largely a welcomed gift to corporations and consumers, it comes at an odd time in the business cycle. Historically, tax cuts were treated as a way to stimulate an economy that was faltering. Under present conditions, though, this is an economy running strong. The added boost to consumers in 2018 can create an environment where retailers finally have the confidence to lift prices.

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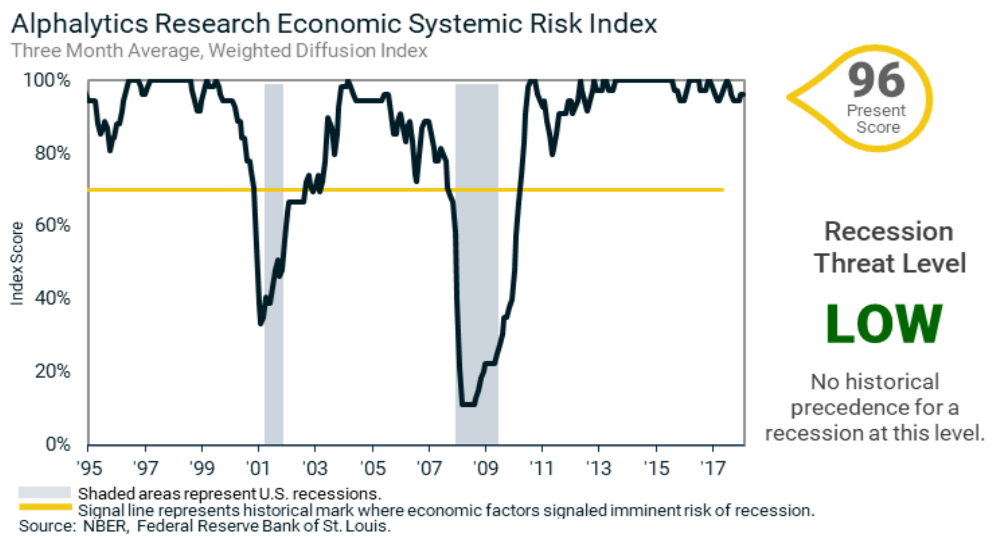
TRADE POLICY AND TARIFFS

A headline priority of the populist movement is restoring the competitiveness of U.S. workers. By all accounts, this is a high priority on the President's agenda and his administration is intent on action. Now, with the administration searching to improve American competitiveness on trade, one cannot deny that tariffs on imports are inflationary to the U.S. consumer. While still much remains to be worked out in the details of such trade maneuvers, tariffs are certainly an item to watch.

In spite of a wide collection of positive trends, the economy is marching into late-cycle dynamics.

Business Cycle Risk Profile

- The fourth quarter of 2017 ended with an acceleration in fundamentals. Corporate earnings finished with double digit growth at 10.1%. Manufacturing saw its best trend in several years, while cap-ex returned to growth after dipping into negative territory in 2016.
- U.S. housing continued its resiliency in 2017. Demand remains steady and supply remains modestly tight.
- The economy has reached "full employment" with the unemployment rate at 4.1%. Initial claims for unemployment insurance is at generational lows.
- In spite of a wide collection of positive trends, the economy is marching into late-cycle dynamics. Consumers are extending their use of credit. Labor is tight and wage inflation is on the horizon. Eighteen states implemented minimum wage increases in 2018.
- At its current level, the index value reflects no historical precedence for a recession.



Interpreting the Index Score:

- The index score measures nine economic factors that have demonstrated co-movement with the deteriorating conditions of the past seven recessions dating back to 1970.
- When the index score is at 100, it means all nine of the factors are measuring at levels consistent with past economic expansion.
- When the index score is below 100, it means that one or more of the weighted factors has moved to a level consistent with past economic contractions.
- In aggregate a score of 70 or higher is interpreted as a composite profile consistent with past economic expansion. A score lower than 70 is interpreted as a composite profile consistent with past economic contraction.
- Markets can, and sometimes do, demonstrate volatility even though the economic factors are measuring consistent with expansion.

Interested in Adaptive Business Cycle Investing?

Today's markets, economies, and policies are more complex than ever, challenging investors on what to watch and when to take action.

At Harman Wealth Management, we understand sound investments are uniquely supported by the conditions that favor them. And, when conditions change, so do the investments that benefit.

That's why we conduct rigorous and disciplined tracking of the U.S. business cycle. We also track the cyclical factors that shape our investing environment, like currencies, commodities, and rates. We embrace a world where investing dynamics are constantly evolving and believe it's imperative to have an investment strategy that adapts with it.

With Adaptive Business Cycle Investing we invest consistent with business cycle forces, aligning investments with the conditions driving returns in the present, rather than chasing what worked in the past.

About Harman Wealth Management

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We value in-depth economic research, evidence-based investment methods, and rigorous risk management. We are committed to integrative advanced planning by aligning investment objectives with business cycle opportunities and risks.

At Harman Wealth Management, our aim is to help clients realize their goals within a disciplined, insightful, and rewarding relationship.

For more information about Harman Wealth Management or investing with the business cycle, contact us at 281-719-8601.

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In general, the bond market is volatile as prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. Bonds are also subject to other types of risks such as call, credit, liquidity, interest rate, and general market risks.

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