FineMark National Bank & Trust

Fine Points

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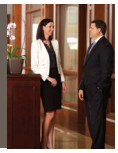
IN THIS ISSUE:



SECOND QUARTER REVIEW & COMMENTARY

By Christopher Battifarano, CFA®, CAIA
Executive Vice President & Chief Investment Officer

Now that we've reached the mid-point of the year, it's a good time to look back at the economic forecasts we made at the beginning of the year and revisit how we expect the rest of the year and beyond to play out. In January, our expectations for 2018 included a measured outlook for equities, including higher volatility, and a downright dour forecast for fixed income returns. These views have largely come to fruition. US equities, as measured by the S&P 500, are up 2.65% through June, as a second-quarter rally regained some of the ground that was lost in the first quarter. Bonds have largely suffered during the year as the Federal Reserve has maintained its steady pace of rate normalization. (Recall that rising rates negatively impact the value of existing fixed-rate debt.) The Bloomberg Barclays US Aggregate Bond Index is down 1.62% so far in 2018. Market volatility, as measured by the CBOE Volatility Index, has increased 45% so far in 2018. While this may seem like an extreme jump, remember that this simply reflects a return from 2017's historically low levels to more normal levels of volatility.

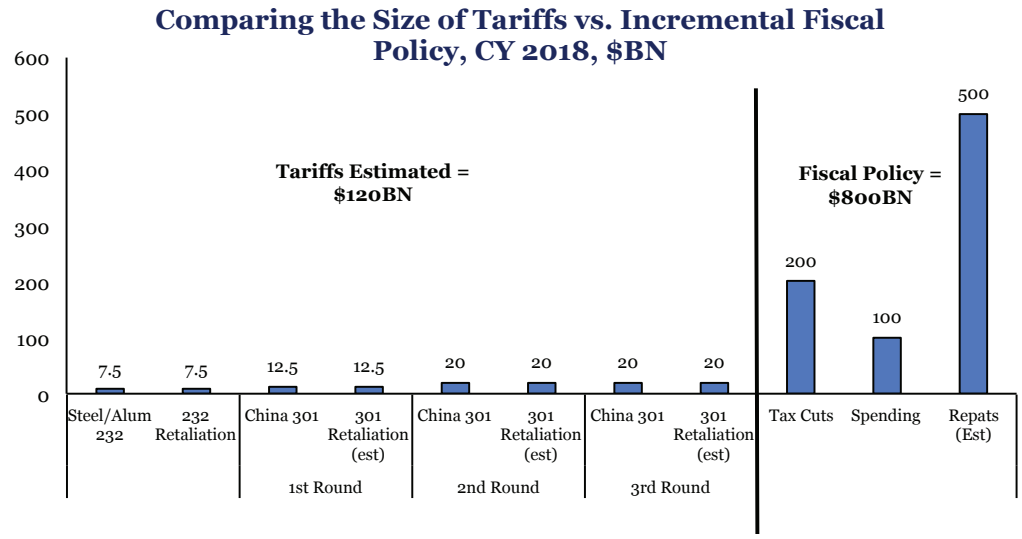
Q2 2018 Returns	
S&P 500	3.43%
Russell 2000	7.75%
MSCI EAFE	-1.24%
MSCI EM	-7.96%
Barclays US Aggregate	-0.16%
Barclays US 5-year Municipals	0.87%
HFRX Equity Hedge	-0.94%
Barclays BTOP 50	-1.05%
HFRX Global Hedge	0.17%

ABOUT THAT "TRADE WAR"

One item that we wrote about extensively in our Q1 letter and that continues to dominate daily headlines is the "trade war" between the US and its trading partners. While our views on trade policy haven't changed since last quarter, we'd be remiss to publish a market commentary without at least a passing mention of the situation.

(continued)

Figure 1



Source: Strategas Securities

As Figure 1 illustrates, the total size of the trade tariffs—those imposed by the Trump administration combined with retribution from America's trading partners—pales in comparison to the fiscal stimulus that was passed into law last December. This critical detail is often overlooked by market pundits.

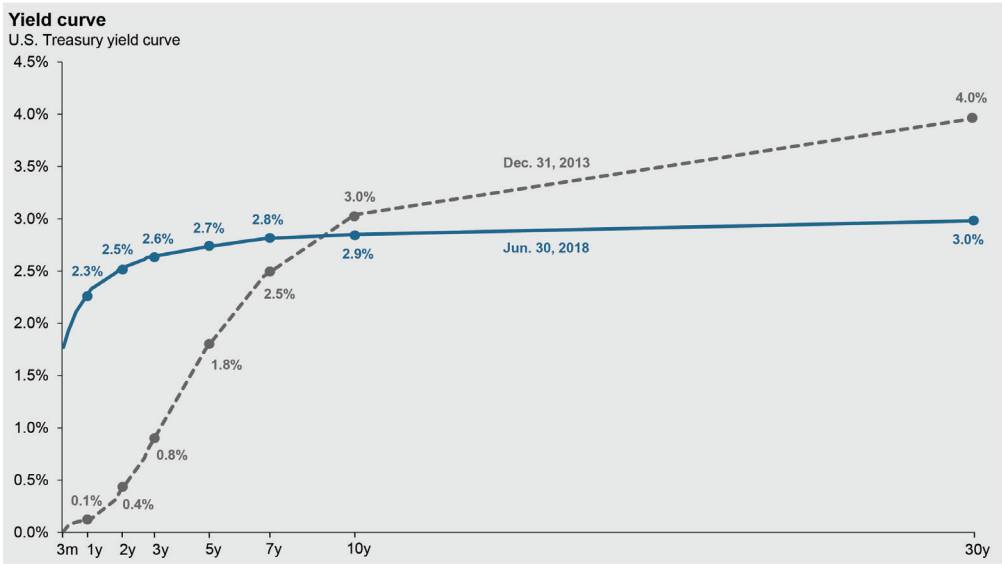
Global markets clearly dislike the Trump administration's approach to trade policy, but market values do not reflect the perceived negative impact of the tariffs on economic growth on this matter. This is largely because many market participants believe that the current rhetoric is more bluster than a deeply held conviction that the White House will adhere to these policies as they lose popularity. If the Trump administration more convincingly communicates its commitment to tariffs, however, we believe that the result will be continued price volatility with a downward bias on equity prices.

Looking beyond the near-term rhetoric, we don't believe that the Trump administration favors an economic system of nationalism and a permanent restriction of free trade. Instead, we believe that the administration is trying to renegotiate trade agreements and use America's hegemony as leverage to strike more favorable terms. We believe that this administration—despite its rhetoric and actions thus far to the contrary—fundamentally supports trade policies that are rooted in the theory that free enterprise, not governments, are the best allocators of capital. We believe that President Trump's freewheeling communication style and bombastic, unconventional approach to negotiating cause many to misinterpret his philosophy of economics.

We don't make these distinctions to endorse one political party or the other. Rather, our goal is to clarify where we believe the current administration stands on economic views as it informs our actions for allocating our clients' capital. If we are incorrect—and Trump in fact is a neo-mercantilist—then the outlook for the US and global economies should be significantly dimmer. These types of protectionist policies, such as the Smoot Hawley Tariffs Act, were tried and failed in the 1930s during the Great Depression. They deepened the depth of economic misery the US suffered during this dark period.

INTEREST RATES AND INVERSION FEARS

Figure 2



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of June 30, 2018.

Interest rates, and specifically the slope of the yield curve, are other areas about which many investors are currently worried. As a reminder, a normal yield curve slopes upward, with lenders receiving higher interest rates on longer-term obligations than on shorter-term ones. This dynamic represents the fact that longer-term obligations are inherently riskier.

Since 2013, the yield curve has flattened considerably, as short-term rates have risen faster than long-term rates. As the spread

between long- and short-term rates narrows, the risk that the yield curve inverts (i.e., long-term rates become lower than short-term rates) increases. Historically, inverted curves have been a dependable harbinger of economic recession. Why? An inverted curve develops when the market expects future economic weakness, and thus begins to price in future rate cuts by the Fed.

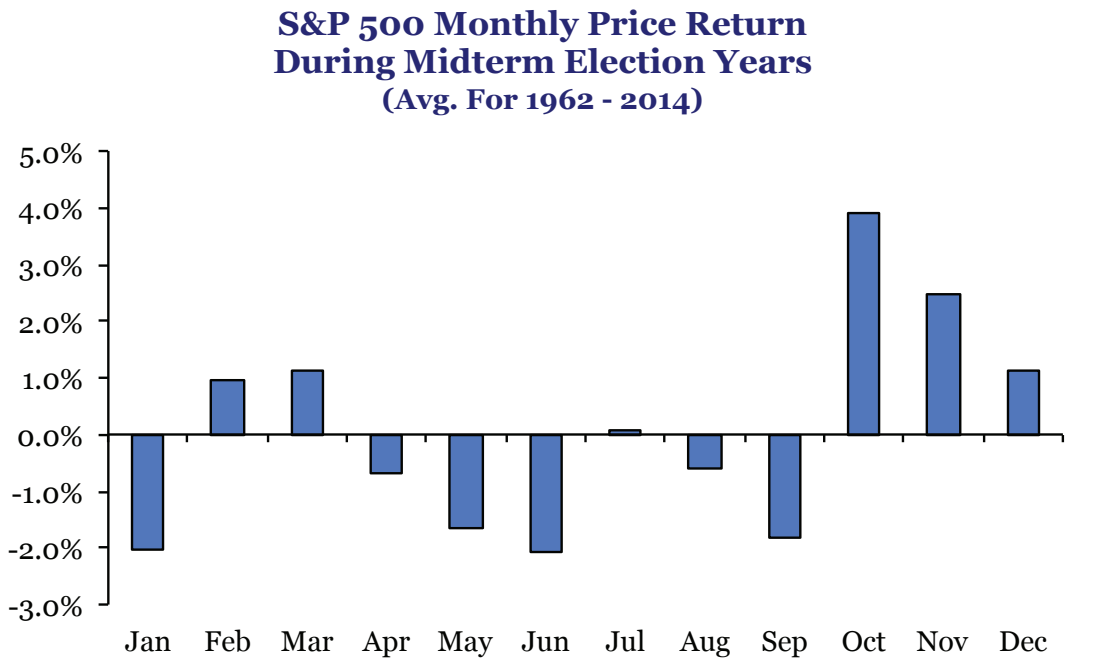
Might the Fed prematurely stop its current monetary tightening efforts to avoid an inversion of the curve? We don't think so. The Fed has explicitly stated that it would rely on data in weighing any changes to its current pace of rate hikes. We think that changing course simply to avoid inversion would be unwise and could create the risk of a far worse future outcome. Said differently, if the Fed failed to sufficiently slow inflation through rate hikes, it could increase the risk of recession. Additionally, the Fed would then need to conduct even more restrictive monetary policy in the future, potentially deepening the severity of a recession.

As a reminder, FineMark is neither forecasting an inversion, nor a recession, in 2018. We believe that the current risk of recession is low, and economic momentum appears healthy. At the beginning of the year, our forecast for long-term rates in 2018 was 3%; we maintain that view. We believe that long-term rates could move up modestly in 2019, perhaps to 3.25%. Based on a multitude of macroeconomic and demographic factors, we don't see a strong underpinning for significantly higher rates. That said, one area we are watching carefully is how continued reductions in unemployment and a tightening labor market could manifest into inflation.

MIDTERMS AND THE MARKETS

Another item that deserves investors' attention is the upcoming midterm elections in November. Historically, the incumbent party—in this case the Republicans—loses seats in both the House and Senate during midterm contests. As shown in Figure 3 below, the months leading up to midterms tend to be more volatile—at least until market participants have a clearer picture of the expected outcome.

Figure 3



Source: Strategas Securities

We wish you a relaxed and restful summer and hope you enjoy some downtime during this typically slower time of the year. As always, we are happy to answer any questions you have about global economics, financial markets, or your personal investment portfolio. Thank you for your continued confidence and trust.

‘TIS BETTER TO GIVE THAN RECEIVE – BUT IS IT STILL TAX DEDUCTIBLE?

By Gregory Otis
Senior Vice President & Private Wealth Advisor

The Tax Cuts and Jobs Act (TCJA) of 2017 eliminated (or limited) many items that previously could be claimed as itemized deductions. However, it did not eliminate the ability to claim charitable contributions as an itemized deduction.

Importantly though, the TCJA did raise the standard deduction to $24,000 for married couples and $12,000 for single filers up from $12,700 and $6,350 respectively in 2017. So, if you are married and your itemized deductions (which include your charitable gifting) do not exceed $24,000, then you are better off taking the standard deduction of $24,000.

Considering this, and to maximize your tax deduction, consider “bunching” your charitable gifting in different years. That way, your gifting will have a bigger contribution towards your yearly, itemized deductions and may (along with your other itemized deductions) exceed the $24,000 standard deduction.

In a few regards, the TCJA actually made charitable giving more tax effective:

1. The ceiling for charitable contributions of cash increased from 50% to 60% of a taxpayer’s adjusted gross income. Importantly, cash contributions exceeding this limit can be carried forward for five years. Note: contributions of securities are limited to 30% of a taxpayer’s adjusted gross income;
2. The Pease Deduction Limitation was repealed. The Pease Deduction Limitation dramatically reduced the value of a charitable deduction for those taxpayer’s with high incomes. The TCJA eliminated the Pease Deduction Limitation, so high income taxpayers will now be able to claim a much higher deduction amount on their tax return; and
3. A quirk of the TCJA involves a smallish sector of the taxpayer population whose income is between $400,000 and $416,700 for married couples and between $200,000 and $416,700 for individuals. For these taxpayers, their income tax rate actually rises from 33% in 2017 to 35% in 2018. Because of this increase, the value of a charitable contribution to their bottom line actually increases by the 2% difference in the increased tax.

The TCJA also left a few nice gifting options in place:

1. Qualified Charitable Distributions from your IRA can still be made (up to $100,000) and still qualify towards a taxpayer’s Required Mandatory Distribution;
2. Donating appreciated stocks, bonds and other assets instead of cash still avoids all capital gains taxes regardless of whether or not a donor itemizes; and
3. Donor Advised Funds were left untouched, thus maintaining a taxpayer’s ability to utilize that vehicle instead of making direct contributions to charities.

As with all tax matters, be sure to consult your individual tax professional to see how the above items will affect your particular situation.