Trust & Investment Bulletin
Fall 2018

It's Fall

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Autumn for you purists. The third season of the year, when crops and fruits are gathered and leaves fall. These are, of course, the things that you can see during the fall.

But there is also a great deal going on behind the scenes. Squirrels gathering and storing food for the winter. Other animals planning their hibernations. A lot is being done to make certain of a smooth transition into winter.

At LCNB, it is much the same thing. You see your regular account activity and you meet in person with your department representatives. But it is behind the scenes where we also can add a lot of value to your financial life. Asset analysis and selection, financial planning analysis, and operational excellence are just a few of the activities that allow us to help you secure your financial future.

As we enter fall, let's get together. It's a great time for us to plan together for winter and for a successful 2019. As always, thank you for allowing us to help secure your financial future.

Warmest Regards,
Mike

Income Tax Planning May Now Supersede Estate Tax Planning

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The exclusion from federal estate and gift tax is now $11,180,000, indexed annually for inflation. Further, a surviving spouse may elect portability to use the deceased spouse's unused federal state tax exclusion, allowing the limit to double and possibly sheltering up to $22 million from federal estate taxes.

Twenty years ago, in 1998, the federal estate tax exclusion was $675,000 and the maximum federal estate tax rate was 55%. In 2008, the federal estate tax exclusion was $2 million and the maximum federal estate tax rate was 45%. Thus, until recently and because the estate tax exemption amount was much lower, most clients' estate plans emphasized avoiding federal estate tax. Because of the high estate tax limit, the focus has changed.

As the number of persons subject to federal estate tax has significantly declined, preservation and management of assets by minimizing income taxes, not estate taxes, has become a major focus. When a person dies, the basis (or purchase price) of an asset used to measure capital gains is "stepped up" to its fair market value as of the date of death. A higher tax basis reduces capital gains taxes if that asset is later sold by heirs. Many of you may therefore wish to plan your estates to preserve a step-up in basis in order to minimize future capital gains taxes. Further, how your investments are allocated and located and how you incorporate charitable gifts and related planning may also affect income taxes incurred by your heirs.

As you review your current planning with your legal counsel and advisors, how you pass your assets to your heirs in the most income tax-efficient fashion should be considered and addressed to maximize the value of your hard-earned wealth. Please feel free to call on your LCNB trust officer for more information and to meet and discuss any necessary changes to your planning. We'll also coordinate the process with your legal counsel.

Economic Summary – Shifting Fed Policy

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U.S. economic fundamentals continue to come in at elevated levels supporting the Fed's previous rate hiking path. The unemployment rate dropped to 3.7% as of the most recent data point from September. Consumer confidence, as measured by the Conference Board Consumer Confidence Index, soared to an 18 year high in September. This led the FOMC to increase the Fed Funds rate by 25 basis points to the 2.00 – 2.25% range at the September meeting.

Notably, the Fed also removed the word "accommodative" from their press release. This signals a shift away from the effort to merely "normalize" interest rates and hints at a possible effort to truly tighten monetary policy. Economists often debate about the true neutral level for interest rates, but one measure is the inflation rate. As the Fed Funds rate moves above inflation (as we are likely to see in December), investors will be able to earn a real (inflation adjusted) risk free return by sitting in cash. This is an important signal that we may be shifting from a "risk on" to a "risk off" environment if the Fed continues to hike rates beyond the neutral level.

Higher U.S. interest rates coupled with ongoing trade tensions has led to a strong U.S. dollar and deteriorating international growth. Emerging market economies have been hardest hit thus far, but developed economies have also slowed. The IMF recently lowered their global growth forecast for this year and next, citing rising trade protectionism. While trade disputes with our North American and European partners may be worked out near-term, it appears more and more likely that issues with China will persist.

Equity Summary:	**3rd Qtr**	**YTD**	**12 Month**	**3 YR**	**5 YR**
S&P 500 (Large Cap Domestic)	7.71	10.56	17.91	17.31	13.95
Russell 2000 (Small Cap Domestic)	3.58	11.51	15.24	17.12	11.07
MSCI ACWI Ex US (International)	0.71	-3.09	2.74	9.23	4.42

Strong Third Quarter Gives Way to October Correction

A strong third quarter for domestic stocks was quickly wiped out in early October. Rising interest rates and trade tensions seemed to trigger the selloff. The S&P 500 Index dropped 8% from a recent all-time high of 2940 to an intraday low of 2710 on October 11th. As of the time of this publication, the index appears to be finding some support around the 200-day moving average of 2765. A significant break of that level could lead to a retest of the spring lows around 2600.

It is important to remember that stock prices are essentially a discount of future expected cash flows. The interest rate at which you choose to discount your future expected cash flows (your expected return) can have a significant impact on the current price you are willing to pay. All else being equal, as interest rates rise, stock prices should fall. Given the recent spike in interest rates, a correction should not come as a surprise.

Earnings season may provide some much-needed support as corporate America is expected to post another strong quarter. Year-over-year results will remain strong through the 3rd and 4th quarter, primarily due to the Trump tax cut. Earning comparisons will be more difficult starting in 2019.

International developed and emerging market stocks have struggled since the first mention of trade tariffs earlier this year. They have continued to decline as trade tensions have escalated and the US dollar has continued to strengthen. Valuations for international stocks remain compelling but we are cautious on the near-term outlook as trade issues are likely to persist. We remain slightly overweight international stock but concede that it could take a while for valuation to win out.

Fixed Income Summary:	3rd Qtr	YTD	12 Month	3 YR	5 YR
US T – Bill 90 Day Index	0.51	1.36	1.66	0.88	0.54
BC Municipals 5YR	-0.19	0.10	-0.67	1.71	1.71
BC Intermediate Government/Credit	0.21	-0.76	-0.96	0.91	1.52

Stop and Smell the Roses

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As I mentioned in the summer bulletin, the Federal Reserve has been committed to a more normalized Fed funds rate. In addition to the September hike, the Fed has signaled four more increases through the end of 2019. When deciding whether to increase, decrease, or keep rates the same, the Fed focuses primarily on inflation and unemployment. They also consider other economic data and general market conditions in their decision-making process.

While we have seen steadily improving economic results throughout 2018, it should be noted that it can take several months for the impact of a rate increase to be fully recognized in economic data. The yield curve has flattened considerably over the past couple of years and the Federal Reserve Bank of Cleveland has set its expected inflation rate at just 2.13% for the next ten years.

During the 3rd quarter, the ten-year treasury moved from 2.87% up to 3.14%, triggering a stock market selloff in early October. This is a signal that investors may not be ready for significantly higher interest rates. Given the current market conditions and benign inflation forecast, it may be time for the Fed to reconsider its hawkish view and slow down their rate increases.

Alternative Investments Summary:	3rd Qtr	YTD	12 Month	3 YR	5 YR
Bloomberg Commodity	-2.02	-2.03	2.59	-0.11	-7.18
Dow Jones Global Real Estate	-0.95	-1.55	2.41	8.15	6.17
Morningstar Broad Hedge Fund TR	-1.15	0.79	4.78	3.96	4.52

Alternative strategies struggled during the 3rd quarter with negative returns from commodities, global real-estate, and hedge funds. Diversification is supposed to be the only free lunch on Wall Street, but throughout the past several years this has not been the case as large cap domestic growth stocks have dominated all other asset classes.

With change being the only constant, this too shall pass and we expect alternatives to play a more meaningful part in portfolios in the years to come. We maintain a fairly light allocation to alternatives, but will look for opportunities to add diversification as the cycle matures.

Announcement

Kelly Schwabacher, Head of Trust Administration, has earned the Certified Fiduciary & Investment Risk Specialist (CFIRS™) designation awarded by Cannon Financial Institute, an exclusive provider of Trust Audit, Compliance, and Risk Management education. "The curriculum is dedicated to the ongoing aspects of fiduciary regulation, oversight requirements, and performance impact necessary to ensure a successful Trust department." ([1]) CFIRS™ designees have acquired the expertise necessary to navigate "the changing nature, rapid growth, and new developments in the field of audit, compliance, and risk management. ([2])

Kelly is excited to use her CFIRS™ education to foster a unique client experience that benefits from industry-leading fiduciary standards. She finds it particularly rewarding to incorporate insights from clients and partners. We encourage you to contact her any time at 513-932-1414, ext. 59102 and introduce yourself.

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Citations:

(1) Cannon Financial Institute 2018 Schools Guide: School Schedule and Registration, pg. 2.
(2) http://www.cannonfinancial.com/designations

We hope that we are exceeding your expectations. The best compliment we could receive would be a referral of your friends and family. Please contact Mike Miller @ 513.932.1414, ext. 59101 or mmiller@LCNB.com for more information.

LCNB National Bank