RIVERVIEW QUARTERLY INSIGHTS

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BUBBLE TERRITORY?
PERFORMANCE VS. EXPECTATION

[Ed. Note: The following article was written before the market fell by almost 10% on Feb. 2- 5. That event, however, does not impact the conclusions in this article. For a discussion of that market correction, see "Be Not Afraid (Again)," posted on our website, under the "Professional Journal" section of the "Resources" tab. www.riverviewtrust.com]

The year closed with record stock market highs (the Dow has broken 26,000 for the first time) and a new tax act. Even after eight years of solid returns, consumer confidence is up, economists are optimistic about growth both worldwide and in the United States specifically, and corporate profits are high. At the press conference after the most recent Fed meeting, Chair Janet Yellen stated that "[a]t the moment the U.S. economy is performing well. . . . The global economy is doing well. We're in a synchronized expansion. This is the first time in many years we've seen this." Fed officials predicted economic growth of 2.5%, and an unemployment rate of 3.9% for the coming year.

For at least the last two years, the growth in U.S. stocks has largely been driven by global growth and a weak dollar, both of which allowed U.S. companies to generate significant overseas profits (S&P 500 companies got about 43% of their sales from abroad in 2016, according to the Wall Street Journal). Earnings per share of more than 20,000 listed companies around the world increased by almost 19% in 2017, the fastest year-over-year rise since 2011. This past year was the first in five years that international stocks outperformed U.S. stocks. Net capital inflows to emerging market stocks are at their highest in two years. This broad base of global growth should encourage investors, as it demonstrates that increasing stock prices are backed by genuine global recovery.

Jobs also did well. The jobless rate held to a 17-year low, and hiring in December rose for the 87th straight month, the longest uninterrupted period of job expansion on record.

The fixed income markets are looking surprisingly good as well. A Wall Street Journal article from January 2 of this year observed that "ordinary investors" are keeping long-term bond yields low (and therefore their prices up) even while the Fed is continuing to raise rates. Yields for the benchmark 10-year Treasury note ended 2017 at 2.40%, which is down from the 2016 year-end yield of 2.446%. This, despite the fact that the Fed raised rates three times in 2017 (which should lead to increased yields). It seems that retail investors have split off from professional advisors in their enthusiasm for fixed income.

And yet . . .

On January 5, the Wall Street Journal also noted that "one of the biggest surprises of the U.S. stock market's relentless rally is how many individual investors have run away from it." Nearly $1 trillion has been pulled from retail-investor mutual funds since 2012 (and over that same period "the S&P 500 soared 116%"). Although much of that outflow probably made its way back into the market as investors pulled out of actively managed funds and into index-based ETFs, the net outflows over the last three years remained significant.

The concerns that the stock market could have a significant pullback are real; warning signs are present. It's widely known that stock prices, as measured by cyclically adjusted price-earnings ratio, are at levels only surpassed right before the Great Depression and the bursting of the Dot-Com Bubble. Some economists predict that unemployment could drop to 3.7% by the end of this year and 3.5% by the end of 2019, which would be the lowest level since 1969. This low unemployment, together with a projected increase in GDP of .2% as a result of the new tax reform act, could cause the Fed to raise rates more steeply, offsetting economic and market gains. Increasing strength in the U.S. dollar also could hamper growth. Bond yields seem likely to rise (and their prices fall) if only because it's been predicted, and the Fed has been raising rates, for so long.

Emerging markets face risk from political turmoil, as at least eighteen elections are scheduled, and there were many credit downgrades, including to China, South Africa and Turkey. The outcome of financial engineering in China is always a wild card. Although its economy is growing, India's "middle class" is not growing in a manner that will make it an increased consumer of discretionary items for at least the next five years.

Further, blue chip corporate bonds are becoming more vulnerable; the spread in rates between investment grade corporate bonds and Treasuries has shrunk to 1%, and average duration is getting longer. Both factors expose bond investors to risk, because if earnings of the companies issuing the bonds drop (and therefore cash flows contract relative to the outstanding debt), the corporate leverage can turn out to be higher than the market expected, which could lead to a market sell-off and a corresponding drop in price.

Perhaps the biggest concern is intangible. As of today, there still don't seem to be classic "bubble" indicators present in the markets (like euphoric optimism and excessive trading). However, investor surveys show a lower than average concern about a coming market crash (which is odd, as it contradicts the pullback from stocks by retail investors noted above). Valuations of all assets remain troublingly high. And it seems that most economists, advisors and investors seem to agree that the economy and the markets will continue to grow in 2018. Such unanimous sentiment can lead to greater dips and selloffs when the stock or bond market encounters even a moderate, routine pullback or correction in price. Unexamined optimism can lead to unexamined pessimism.

So what is an investor to do with these conflicting signals? The answer, at least for those who have a well-diversified portfolio of investments, is nothing. Yes, valuations are troublingly high. No, there aren't signs of a bubble yet. Yes, this is the second-longest bull market run on record. No, there aren't any signs that the economy can't support at least one more year of solid growth. Yes, the tax reform act might stimulate the economy further. No, the Fed won't stop increasing rates, which will slow the effects of that stimulation.

The truth is that, despite every impulse of what seems like common sense, no investor can time the market. Not amateurs, not professionals. The single most important indicator of the health of a portfolio is whether it has a proper asset allocation that is tied to the time horizon of its owner. Such a portfolio will take hits from market corrections, including some really big hits during events like the Great Recession. However, as we've also learned from living through that recession, those investors who rode out the storm by doing nothing to change their asset allocation were rewarded.

So hold tight, keep your asset allocation steady, rebalance at least yearly, keep your fixed income durations low, and watch the ride in 2018. It promises to be a very interesting year.

SPOTLIGHT ON PLANNING

THE TAX CUTS AND JOBS ACT: SELECTED ISSUES FOR INDIVIDUALS

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (the "Act"), one of the most sweeping changes to the Internal Revenue Code since 1986. The act will have a significant impact on the way taxes will be paid by individuals and businesses.

Major changes impacting individuals include new tax rates and brackets, elimination of personal exemptions, a nearly doubled standard deduction, and changes to and limitations on itemized deductions. Most of these changes sunset after 2025, when the previous rules return. There are also significant changes to the business landscape, including the new flat 21% corporate tax rate (which is permanent), enhanced depreciation and expensing rules, and a new 20% deduction for income from pass-through entities.

In this article we will focus on a few of the important changes impacting individuals, as well as some of the planning opportunities they may provide. We have to stress that this article is not comprehensive, and we strongly urge you to consult your tax professional to determine how these changes will impact you.

Unless otherwise stated, rates and exemptions presented in this article are for married couples filing jointly.

INDIVIDUAL RATES, EXEMPTIONS, AND CREDITS

Although the original version of President Trump's tax plan proposed only 3 brackets, the final bill finds us still with 7 brackets, but with modified breakpoints and a couple-point rate reduction in most cases. For example, the maximum tax rate (for individuals) is now 37%, down from 39.6%. Most individuals will find themselves with a lower overall tax rate. Whether this translates into actual tax savings depends on the impact of many other changes brought to us via the Act.

For the most part capital gains rates are unchanged, with rates at 0%, 15% and 20%. However, the income thresholds, which were previously determined by your ordinary income tax bracket, are now determined by a standalone set of brackets, starting with the 2017 threshold amounts, now indexed for inflation.

Personal exemptions and dependency exemptions are suspended; However, the Act increased the child tax credit to $2,000 and increased the phase-out level to $400,000 from its previous $110,000, making the credit much more widely available.

Other than the change in capital gains tax brackets, the items above will revert back to prior law after 2025.

THE STANDARD DEDUCTION AND ITEMIZED EXPENSES

For most individuals, the increase in the standard deduction, combined with reduced or eliminated itemized deductions, is perhaps the most significant change. Originally scheduled to be $13,000 in 2018, the standard deduction is now increased to $24,000 until 2026. This is important, because taxpayers are allowed to deduct either the standard deduction or the sum of all their itemized deductions. By increasing the standard deduction and reducing or eliminating many itemized deductions, the Act will cause many taxpayers NOT to itemize.

One important change in itemized deductions is the limitation on state and local taxes. This is particularly impactful for our Oregon and Washington clients. Previously, state and local income (or sales) taxes and property taxes were deductible against federal taxable income. Under the Act, however, the deductible portion of such taxes, combined, is capped at $10,000. This limitation does not apply to property taxes properly allocable to a trade or business.

Another common deduction affected by the Act is the deduction for mortgage interest. As a reminder, the law recognizes two different kinds of mortgage interest; interest on home acquisition debt and interest on home equity debt. Starting in 2018, the deduction for home equity interest is suspended, and the deduction for mortgage interest, which was previously limited to interest on underlying debt of up to $1 million, is now limited to interest on underlying debt of $750,000. Home acquisition debt incurred before December 15, 2017, is grandfathered in under the old rules. It is important to note that home equity interest might be deductible if the loan proceeds were used for business expenses or home improvement, for example. The rules are complex and require the ability to 'trace' how the loan proceeds were used, but it is worth a closer look.

One deduction that becomes temporarily more useful under the Act is the deduction for medical expenses. Previously, such expenses were deductible only to the extent that they exceeded 10% of the taxpayer's adjusted gross income. Under the Act, that threshold is reduced to 7.5% of adjusted gross income for years 2017 and 2018.

Another potential win for taxpayers is with charitable contributions. Previously, contributions to a charity were limited to 50, 30 or 20 percent of modified adjusted gross income, depending upon the type of charity to whom the property was donated, and the type of property donated. Under the Act, the 50% limitation on cash contributions to public charities is increased to 60%.

A potential planning opportunity this year might be to bunch medical expenses and charitable giving into 2018, pulling forward expenses that otherwise would be incurred in 2019, in order to exceed the standard deduction and the 7.5% floor for medical expenses, increasing the overall tax savings from those expenses.

Miscellaneous itemized deductions, which include fees for investment advice, tax prep fees, and professional dues, among other things, and which are subject to the 2% of AGI floor, have been suspended.

In good news to higher income taxpayers, the limitation on itemized deductions (known as the "Pease" limitation) under which such deductions were reduced by 3% of a taxpayer's AGI if it exceeded a stated threshold, has been suspended.

These changes to the standard and itemized deductions also sunset after the year 2025.

ALTERNATIVE MINIMUM TAX

The Alternative Minimum Tax, or "AMT," was originally intended to prevent high income taxpayers from avoiding tax liability through the excessive use of various deductions, exclusions and credits. Unfortunately, the exemption amount used to eliminate certain deductions was not indexed for inflation, so that over the years a greater number of taxpayers were subject to AMT. Although AMT was not eliminated under the Act as had been initially proposed, it has been retained with higher exemption amounts: it increased from $86,200 to $109,400. A discussion of how the exemption works and how AMT is calculated is beyond the scope of these materials; however, we expect that the changes to AMT will take a great number of taxpayers out of the AMT regimen.

PASS-THROUGH INCOME CHANGES

The Act may provide a significant benefit to individuals with trade or business income from an S corporation, partnership, LLC, or sole proprietorship. The individual is entitled to a 20% deduction on "qualified business income" (QBI) from such an entity. Investment income is generally not included in QBI, nor wages paid to an S corporation shareholder or guaranteed payments paid to a partner. Also, for taxpayers with taxable income exceeding $315,000, the deduction is limited or disallowed in the case of specified service businesses. A specified service business includes health, law, consulting, athletics, financial services, brokerage services, or where the reputation or skill of an owner or employee is its principal asset.

This deduction may benefit many taxpayers, but there are many limitations and computational complexities involved in determining the amount of this deduction. Sole proprietors or the owners of a pass-through entity should consult with her tax and legal advisor in the coming year to determine if they qualify or if there are steps that can be taken to become qualified for this deduction.

This deduction is only available through 2025.

ESTATE AND GIFT TAX CHANGES

The big news in the estate and gift tax arena is that the Act has again reduced the number of taxpayers subject to Federal estate or gift tax. Specifically, the Act doubles the exemption for federal gift, estate and GST taxes. After inflation indexing, an individual can avoid estate tax on the first $11.2 million of her estate, and a married couple can shield $22.4 million. The estate, gift and GST taxes regimes all remain in place, and the estate, gift and GST tax rates remain at 40 percent. The change is effective through Dec. 31, 2025. Finally, heirs will continue to receive a full step-up in basis for inherited property included in the decedent's taxable estate.

Note, however, that the Oregon and Washington estate taxes have not gone away, nor have their much lower exemption limits been increased. So for residents of Oregon and Washington, and any other state with an estate tax for that matter, there is still a need to consider the need for state estate tax planning.

PLANNING OPPORTUNITIES

The Act produced sweeping changes, and many complex new rules and deductions. We've only covered a few areas of the reform, and it's clear that an apparent 'win' for a taxpayer in one area may be offset by a 'loss' in another. To recap, the planning points we discussed above, along with a couple more you might consider, are as follows:

Review your home equity lines of credit: Take a look at how the loan proceeds were used and whether the interest is tax deductible under any other rules.

Be strategic with your charitable donations: Because taking the standard deduction may become more beneficial than itemizing, donors may be making charitable donations for which they don't get any tax benefit. Here are two ideas to help optimize the tax benefit of charitable giving:

> **1. Donate your IRA minimum distribution (or more).** A person with significant retirement plans who is over age 70 ½ must take out required minimum distributions (RMDs) each year, which are taxed as ordinary income. However, these RMDs can be transferred directly to charity. This achieves the same effect as a fully deductible charitable donation, because the RMD is no longer included as ordinary income (instead of taking it as a deduction you simply remove it from income).
>
> **2. Bundle multi-year charitable gifts.** Rather than giving to your favorite charities every year, consider giving multiple years' gifts at once, so the gifts significantly exceed one year's standard deduction and become deductible. You might do this by saving up 2, 3 or 4 years' worth of funds you otherwise would have donated

and make them all in the final year. Also, if you have sufficient cash on hand, you could instead make one large up-front donation (a couple years' worth) into a donor advised fund, which allows you to take the full donation as a deduction immediately, but you then dole out the donations from the fund itself to your charities of choice. There are many different kinds of donor advised funds and each has its own restrictions, so be sure to do your research and select a fund aligned with your giving philosophy.

Consider gifting 'extra' assets to children or grandchildren: Very wealthy people might consider making large gifts to family members over the next five years. Like most of the meaningful benefits to individuals under the Act, the increased amount of estate and gift tax exemption goes away after 2025. So, for individuals worth more than previous exemption of $5.5 million (or couples worth more than $11 million) now is a good time to consider getting some assets out of their estates that they won't need to live on. This is beneficial for two reasons. First, all of the future appreciation on those gifts is also out of their estates (which will be even more impactful from an estate tax savings perspective if the exemption amount returns to its lower level). Second, it would greatly reduce their Oregon or Washington estate tax liability, since neither Oregon nor Washington has a gift tax.

These are just a few of the planning opportunities created by the Act. Many more strategies will be developed over the coming years as the rules are better understood and additional guidance is issued. We strongly recommend that you see your tax advisor to discuss and plan for how these rules impact you personally. Although filing may be simpler for some taxpayers, there is enough change and complexity to warrant professional guidance to maximize your personal tax savings. If you don't have a tax advisor, this might be the year to consider hiring one.

ECONOMIC SNAPSHOT

MARKET SUMMARY – 2017 INDEX RETURNS

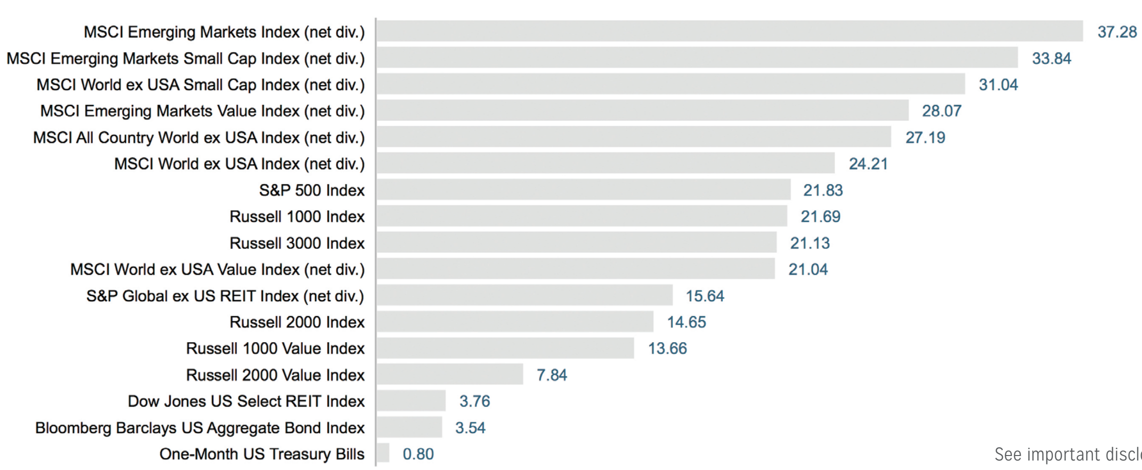
At the beginning of 2017 many 'experts' predicted the markets would not repeat the strong returns from 2016. Among other things, they pointed to global economic uncertainty, political turmoil, conflicts in the Middle East, and North Korea's nuclear goals. However, the global markets defied their predictions, producing another year of strong returns. Emerging markets produced the largest annual return, with International developed and US equities close behind.

	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
2017	**STOCKS**				**BONDS**	
	21.13%	**24.21%**	**37.28%**	**7.41%**	**3.54%**	**2.06%**
Since Jan. 2001						
Avg. Annual Return	8.4%	7.0%	14.8%	11.0%	4.8%	4.5%
Best Year	33.6% **2013**	39.4% **2003**	78.5% **2009**	37.4% **2006**	10.3% **2002**	9.8% **2014**
Worst Year	-37.3% **2008**	-43.6% **2008**	-53.3% **2008**	-45.7% **2008**	-2.0% **2013**	1.4% **2013**

See important disclosure information

WORLD ASSET CLASSES – 2017 INDEX RETURNS (%)

Looking at broad market indices, emerging markets outperformed US and non-US developed markets in 2017. The value effect was negative in the US, non-US developed markets, and emerging markets. Small caps outperformed large caps in non-US developed markets but underperformed in the US and emerging markets.



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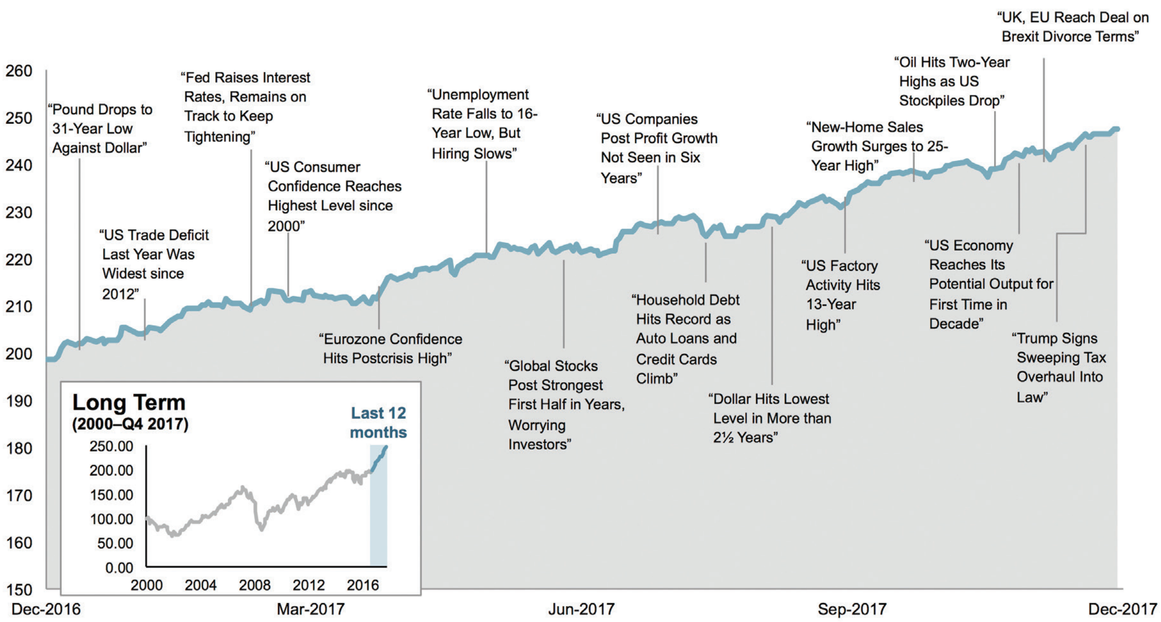
WORLD STOCK MARKET PERFORMANCE – SHORT TERM (Q1 2017 – Q4 2017)

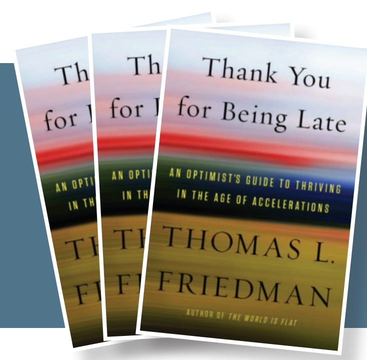
MSCI All Country World Index with selected headlines from past 12 months

These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.



Graph Source: MSCI ACWI Index [net div.]. MSCI data © MSCI 2017, all rights reserved.
See Important Disclosure Information.

BOOK REVIEW



THANK YOU FOR BEING LATE

By Thomas L. Friedman

Everything in the world seems different, unsettled (at least if you're an old guy like me). And you don't need to look at your investment statement to see it: natural disasters like fires and floods seem commonplace, politics is toxic and disgusting on all sides, many traditional jobs are disappearing, the retail environment is blowing up, and people are so absorbed in the electronic world of their cell phones that they don't seem to notice the real world that's all around them. This is the world that Thomas Friedman addresses in his latest book (recently out in paperback) entitled, "Thank You for Being Late: An Optimist's Guide to Thriving in the Age of Accelerations." And the best thing about this book is that, despite the challenges it addresses, it IS optimistic.

The title comes from a regular breakfast date that Mr. Friedman has with friends and interview subjects. On one particular day, the person he was supposed to meet was late. Friedman noticed that he enjoyed having the time to himself, to slow down and be alone with his thoughts. He was feeling "overwhelmed and exhausted by the dizzying pace of change." Which (together with an ongoing encounter with a parking attendant) got him thinking about his own place in the world, and how the economy around him has influenced that place.

Friedman locates the time that the world changed in 2007: the year the iPhone was introduced. And that was only the biggest development that year. Also in 2007, Google introduced Android, Amazon introduced the Kindle, IBM began work on Watson, and many other less familiar but equally important innovations were unleashed. (That was only ten years ago, but think back to how different the world was then.) According to Friedman, the innovations

> birthed around the year 2007 surely constituted one of the greatest leaps forward in history. It suffused a new set of capabilities to connect, collaborate, and create throughout every aspect of life, commerce, and government. Suddenly there were so many things that could be digitized, so much more storage to hold all that digital data, so many faster computers and so much more innovative software that could process that data for insights and so many more organizations and people (from the biggest multinationals to the smallest Indian farmers) who could access those insights, or contribute to them, anywhere in the world through their handheld computers – their smartphones.

The key to this growth is the exponential growth in computing power represented by "Moore's Law," which holds, roughly, that computing power doubles about every two years. This law has been in effect for the last 50 years, but only in the last ten has it become so big and fast that when it doubles, the changes each year become fundamentally different (which is why in 2017 we're talking about self-driving cars and computers that can beat humans at the most complex games humans have devised, rather than Palm Pilots).

This exponential growth in technology described in Moore's Law is the first of three "giant forces" that Friedman sees as making the world what it is today. The second is the acceleration of commercial and financial globalization (which he refers to as "The Market") and the third is climate change, population growth and biodiversity loss (all of which Friedman calls "Mother Nature"). The accelerations in Moore's Law, Mother Nature and the Market together put mankind in the "age of accelerations," in which each force impacts the other (Moore's Law drives Market changes, which have significant impacts on Mother Nature, for instance) and all three transform "almost every aspect of modern life."

It's beyond the scope of this book review to touch on the detail Friedman provides for each of the three forces. But a few examples might help. In the case of Moore's Law, he notes that it has created a technological "Supernova," in which connectivity and access to complexity is fast, free and invisible. The combination of education plus connectivity plus the "Supernova" means that more and more people are becoming empowered at lower and lower levels of income, and are demanding more security, dignity and human rights. Where the Industrial Revolution was a "ten-million-person story," this shift is a "couple-of-billion-person story," one that we're only experiencing the opening chapter of.

The global changes made by the Market have, optimistically, created "floors," not "walls." Although the concept of "globalization" is often perceived negatively, thought to stand only for the principle of losing jobs overseas, in fact the global flow of information is allowing people around the world to lift themselves out of poverty and participate in solving the world's problems. It dislocates some, but it allows many to perform ever more creative tasks.

The story of changes to Mother Nature, on the other hand, is more desperate; Friedman notes that

> We are the first generation for whom "later" will be the time when all of Mother Nature's buffers, spare tires, tricks of the trade and tools for adapting and bouncing back will be exhausted or breached. If we don't act quickly together to mitigate these trends, we will be the first generation of humans for whom later will be *too late*.

What we do, or fail to do, right now, will determine the future of all life on Earth.

Much of Friedman's point is that governments and other groups will have to take notice and take action. Societies have to maintain "dynamic stability;" much like balancing on a bike while riding it. It means innovating on the fly, redesigning workplaces, politics and communities. Workplaces need to determine exactly what humans can do better than machines, as opposed to better with them.

On an individual level, Friedman believes personal responsibility has never been greater:

> No politician in America will tell you this, but every boss will: You can't just show up. You need a plan to succeed. Like everything else in the age of accelerations, securing and holding a job requires *dynamic stability* – you need to keep pedaling (or paddling) all the time.

People have to know more, update what they know more often and do more creative things with that knowledge than simple routine tasks. "The future will belong to those who have the self-motivation to take advantage of all the free and cheap tools and flows coming out of the Supernova."

Friedman concludes with a trip back to his first home, St. Louis Park, Minnesota. Describing the decency and commitment to community within his home town and the state generally, he notes how it has evolved over time to keep pace with the changes wrought by Moore's Law, the Market and Mother Nature. He points out that it is "so much easier to venture far – not just in distance but also in terms of your willingness to experiment, take risks, and reach out to the other – when you know that you're still tethered to a place called home, and to a real community." Ultimately, his book inspired me to look for those tethering points, to places where I can contribute and to how I can take advantage of this age of accelerations.

IMPORTANT DISCLOSURE INFORMATION

Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net div.]), Emerging Markets (MSCI Emerging Markets Index [net div.]), Global Real Estate (S&P Global REIT Index [net div.]), US Bond Market (Bloomberg Barclays US Aggregate Bond Index), and Global Bond ex US Market (Citi WGBI ex USA 1-30 Years [Hedged to USD]).

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