Fiduciary Trust International

# PERSPECTIVE

JULY 2018

IN THIS ISSUE



ECONOMIC AND INVESTMENT OUTLOOK

## If Everything is so Good, why Does it Feel so Bad?

As we wrote in our 2018 Outlook, it was our belief that the extraordinarily low volatility and strong returns for US stocks and bonds in 2017 were unlikely to repeat this year. In many ways, our expectations played out in the first half of 2018 as the market profile flipped. What was a near-ideal environment of easy financial conditions, strong economic and corporate fundamentals in 2017 has given way to a tug-of-war between pro-US policies and pro-growth fiscal policies.

While many benefits of the pro-growth policies enacted last year are still to come, headlines referencing forthcoming stimulus have been replaced with ones about the administration's pro-US trade policy. At the same time, we got our first indication of the impact of the recent tax overhaul in first quarter earnings. Corporations in the US grew profits at an astounding 23% year over year, with an estimated 7% of that coming from the benefits of tax reform. Even without the temporary lift from business-friendly tax changes passed last year, first quarter earnings ranked near the top for any quarter this cycle.

However, markets were forced to grapple with the escalation of geopolitical risks, trade policy rhetoric and concerns about rising inflation and tighter monetary policy—none of which were major factors in 2017. As a result, valuations in the US have adjusted meaningfully downward, largely wiping out the impact of strong corporate earnings on equity market returns. Also, in stark contrast to the tranquil environment in 2017, equity volatility has roared back as trade policy headlines have roiled markets throughout the year.

*(continued on next page)*

## Distracted by Policy Uncertainty

Due to heightened policy uncertainty, there has been a notable uptick in equity volatility and a subsequent recalibration of US equity valuations in 2018. The price-to-earnings (P/E) ratio for the S&P 500 dropped below 17x at the end of May, down from roughly 20x last December. At the same time, headline risks have led to a period of significant market gyrations with only marginally higher equity prices despite the strong fundamental backdrop.

While traditional safe-haven assets did not materially benefit over the first part of the year, our interpretation of the trading behavior is that investors are demanding a greater level of compensation for owning equities. Uncertainty over government policy appears to be causing a disconnect between market returns and fundamentals.

### Trade Tensions Unsettle Investors

Investors do not like uncertainty. So, this combination of trade tensions between the US and several major trading partners, along with the unpredictability of the Trump administration's next move, have been unsettling. Driven by government rhetoric and newspaper headlines (CHART 1), it has become relatively common for the US equity market to swing by more than 1% over the course of a single trading session. After 2017, which was devoid of any market volatility, this feels unfamiliar and uncomfortable to investors, even though the average level of S&P 500 volatility this year has been near its historical mean.

As the landscape shifts, US equity investors appear to be caught in the middle of a standoff between policy uncertainty and constructive fundamentals. Eventually, we believe fundamentals will prevail, although it may take time for headline risks to fade into the background and for greater clarity around the future of trade policy to emerge.

### Treasury Bond Yields Move Higher

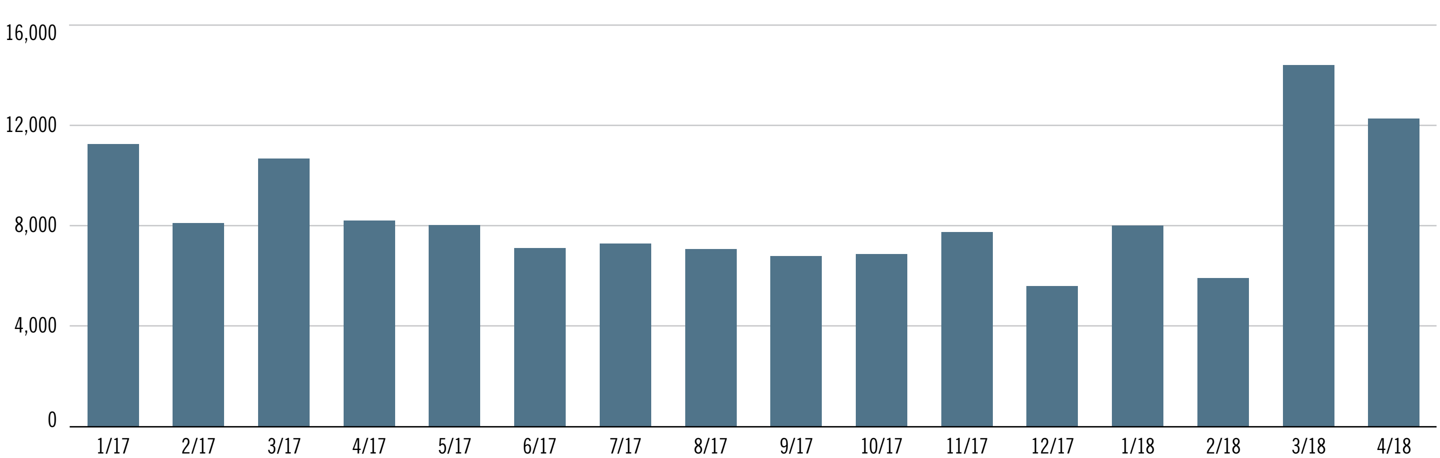
An additional risk being weighed by market participants this year is the prospect of higher inflation leading to tighter monetary policy. The recently enacted fiscal stimulus package comes at a time when the unemployment rate is below 4%. This could increase the risk of continued inflationary pressures, which is beginning to be priced into bond markets.

Headlines about monetary policy may have been less alarming than those about a possible trade war, but interest rates are still a powerful influence on markets. As the Fed has continued to raise rates and unwind its balance sheet, yields on six-month Treasuries have eclipsed the dividend yield of the S&P 500 for the first time since 2008 (CHART 2).

**CHART 1:**

**Trade-Related Headlines Dampened Investor Confidence**

Number of news stories published about trade tensions, January 2017 to April 2018




Source: Bloomberg.

This, combined with the perception that equity markets have become "riskier," has led income-oriented investors who have been searching for yield away from dividend-paying stocks.

The Fed is forecasting two more quarter-point interest rate hikes in 2018 and another three increases in 2019, aiming to slowly push the fed funds rate closer to 3%. In addition, the Treasury Department is expected to issue an additional $1 trillion in bonds in 2018 and again in 2019 to finance tax cuts and the government's new spending-heavy budget, which could also contribute to higher yields for Treasuries.

## An Evolution, Not a Revolution

The concerns drawing the attention of equity investors today are valid, but it appears to us that many investors have begun to price in a less favorable outcome for some trade and foreign policy uncertainties. With respect to the path of monetary policy, we believe the Fed will continue to take a measured and data-dependent approach in an attempt to tighten without constraining the economy.

### Financial Conditions Have Moved from Ideal to Supportive

While we may have departed from the "Goldilocks" environment that propelled markets in 2017, we do not see financial conditions moving to a place that is problematic for equities in the near term. The shift we have seen to date is from a backdrop that was favorable for equities to one that is just supportive. We are in the midst of an awkward transition away from benign inflation and record-low interest rates, but both are still low in a historical context. We remain mindful of the potential for a policy error on the Fed's part, but we expect policymakers to proceed slowly and cautiously in their approach to normalization.

While pressures on inflation are building, we do not believe there will be an inflationary shock, mainly because the structural forces that have kept inflation muted to this point—globalization, technological innovation and demographic shifts—are still in place and appear likely to persist for some time. The Fed seems to concur, indicating that it expects inflation to oscillate around its long-term target over the next few years.

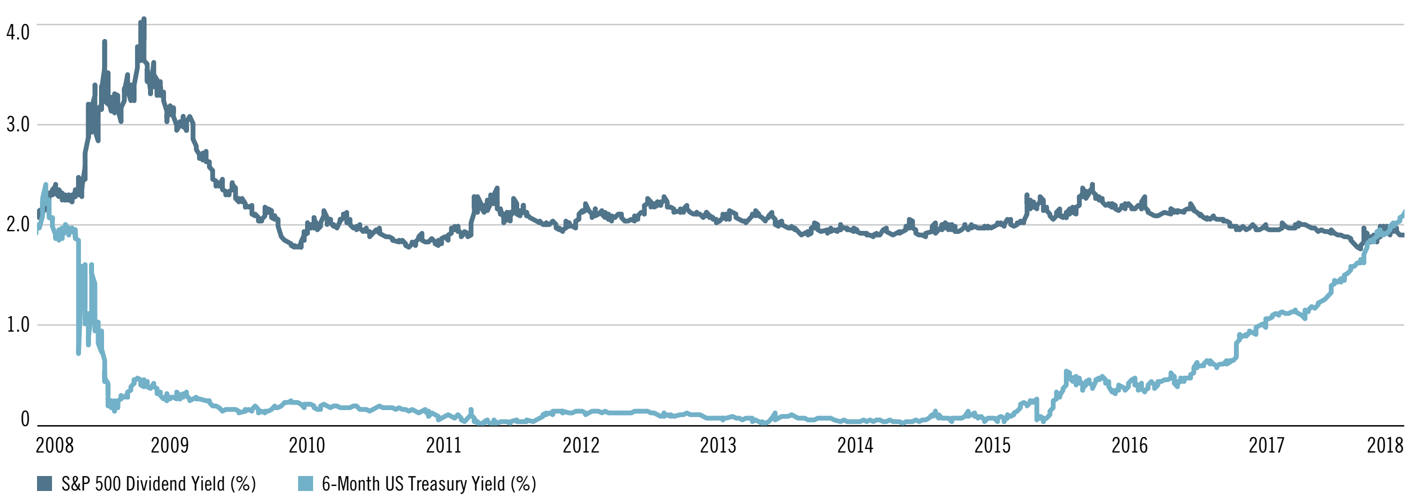
### In the Long Run, Headlines Don't Determine Valuations

In our view, the trade tensions we are experiencing represent an effort by the administration to level the playing field for global trade, not to enact destructive trade barriers. When all is said and done, we believe the posturing between the US and our trading partners will end with a negotiated resolution rather than a full-blown trade war, the latter of which would be damaging for all countries involved.

**CHART 2:**

**Dividend-Paying Stocks Saw Competition from Higher Treasury Yields**

S&P 500 dividend yield versus 6-month Treasury yield, May 2008 to May 2018




Source: Bloomberg.

In the short term, we expect volatility in equity markets to continue as trade negotiations progress. But in the long run, valuations are a product of economic and corporate fundamentals—an area where we see continued strength—not government rhetoric or newspaper headlines. Having said that, should the current environment give way to restrictive trade policies, there is a risk of constraining the global economy.

## Fundamentals Support Risk Assets

Despite slightly softer economic data in the first quarter, we maintain our positive outlook on the economic cycle. We expect that this, in conjunction with the robust corporate backdrop, will continue to support risk assets. Even amid the volatility in equities to start the year, flows into global stock ETFs and mutual funds were significantly positive, indicating that sentiment has shifted, but demand for equities has not (CHART 3).

Finally, it is worth pointing out that US trade policy, rising interest rates and inflation can affect different sectors of the equity and fixed income markets, as well as individual securities, in vastly different ways—some for the better and some for the worse. In our view, this distinctly different and more challenging backdrop is precisely the type of environment in which our active approach to investment management and high degree of selectivity can add value.

**RONALD J. SANCHEZ, CFA®**
Chief Investment Officer
June 1, 2018

*Kyle Hutchinson, Assistant Vice President, contributed to this report.*

### KEY TAKEAWAYS

- **Keep Policy Uncertainties in Perspective**
  While geopolitical tensions, trade policy and rising rates are generating sensational headlines and present real risks, we do not expect a worst-case scenario.

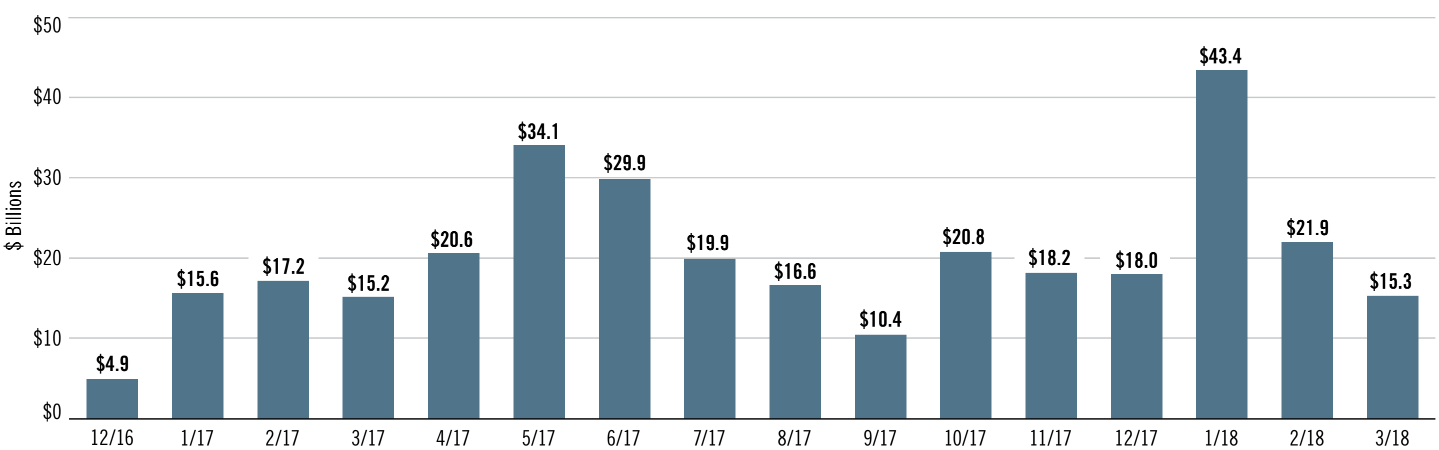
- **Focus on Macro and Micro Fundamentals**
  Over the long term, valuations are determined by fundamentals, not headlines. The economy is growing, earnings are strong, and the benefits of tax reform are still ahead.

- **Look to Risk Assets for Growth Potential**
  Despite recent volatility, we believe the health of the economy and US balance sheets support risk assets. But a high degree of selectivity is essential.

**CHART 3:**

**Investors Continued to Favor Global Equities**

Monthly net flows into long-term world mutual funds and ETFs, December 2016 to March 2018




Source: Investment Company Institute.

ASSET ALLOCATION UPDATE

# Solid Fundamentals Continue to Support Equities

## Tax Reform and Deregulation Favor US Small-Caps

We remain confident in our “risk-on” asset allocation and overweight to global equities, a position supported by leading economic indicators that are still at or near cycle highs.

### Equities: Looking for Opportunities

We are maintaining our overweight exposure to equities given the strong economic and corporate fundamental backdrop and fiscal thrust that remains in the pipeline.

In the US, we also maintained our neutral view on equities, although we favor overweighting small-caps, which could be the biggest beneficiary of economic growth, tax reform, deregulation and the shift from monetary to fiscal policy.

We also see opportunities in certain international developed markets, such as Japan and Europe, which appear to be in the earlier stages of an economic growth cycle than others, as highlighted by the divergence of central bank monetary policy.

In emerging markets, our neutral view also remains in place. A stronger dollar has weighed on emerging market valuations, but currency risks appear to be contained to specific countries rather than the broader asset class. Therefore, we are watching the space closely for potential buying opportunities.

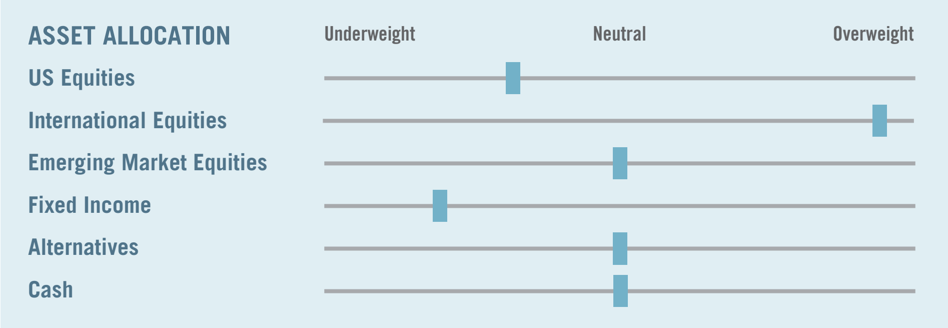
### Fixed Income: Positioned for the March Higher

Rising rates were a major theme for investors throughout the first half of the year, driven by multiple factors. The supply of Treasury bonds is increasing as new bonds are issued to fund government spending, while demand from the Fed is fading. An increase in oil prices also lifted inflation expectations, which encouraged higher rates, and the Fed has expressed confidence in the direction of economic growth.

Within our fixed income allocation, we prefer US investment-grade credit over government bonds and we are maintaining our short duration bias relative to our benchmark to guard against interest rate risk. For investors in high tax brackets, the municipal bond market continues to offer tax-advantaged income.

### Alternatives: A Hedge Against Volatility

Low levels of market volatility and interest rates in recent years have dampened hedge fund performance, but a rising-rate environment is presenting new opportunities to generate alpha. Alternatives could also offer valuable downside protection for multi-asset-class portfolios if volatility remains elevated compared to 2017, as we expect it to, or if we experience additional sell-offs.



FIDUCIARY TRUST FORUM

# Protecting Your Pets: How to Make Financial Provisions in a Will or Trust

*Gerard F. Joyce, National Head of Trusts & Estates, and his 14-year-old Cockapoo, Buddy*

For many people, pets aren't property—they are members of the family in every sense of the word; providing emotional support, protection and comfort in good times and bad.

In return, we give them shelter, affection and a significant amount of financial support. According to a Harris Poll survey, Americans spend an average of nearly $1,500 on essentials such as food, grooming, boarding and trips to the veterinarian's office for their pets each year. Horses are the most expensive at roughly $13,000 a year.[1]

But making financial provisions for a pet who outlives you hasn't always been possible, at least not formally. Trusts were designed originally to benefit humans or charity, not animals. It was not until the early 1990s when pet trusts were expressly enabled by a handful of US states. Since then, all 50 states and the District of Columbia have adopted laws that allow trusts to be established for your furry, feathered or four-legged friends.

Different states have different restrictions on pet trusts, including limits on how long they can continue. So be sure to work with a qualified attorney before funding a trust for Fido or Fluffy.

Here, National Head of Trusts and Estates, Gerry Joyce, answers commonly asked questions.

## Q: Should I Use a Will or a Trust to Protect My Pet after I'm Gone?

**GERRY:** Both are important when making financial provisions for a pet. First, your will should name your pet's new caregiver (owner) after your passing. If you do not include specific language in your will, your pet's care may be left to a trustee, individual, or group of people that is not your first choice. Second, you can set aside money in a pet trust, which is a segregated fund you create as part of your will or in a separate agreement during your lifetime. You name a trustee to distribute funds to the pet's guardian (the owner) or make payments directly to veterinarians, groomers, dog-walkers and other service providers.

## Q: Could I Simply Leave Money to a Trustworthy Friend?

**GERRY:** Yes. It is possible to leave a sum of money to a friend and request that the funds be used to take care of your pet. But the downside of this approach is that the request would not be legally binding, so the recipient could theoretically use those funds for other purposes, including the possibility of being legally required to pay a claim made by one of his or her creditors. Instead, you might consider creating a trust that is managed by a professional trustee and naming a friend or family member as beneficiary. Then you can include language in the trust document instructing the trustee to make special payments to the beneficiary who takes care of your pet.

## Q: Why Is the Trust Document so Important?

**GERRY:** When you create a trust for your pet, the trust document allows you to spell out its purpose in detail. For example, in addition to specifying that the trust is intended for the "care of" your pet, the trust document should articulate exactly what you mean by "care." It can be interpreted in many ways—from basic services such as medical attention and shelter to specific preferences for different types of food, veterinary care, treats and dog-walking services (apologies to cat owners for singling out dogs). It might also include directions for grooming and set your expectations for special activities your pet enjoys, such as a daily romp in the park, mountain hikes or trips to the beach.

It is also important to include the name of your pet and the name of the pet's guardian in the trust document so they are both perfectly clear. You might also require the trustee to conduct in-person visits to be sure your pet is being treated well and name a remainder beneficiary to inherit any money not spent on your pet. Finally, while it's true that cats have nine lives (see, I love cats too!) you should also consider making provisions for what happens at the end of your pet's natural life, such as directions for a proper burial and/or memorial service.

## Q: How Long Can a Pet Trust Continue?

**GERRY:** Some states limit the term of a pet trust to 21 years, which may not be sufficient to take care of certain types of birds (especially parrots), horses and other pets with especially long lifespans. So, it is important to establish your trust in a state that allows "noncharitable purpose trusts" to take care of your pets as long as they are living and can also take care of their offspring.

## Q: How Much Money Can I Leave to Care for My Pet?

**GERRY:** You can leave as much money as you'd like, but trust laws in many states allow the courts to reduce any trust that is deemed excessive. The most famous example of this situation is the case of Leona Helmsley, heiress to the Helmsley Hotel fortune, who made headlines by leaving $12 million to a Maltese named, appropriately enough, Trouble. A New York judge ruled that the dog's inheritance was unreasonable (excessive) and reduced it to $2 million.

Although Trouble did not live a life of austerity (his daily menu reportedly included fresh chicken and vegetables prepared by a Helmsley Hotel chef and served on fine china) the Helmsley case illustrates the power of the courts to reduce the size of pet trusts. Large bequests for the benefit of a pet can also open the door to financial abuse. For example, we have heard of cases in which the pet died, and the guardian went out and bought a new pet that looked exactly like the original so he or she could continue to collect a stipend. Some, but not all, of these problems can be avoided by constructing a proper trust document.

## Q: What Are the Most Unusual Trust Provisions You Have Seen?

**GERRY:** We have seen all kinds of special provisions included in pet trust documents, so I wouldn't describe any of them as "unusual." The number of special provisions you can include is virtually unlimited—all you must do is think about the things you do for your pet today and include them in the trust document. The challenge is that turning your wishes into reality can be expensive and not everyone is in a financial position to leave millions to care for their beloved pets.

Even so, most people have a deep and abiding love for their pets, and the growing popularity of pet trusts proves that our love (and financial support) continues even after we're gone.

**GERARD F. JOYCE, JR.**
Managing Director, National Head of Trusts and Estates

1. Source: Grow From Acorns, *Which Pets Are the Most Expensive to Own?* May 31, 2017.

# Introducing *Generations*

## New resources to help the next generation make educated financial decisions

Throughout our history, Fiduciary Trust has demonstrated a commitment to growing, protecting and transferring family wealth in the most tax-efficient manner possible. One of our top priorities is educating future generations to lead financially productive lives and become responsible stewards of family wealth.

We invite you to learn more at fiduciarytrust.com.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- Investment Management
- Charitable Giving
- Manager Selection and Monitoring
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