GREENLEAF TRUST

Perspectives

A Greenleaf Trust Newsletter

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Chairman, Greenleaf Trust

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Economic Commentary

Financial markets look to economic data releases to forecast monetary policy. In essence, they are searching for changes in forward policy as a result of what has been measured and reported. So what did last week's release of Q2 GDP tell the financial market world about the near term outlook for monetary policy? Those that were expecting a GDP growth rate of 2.7% were caught off guard by the released growth rate of 1.2%, which was not dramatically ahead of the 0.8% growth rate of Q1.

On the surface, the disappointing growth rate affirmed the belief that the Fed will retain its accommodative stance, and that rate hikes for the balance of 2016 are unlikely. Recall that earlier in the year most had assumed, and in fact the Fed had signaled, that the possibility of two to three rate hikes during the year were quite probable. Their focus earlier in the year seemed locked on to employment data reports and less on inflation and growth data.

There seems to be a combination of forces operating that defy normal cause and effect relationships. The consumer is spending, but business investment remains paltry at best. Employment growth is steady, but productivity is down. Job gains as well as wage growth have been consistent in 2016, yet GDP growth is very weak; why the disconnects?

We spoke last month about the notion that business in general has greater control in the near term on labor cost than they do with capital investment. Labor can be increased or decreased quickly, whereas capital investment costs have a greater duration on the balance sheet and P&L statement. The recession that rocked the globe and began the stream of job losses, at a rate of seven to eight hundred thousand a month, also froze capital investment in nearly all industries.

As liquidity and credit were restored and the economic recovery began in 2009, with increased demand for goods and services, employers began to add back labor but left capital investment on the back burner. Productivity is a measure of output. Simply put, what is produced by each unit of labor applied? Central questions of business planning have economic implications. Businesses often plan around the notions of quality, efficiency, productivity cost reduction and profitability. It was understandable that

Commentary, continued

in the near term following a very severe recession that business would hesitate to take on significant capital costs associated with investment for productivity, efficiency and cost reduction but would instead focus on matching demand improvement with the addition of labor which was in huge supply.

As domestic demand for goods and services grew, job growth consistently though incrementally grew, and nearly eight years into the recovery we find ourselves with unemployment below 5% and U-6 unemployment resting at 9%. Yet productivity rates are the lowest in nearly a decade. In general, economists argue that reduced productivity limits output and therefore GDP growth. In essence, the application of labor is limited in impact with respect to output. Our current condition, then, is modest domestic demand, weak non-US demand, pretty good employment levels and decreasing productivity, which all results in sub two percent GDP growth.

"In general, our expectations for growth beyond 3% on an annual basis probably don't reflect some real conditions."

For most, the reports of GDP growth are somewhat of a surprise. Auto sales are strong, housing permits and starts are consistent, inventories of homes for sale are at an eight-year low, as are days on market. Are we really that close to recession? Is the end of the recovery near and are equity markets at an all-time high if our growth rate is so weak? Is this really the new normal?

To clarify, the actual activity level of our second quarter GDP was 2.7%, from which we deduct the negative impact of our trade imbalance (Americans bought more foreign produced goods than they did those produced in the US, and thus it was not US produced output) and US companies produced goods that remained in inventories at a higher level than the previous quarter (not an unusual 2nd quarter event) and thus the adjusted Q2 result was a weak 1.2%, yet from a consumer spending and employment perspective the quarter felt better than the result.

Q3 and full year consensus estimates for GDP growth have generally been revised downward to reflect mostly what has occurred as opposed to what is forecasted for Q3 and Q4 of this year.

Most estimates now reflect full year growth at 1.9% with a range of estimates for the back half of 2016 to be between 2.5% – 3%, and we find little reason to challenge those estimates — and while activity in the 2.5% – 3% range is modest at best, it is far from recessionary levels.

Recoveries that last beyond nine years without interruption are few, yet generally downturns don't occur until we see consistent deterioration in important data sets such as employment, consumer confidence and PPI reports. In general, our expectations for growth beyond 3% on an

annual basis probably don't reflect some real conditions. Our population is not growing and thus our domestic demand is more constant than expansive. Our ability to increase our output relies upon our ability to find more customers beyond our borders and if we are going to produce the goods and services in our country to sell into the global demand that exists beyond our borders, we must have public policy that allows and encourages us to do so.

The political party conventions have taken place. We have the nominees for the Office of the Presidency of the United States and we have the party platforms written and endorsed by each party. At first glance both platforms seem restrictive to commerce and wish to impose sanctions on production as well as higher taxes on earnings. Party platforms are often designed to appeal to the party base and so the platforms of both parties need to be put into perspective, and much of a party's platform rarely becomes bound by legislative action. I find nothing in either platform that acknowledges that we are a mature economy with a stagnant population growth existing in a global economy. Neither party has advocated solid public policy that encourages growth of markets while incentivizing production within the US and neither advocates for tax policy that allows for foreign-earned profits to be repatriated at a tax rate that encourages more, not less, investment within our borders.

"Neither party has advocated solid public policy that encourages growth of markets while incentivizing production within the US..."

We have often stated the position that public policy matters. Our country's budgetary decisions to invest at various moments in our history facilitated growth and opportunities. The GI Bill created education, training and housing opportunities that fueled our post World War II growth. Eisenhower's highway legislation connected our country from east to west and developed our port growth. The National Institute of Health investment helped to irradiate horrendous disease and affliction globally, saving tens if not hundreds of millions of lives. Without the investment in the National Aeronautic and Space Administration, thousands of industries would not have had the launching pad that they did. History is replete with many examples that tell us it is not how much we spend but rather what we spend our national treasure on that matters.

We are at a time in our history where opportunities seem out of reach for many. Limited growth limits opportunities. We should be smart enough to craft public policies that provide opportunity for growth through investment that meets the reality of our time as well as the dramatic needs for the future. Read the party platforms and see if you find it.

Michael F. Odar, CFA
President

The Meaning of Your Financial Life

When I went to school, you were taught that a person's financial life is about achieving financial independence. And, as their advisor your job was to help them stay focused on saving and investing and eventually they would have the life that they wanted by achieving "their number." When I got out into the "real world" and began actually advising clients on their financial lives, I quickly realized that saving and investing were only part of the story. People's financial lives were more about what was meaningful to them over their lifetimes rather than achieving a number by a certain age.

I recently came across a study conducted by Barnaby B. Riedel, chief strategist of Riedel Strategy, a social science based research firm, which was affirming to me. The study was commissioned by United Capital, a large registered investment advisor, to gain more insight into how people think about their financial lives and whether this was aligned with traditional wealth management textbook lessons. After listening to hundreds of financial life stories, Riedel concluded that working, spending, saving, and investing were more representative of a person's financial life stages than were the traditional accumulation, protection, and distribution stages found in textbook lessons. Furthermore, saving and investing accounted for only 10% of these people's financial lives when listening to their stories. Working and spending played a much bigger role in people's financial lives. And, saving and investment decisions were often the outcomes of working and spending decisions.

"People's financial lives were more about what was meaningful to them over their lifetimes rather than achieving a number by a certain age."

Riedel found that while saving and investing are important, when people did not pay attention to the choices they made in the areas of working and spending, they experienced the deepest regrets, such as working too much and not spending enough time with family or spending too much in an effort to "keep up with the Joneses."

When we started Greenleaf Trust, our belief was always to take a holistic approach to wealth management. True wealth management encompasses so much more than how many firms define and approach wealth management. To many, portfolio management is wealth management. To us, portfolio management is a component of wealth management. Holistic wealth management involves managing each client's wealth to allow for the pursuit of what matters most to the client, be it personal, dynastic, emotional, and philanthropic or a combination thereof. Managing wealth involves helping clients with all types of financial decisions – working, spending, investing, and saving. At its foundation, wealth management also starts with comprehensive planning that involves focusing on clients' personal values and recognizing that their financial decisions are made in the pursuit of nonfinancial life goals.

Everyone's financial life story is different. Finding the meaning of their story is where we start.

Tale of Terminating Employees— The Distribution Dilemma

Chris A. Middleton, CTFA
Executive Vice President
Director of Retirement Plan Division

Switching jobs has become the norm. An often overlooked consequence of job changes is how they tend to affect retirement savings. The Qualified Retirement Plan (QRP) system is designed to encourage employees to save money, invest efficiently, and eventually take distributions in a fashion that protects against outliving one's assets. The first two goals are very important but let's focus on the distribution dilemma.

A terminating participant (employee with a retirement plan account balance) has, more or less, three choices: take her benefit in cash; roll her benefit over to an IRA; or keep her dollars within the retirement plan system (e.g. with her new employer's plan). Currently the easiest thing to do is take cash. Although keeping the assets within the retirement system allows the highest chance for retirement planning success, it is the most difficult option to pursue. Not surprisingly, the statistics show that terminating employees take the path of least resistance. According to a recent survey, 42% of terminating employees take cash. This trend needs to change if we are serious about the QRP system providing reasonable retirement nest eggs for the masses.

"An often overlooked consequence of job changes is how they tend to affect retirement savings."

Typically, it's younger, lower-paid participants with small account balances that take cash. Although the amounts cashed out are generally small, because it's younger participants that are cashing out, the loss of long-term compounding significantly reduces their future account balances. An ironic beneficiary in this tragedy is the IRS, which retrieves significant revenue through the 10% early withdrawal penalty for cash outs prior to age 59½. These early withdrawal incidents have been relatively steady over the last few decades and that is good for the IRS. In fact, published data from the IRS indicates that more than 5 million tax filers paid $4.6 billion in early withdrawal penalties in the 2006 tax year alone! This penalty is supposed to serve as a deterrent for tapping into a 401(k) early. Seems like a flimsy deterrent and it seems like the IRS has $4.6 billion reasons to keep the status quo.

Solving the distribution dilemma is admittedly involved but it seems logical to make the QRP to QRP transfer process much easier. Employers and retirement plan providers will have to support this change but that will only happen when regulators accommodate such a system. A few steps in the right direction could be:

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Distribution Dilemma, continued

1) Reduce or remove the fiduciary risk of advising participants to keep their money in the QRP system. The egregious financial abuses are much more prevalent outside the QRP system than they are inside. There is no sense in punishing people whose advice is almost certainly veered toward protecting the average employee from their own financial ignorance.
2) Reduce the effort required to confirm transferring money is "qualified." If money is being wired from an institution indicating the assets are qualified, that should be sufficient to allow a transfer. There is no material evidence of attempted abuse in this area. It would take a very sophisticated and lucky employee to successfully sneak money into the QRP system.

"Rule makers haven't had the strongest track record recently but this issue is one that both sides should be able to agree on."

Rule makers haven't had the strongest track record recently but this issue is one that both sides should be able to agree on. If the highest priority is collecting tax revenue from younger, lower-paid participants with small account balances then we should keep things just the way they are. If, however, we really want to help all Americans have a chance to save, invest wisely, and retire with some financial dignity then we need to make it easier to keep money within the retirement system!

Context for the Conventions

Christopher D. Burns, CFA, CPA
Fixed Income Analyst

The Republican and Democratic political conventions wrapped up in July with the nominations of Donald Trump and Hillary Clinton, respectively, as candidates for the Presidential election in November. Jobs and wages were a focus at both conventions, with each candidate putting forward their vision for improving the labor market. With that in mind, this article aims to provide context to the condition of the United States' shifting labor markets.

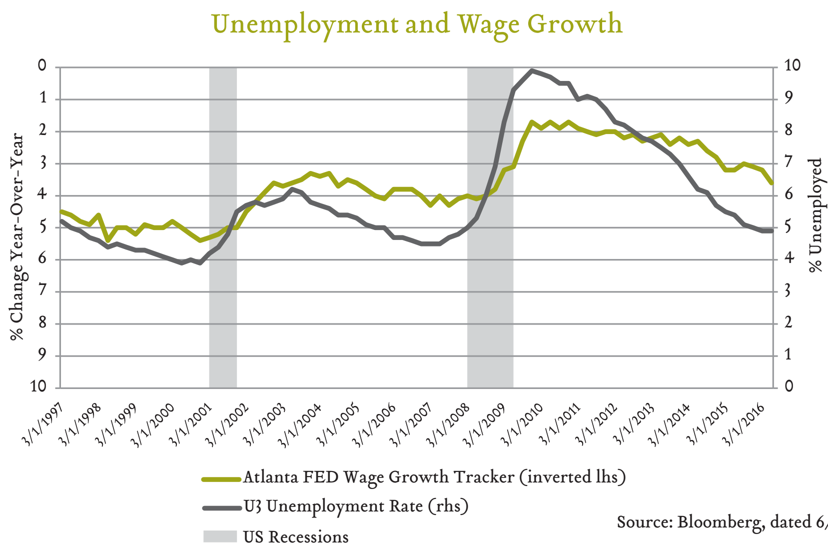
At Greenleaf Trust, our Fixed Income Committee follows the labor market closely because of its influence on inflation. Rising inflation and inflation expectations can cause bond yields to rise (and bond prices to fall). If the labor market is tight, unemployment is low, and there is a scarcity of workers, wages may rise. If wages rise, that may cause increases in aggregate demand and may generate increasing inflation.

This dynamic is the concept behind what's known in economics as the Phillips Curve. The Phillips Curve underlies the Federal Reserve's statutory objectives of maximum employment, stable prices, and moderate long-term interest rates. Therefore, to understand the FED, you must seek to understand dynamics in the labor market.

First, let's get up to speed on the overall employment and wage picture.

> "Jobs and wages were a focus at both [Republican and Democratic] conventions, with each candidate putting forward their vision for improving the labor market."

Unemployment and Wage Growth



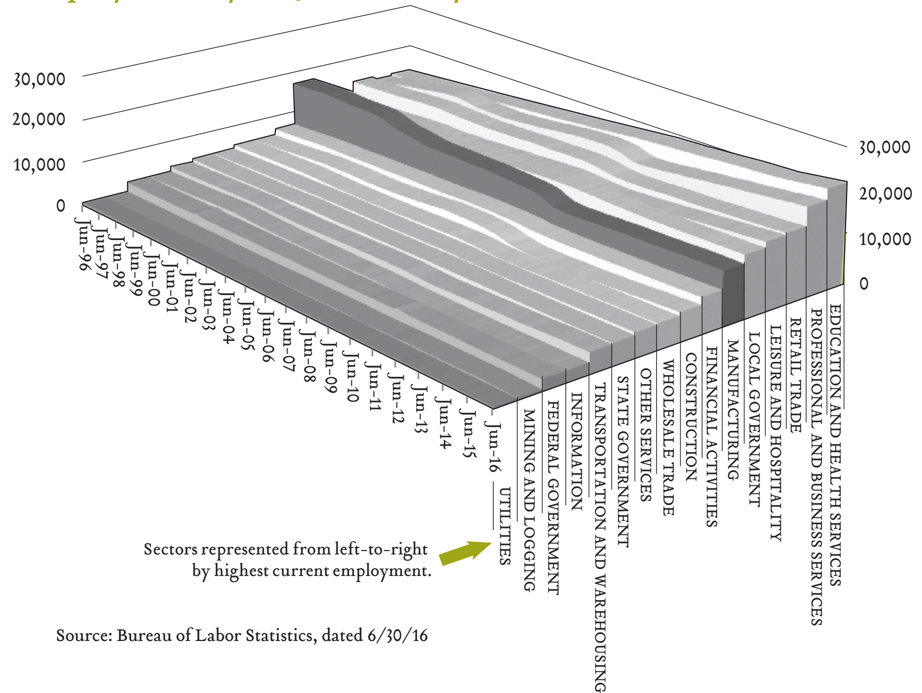
Source: Bloomberg, dated 6/30/16

The unemployment rate has fallen steadily since 2009 and currently registers at 4.9%. This level is relatively low and probably indicates that the economy is close to full employment. Wage growth, however, has been slower to recover, but has recently accelerated to 3.6% year-over-year. During the 1990's and 2000's, an unemployment rate below 5% was typically associated with wage growth of 4% or greater, so this period has been a bit anomalous for wages. If wage growth continues to accelerate, it could generate inflationary pressure domestically.

Context for the Conventions, continued

So, the overall labor market appears relatively healthy. However, these statistics belie a very uneven employment recovery at the industry level. Next, let's examine what types of jobs have been added over the last two decades.

Employment by Major Industry Sector 1996-2016



Source: Bureau of Labor Statistics, dated 6/30/16

"Manufacturing was America's largest employment industry by a comfortable margin in 1996. Since that time, around 5 million fewer Americans are employed in Manufacturing..."

This graph depicts a massive shift in employment over the past 20 years, particularly in the manufacturing sector. Manufacturing was America's largest employment industry by a comfortable margin in 1996. Since that time, around 5 million fewer Americans are employed in Manufacturing, which currently ranks sixth in terms of total employment. Meanwhile, the services industries have been adding jobs, with Professional and Business Services as well as Education and Health Services adding a majority of new jobs since 1996. Here is a look at current employment levels compared to their peaks.

Sector	Current	Peak	Peak Date	Jobs from Peak	% of Peak
Education and health services	22,685.0	22,685.0	Jun-16	-	100%
Professional & business services	20,158.0	20,158.0	Jun-16	-	100%
Retail trade	15,952.4	15,952.4	Jun-16	-	100%
Leisure and hospitality	15,502.0	15,502.0	Jun-16	-	100%
Local government	14,232.0	14,610.0	Jul-08	(378.0)	97%
Manufacturing	12,296.0	17,637.0	Apr-98	(5,341.0)	70%
Financial activities	8,280.0	8,394.0	Dec-06	(114.0)	99%
Construction	6,643.0	7,726.0	Apr-06	(1,083.0)	86%
Wholesale trade	5,924.9	6,041.8	Nov-07	(116.9)	98%
Other services	5,690.0	5,690.0	Jun-16	-	100%
State government	5,105.0	5,214.0	Aug-08	(109.0)	98%
Transportation & warehousing	4,880.1	4,889.5	May-16	(9.4)	100%
Information	2,787.0	3,717.0	Mar-01	(930.0)	75%
Federal government	2,782.0	3,416.0	May-10	(634.0)	81%
Mining and logging	692.0	904.0	Sep-14	(212.0)	77%
Utilities	565.2	639.7	Jun-96	(74.5)	88%

Source: Bureau of Labor Statistics, dated 6/30/16, author calculations

It is easy to understand feelings of anxiety among the American labor force. Many workers have transitioned industries, some in their mid-to-late careers. These workers may be facing a skills mismatch from their prior employment. Additionally, the Manufacturing industry has been concentrated in the Midwest and Rust Belt states, which has contributed to differing regional economic outcomes across the country and may be exacerbating sentiment about economic inequality generally.

Looking forward, the U.S. Bureau of Labor Statistics projects that over 80% of new jobs through 2024 will be created in the service-providing sectors, with the largest gains in the health care and social assistance industry and the professional and business services industry. They project further losses in the Manufacturing industry totaling an additional 800 thousand jobs through 2024.[1]

So, with goods-producing sectors likely to be constrained to create jobs going forward, we will be looking for evidence from service-sector firms regarding hiring and wages. Indeed in the past year firms from Walmart to Starbucks to JPMorgan Chase have announced relatively substantial plans to increase wages for their lower-wage-level employees.[2,3,4] If these announced raises materialize in employment statistics, it can have important implications for our investment strategy moving forward.

In conclusion we see the trends in the labor market as likely to continue, but looking forward we are keeping our eye out for the following implications:

- The revival of the Phillips Curve; if wages accelerate, we will be watching for increases in inflation and will adjust our interest rate outlook accordingly.
- Monetary policy; Federal Reserve Chair Janet Yellen has pointed to signs of faster wage growth in communicating the appropriateness of future increases to the federal funds rate.[5] We will be monitoring the FED's communications about the labor market to set our own expectations of the future path of monetary policy.
- Corporate margin pressure; we will be considering the impact of potentially higher wages in our equity and credit selection processes. If wages grow faster than revenues, profit margins could compress.
- Political implications; the long-term evolution of the labor market away from goods-producing sectors and towards service sectors has contributed to political pressure. We will evaluate the potential impact of candidates' policies on trade, the minimum wage, and the labor market as we go through the 2016 election cycle.

"Looking forward, the U.S. Bureau of Labor Statistics projects that over 80% of new jobs through 2024 will be created in the service-providing sectors..."

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Newly Proposed Regulations Would Limit Valuation Discounts

For those who own interests in family controlled businesses, now would be a good time to review how and when such interests might be sold or given to family members. Opportunities to adjust the valuation of such interests, the effect of which is often substantially lower estate and gift taxes, will become significantly more challenging if newly proposed IRS regulations are adopted (as written).

Historical and Statutory Background

The transfer of business interests between family members is subject to gift, estate and generation-skipping transfer tax based on the fair market value of the interest. Valuation discounts, due to lack of control and/or marketability, have been widely utilized by taxpayers to effectively reduce federal estate and gift taxes on these transfers. The IRS has a history of challenging the use and amounts of valuation discounts and Internal Revenue Code Section 2704 was specifically enacted in 1990 with the intent to limit the use of such discounts in transfers or gifts of interests in family businesses to family members. However, the statute, as currently written and interpreted by Tax Court decisions, has been largely ineffective in deterring valuation discounts. Hence, the newly proposed IRS regulations.

> "The transfer of business interests between family members is subject to gift, estate and generation-skipping transfer tax based on the fair market value of the interest."

Section 2704(b), in relevant part, provides that if an interest in a family controlled entity is transferred to a family member any "applicable restriction" is disregarded in valuing the transferred interest. "Applicable restriction" is defined as a restriction that limits the ability of the entity to liquidate if, after the transfer, such restriction lapses on its own or the restriction can be removed by the transferor or a member of the transferor's family. The Code Section was targeted at restrictions commonly employed in shareholder, partnership and entity operating agreements which the government perceived as having only been included to depress the value of interests in such entities for gift and estate tax purposes, but which do not actually affect the value to the transferee. However, another provision in the law, § 2704(b)(3)(B), provides that the term "applicable restriction" shall not include "any restriction imposed, or required to be imposed, by any Federal or State law." Many states, after the Code Section's enactment in 1990, enacted taxpayer-friendly legislation which supplied default provisions (imposed restrictions) that apply if the entity's operation agreement does not override them. As such, the "state law exception" has, to a large extent, effectively neutered the Code Section. Tax planners have utilized these state laws to increase restrictions in entity operating agreements so as to decrease the transfer tax value when ownership interests are transferred between family members.

Proposed Regulations

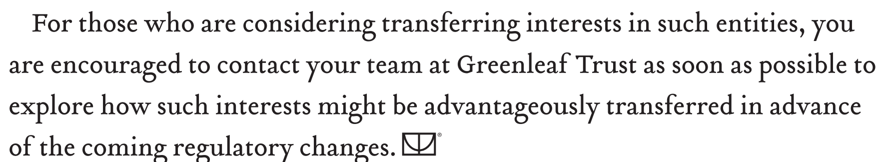
On August 4, the Internal Revenue Service (a bureau of the Department of Treasury) issued its long-anticipated proposed regulations under the Internal Revenue Code §2704. IRS regulations are the Treasury Department's official interpretation of the Internal Revenue Code and are one source of federal income tax law. Importantly, the statute specifically grants the Treasury the authority to issue regulations to cause "other restrictions" that reduce valuation to be disregarded. The newly proposed regulations are intended to do just that. While a detailed analysis of the proposed regulations is outside the scope of this article, it is fair to say that as written, the regulations appear to have met the Treasury's intent and will, if adopted, eliminate almost all minority (lack of control) discounts for closely held businesses.

The new rules will not take effect until thirty days after the regulations are published as final regulations. A public hearing on the proposed regulations is scheduled for December 1. Given the significant change from current regulations, it is expected that there will be several challenges to the Treasury's authority to adopt the proposed regulations in their current form. We can expect there will be many written comments submitted in advance of the hearing and that the discussion at the hearing will be robust.

Conclusion

While we do not know what the final regulations will look like or when they will take effect, it is clear that the Treasury has wanted to limit valuation discounts for many years. In its summary of the proposed regulations, the IRS has indicated that the regulations "are necessary to prevent the undervaluation" of transferred interests. It is highly likely that whatever the final regulatory language is, the tax cost to transfer interests in family-controlled businesses will increase, perhaps dramatically.

For those who are considering transferring interests in such entities, you are encouraged to contact your team at Greenleaf Trust as soon as possible to explore how such interests might be advantageously transferred in advance of the coming regulatory changes.



"While we do not know what the final regulations will look like or when they will take effect, it is clear that the Treasury has wanted to limit valuation discounts for many years."

Stock Market Pulse

Index	7/31/16	Total Return Since 12/31/2015
S&P 1500	503.16	8.14%
DJIA	18,432.24	7.38%
NASDAQ	5,162.13	3.82%
S&P 500	2,173.60	7.66%
S&P 400	1,559.46	12.56%
S&P 600	743.98	11.64%
NYSE Composite	10,785.51	8.09%
Dow Jones Utilities	711.42	25.32%
Barclays Aggregate Bond	113.02	5.88%

P/E Multiples	7/31/16
S&P 1500	18.7x
DJIA	17.6x
NASDAQ	22.1x
S&P 500	18.6x
S&P 400	20.2x
S&P 600	20.1x

Key Rates

Fed Funds Rate	0% to 0.25%
T Bill 90 Days	0.25%
T Bond 30 Yr	2.18%
Prime Rate	3.50%

Current Valuations

Index	Aggregate	P/E	Div. Yield
S&P 1500	503.16	18.7x	2.05%
S&P 500	2,173.60	18.6x	2.11%
DJIA	18,432.24	17.6x	2.51%
Dow Jones Utilities	711.42	NA	3.08%

Spread Between 30 Year Government Yields and Market Dividend Yields: 0.13%

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