

THIS ISSUE

The Captain Has Turned On the Seat Belt Sign

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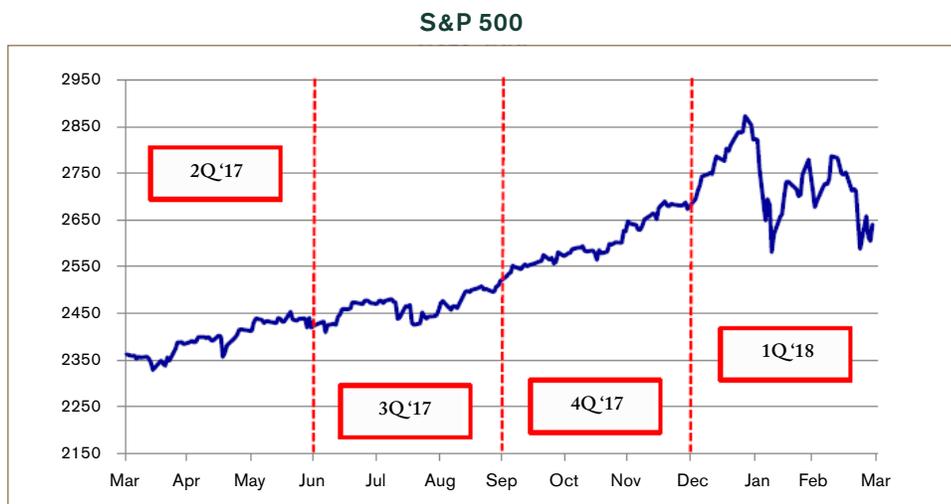
Market Diary

Tennessee Community Property Trust Advantages

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THE CAPTAIN HAS TURNED ON THE SEAT BELT SIGN

Financial markets marked two significant events in the first quarter: the 10th anniversary of the financial crisis and the 9th anniversary of the current bull market in stocks. No champagne or cake was served. There was, however, an impressive display of volatility and the first quarterly loss in value for the S&P 500 index since the third quarter of 2015 (see chart below). There were 23 trading days in the quarter in which the index advanced or declined more than one percent vs. just eight times for all of 2017. Foreign stocks were also marked down.



Source: Strategas Research Partners

Political uncertainty no doubt contributed to the rough ride. Presidential tweets about imposing tariffs on domestic importers of foreign steel and aluminum evolved into official policy, inviting China to “retaliate” by imposing similar taxes on its own citizens and companies buying certain industrial and agricultural imports from the U.S. Chief economic advisor Gary Cohn resigned almost immediately. Also, Secretary of State Rex Tillerson was fired and replaced just as North Korea appeared willing to limit its nuclear ambitions in upcoming negotiations with the U.S. Also, Congress passed an omnibus spending bill which keeps the government running until the end of the fiscal year but further increases the deficit.

The economic data releases were generally positive. Non-farm payroll growth was strong and hourly wages continue to grow modestly. The unemployment rate remained low and steady. Houses sold briskly, but housing starts were down. The core PCE Deflator, the Federal Reserve’s primary measure of inflation, was up 1.6% at last report, well below its 2% target rate.

The Fed raised the funds rate by 0.25% as widely expected. The unusual result was that short-term bond prices declined at the same time stock prices fell, and there was no “winning” asset class for the quarter. It is not clear whether the flattening of the yield curve is a reflection of short-term supply-and-demand factors or if it is a foretaste of the structural phenomenon of an inverted yield curve, normally

*“Income tax returns
are the most
imaginative fiction
being written today.”*

– Herman Wouk (1915 -)

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THE CAPTAIN ... *(continued)*

associated with recessions. One positive is that many money market mutual funds and bank deposit accounts now pay clients more attractive returns. Meanwhile, money supply growth (as measured by M2) has continued to slow, a condition not consistent with a growing economy.

Dividend-focused investors were hit hard as interest-sensitive stocks such as REITs, utilities and consumer staples faded in sync with bonds. Even dividend-heavy energy stocks declined despite a jump in oil prices.

Among equities, tech stocks declined disproportionately because they represent a very large segment of the market. Facebook’s common stock was hit hard after news outlets reported the social media titan had allowed private data to be released to Cambridge Analytica for political-consulting and audience-targeting purposes. Amazon also struggled after it became a target of President Trump’s

tweets threatening anti-trust action and complaining about the company’s alleged abuse of the U.S. Postal Service. Industrial stocks took hits from traders concerned about the impact of proposed tariffs and the possibility of a “trade war” with China. Boeing and Caterpillar were notable casualties.

Despite the success of most investments over the past nine years (see chart below), we think the current correction creates buying opportunities.

While valuations of stocks and bonds certainly remain high in many cases, stocks are still reasonable in terms of expected earnings growth. Federal fiscal policy is expansionary, making a near-term recession highly improbable. We believe there are better opportunities for new investment now, at the beginning of the second quarter, than there were in the first.

A Look At The Markets 9 Years Later

	March 09, 2009	March 09, 2018	Percent Change
S&P 500	676.53	2,786.57	311.9%
Dow Jones Industrial Average	6,547.05	25,335.74	287.0%
Nasdaq	1,268.64	7,560.81	496.0%
EuroStoxx	1,809.98	3,420.54	89.0%
Nikkei	7,086.03	21,469.20	203.0%
U.S. 10 Year Treasury	2.86	2.89	1.1%
WTI Oil	\$47.07	\$62.04	31.8%
Gold	\$922.35	\$1,323.94	43.5%
Fed Funds Rate Target (%)	0.25	1.50	500.0%
Fed Balance Sheet (\$Tn)	\$2.07	\$4.40	112.6%
U.S. Treasury Debt Outstanding (\$TN)	\$11.00	\$20.90	90.0%
Unemployment Rate (%)	8.70	4.10	-52.9%

Source: Strategas Research Partners

TENNESSEE COMMUNITY PROPERTY TRUST ADVANTAGES

In the wake of the increased estate tax exemptions, clients should not overlook managing and trying to minimize income taxes, particularly capital gains taxes. Residences can be one of the largest assets held by married couples as they enter retirement, and they may own other assets that have a low cost basis and high fair-market value as well. Frequently, assets owned by couples or individuals for lengthy periods and with low cost basis but high fair-market value, have a potential tax hit lurking. Although married couples are able to disregard up to \$500,000 of capital gain on the sale of a primary residence that meets certain requirements, even this amount still may not be sufficient to offset gains for more expensive residences

that have been owned for long periods of time. There is no comparable exclusion for capital gains on the cash sale of commercial properties or stocks.

There are several ways to deal with one’s primary residence as part of estate planning. In Tennessee, one possible way to minimize this gain is to contribute the residence into a Tennessee community property trust, thereby converting the property from joint ownership to community property ownership. The change in ownership may lead to a “step up” in tax cost basis for both spouses in the entire property when the first spouse dies. Consequently, whenever the surviving spouse sells the property, the capital gain on the

Market Diary Period Ending March 31, 2017

RATES OF RETURN

FIXED INCOME	Last 3 Mo.	YTD	1 year	3 years	5 years	10 years
90 Day U.S. Treasury Bills	0.37%	0.37%	1.17%	0.56%	0.35%	0.32%
Barclays Aggregate	-1.46%	-1.46%	1.20%	1.20%	1.82%	3.63%
Barclays Municipals	-0.71%	-0.71%	1.18%	1.42%	1.77%	3.34%
Barclays High Yield	-0.86%	-0.86%	3.78%	5.18%	4.99%	8.27%
EQUITIES	Last 3 Mo.	YTD	1 year	3 years	5 years	10 years
Global Stock Market (MSCI All Country World)	-1.03%	-1.03%	14.76%	8.10%	9.19%	5.57%
U.S. Stock Market (S&P 500)	-0.76%	-0.76%	13.99%	10.79%	13.31%	9.50%
U.S. Mid-Cap Stocks (S&P 400)	-0.77%	-0.77%	10.97%	8.97%	11.97%	10.91%
U.S. Small-Cap Stocks (S&P 600)	0.57%	0.57%	12.68%	10.78%	13.56%	11.36%
International Stocks (MSCI AC World ex US)	-1.33%	-1.33%	16.35%	6.14%	5.86%	2.68%
ALTERNATIVES	Last 3 Mo.	YTD	1 year	3 years	5 years	10 years
Hedge Funds (Wilshire Liquid Alternatives)	-1.00%	-1.00%	2.59%	0.53%	1.30%	1.39%
Commodities (Bloomberg Commodity)	0.95%	0.95%	5.21%	3.10%	-4.20%	3.38%
Gold (S&P GSCI Gold Total Return)	-0.79%	-0.79%	2.49%	-3.76%	-8.65%	-8.01%

Rates of Return for periods longer than 12 months are annualized. Data is provided by Black Diamond.

TENNESSEE COMMUNITY PROPERTY ... *(continued)*

sale would be limited to the amount of appreciation on the property from its fair market value on the date of death of the deceased spouse until the date the property is sold.

The statutory requirements to establish a valid Tennessee community property trust are as follows:

- The trust must expressly declare that it is a Tennessee community property trust.
- The trust must have at least one trustee who is a qualified trustee whose powers include maintaining records for the trust and preparing any income tax returns to be filed by the trust. Both or either of the spouses may be trustees.
- The trust agreement must be signed by both spouses.
- The trust agreement must display the following language at the top of the document:

THE CONSEQUENCES OF THIS TRUST MAY BE VERY EXTENSIVE, INCLUDING, BUT NOT LIMITED TO, YOUR RIGHTS WITH YOUR SPOUSE BOTH DURING THE COURSE OF YOUR MARRIAGE AND AT THE TIME OF A DIVORCE. ACCORDINGLY, THIS AGREEMENT SHOULD ONLY BE SIGNED AFTER CAREFUL CONSIDERATION. IF YOU HAVE ANY QUESTIONS ABOUT THIS AGREEMENT, YOU SHOULD SEEK COMPETENT ADVICE.

As long as the trust satisfies these mandatory terms, the parties are then free to add a broad range of terms that govern the trust and the assets held by the trust. This includes the management and control of the property in the trust, how the property will be held or distributed in the event of dissolution of the trust, death of either spouse as well as other specified events.

Upon the death of the first spouse, assets in a Tennessee community property trust will have their entire tax cost basis increased or "stepped up" to their fair market value as of the date of death. This enables the surviving spouse to sell assets in the trust and take advantage of the increased tax cost basis. To illustrate the potential tax savings, here are two scenarios (joint tenancy versus community property) in which a surviving spouse sells a residence soon after the other spouse dies.

Joint Tenancy example

Tax cost basis of \$400,000; property owned as joint tenants by husband and wife; husband dies in 2018 and fair market value is \$1.6 million

In this first scenario, the husband and wife each have a cost basis of \$200,000 ($\$400,000 \div 2$). The $\frac{1}{2}$ interest included in the husband's estate would receive a step-up equal to

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TENNESSEE COMMUNITY PROPERTY ... *(continued)*

half of the \$1.6 million dollar value as of his date of death, or \$800,000. As the surviving joint tenant, the wife's new tax cost basis will be \$1,000,000 (her original \$200,000 basis plus an \$800,000 for the portion included in the husband's taxable estate). If she sold the property after 2018, the recognized capital gain would be \$350,000 (\$600,000 realized gain less the \$250,000 exclusion for the sale of a primary residence). The resulting capital gains tax on \$350,000 could be as high as \$83,300.

Community property trust example

In a second example, with identical values, the husband and wife contribute the same property to a Tennessee community property trust with each spouse having a tax cost basis of \$200,000 in a property valued at \$1.6 million. Again, the husband pre-deceases the wife. The property (and other assets in the community property trust) would receive a step-up in basis to the full \$1.6 million value of the property at that time. If the surviving spouse were to sell the property after 2018 for its fair market value of \$1.6 million, there would be no capital gain realized on the sale.

Step-up applies to all assets in a Community Property Trust

In addition to the example of the residence illustrated here, all other assets contributed to a community property trust such as stocks, real estate and artwork would similarly

receive a step-up in basis to their fair market value as of the date of death for each spouse. Most community property trusts do hold a range of assets and are not limited to holding a residence.

There are a few potential disadvantages to converting separately owned property to community property that should be considered. First, in a divorce scenario, each spouse usually receives half of all community-owned property. The contributing spouse should be aware of this. Second, when separately owned property is converted into community property, the contributing spouse loses certain controls and management involvement over the property, since any sale or gift of the property or encumbrance of the property with debt will require the consent of both spouses. There are also differences with respect to creditors rights to be considered when transferring jointly owned property into a community property trust. Finally, if community property should ever decrease in value, unfortunately, the tax cost basis for the surviving spouse will assume the lower fair market value at the date of death of the first spouse – a step-down in cost basis.

For individuals looking for avenues to increase tax cost basis for surviving spouses, a community property trust offers that benefit. However, as with any estate planning considerations, consult your legal and tax advisors to be certain that all aspects of this benefit are consistent with your individual circumstances.

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