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WISDOM *for* GENERATIONS

REAL ESTATE REFRESHER: HELPFUL TAX PROVISIONS IN CALIFORNIA AND BEYOND

By Erica S. White
CFA

Homeownership has long been touted as a key contributor to personal wealth. Indeed, over time there can be great benefit to investing in real estate and owning a primary residence. Particularly in California, housing prices have grown at a fast rate, and since the 1940s, California home prices have risen more quickly than the U.S. average. While in 1940 the average California home cost about 20% more than the average U.S. home, by 2015 the average California home cost 250% more than the average U.S. home.

Given this trend, many of our clients and particularly those in California have experienced tremendous long-term appreciation in their homes. Homeownership may represent a substantial part of an individual or family's balance sheet. At Clifford Swan, we understand that your financial life extends beyond the portfolios we directly manage. The investments we make take into consideration your entire financial picture, as does the counsel we provide. As always, we recommend consulting a tax professional regarding your unique situation, but in broad terms, this article is meant to explore some of the tax guidelines that both inform our advising and decision-making when it comes to questions about real estate.

By way of background, owning a primary residence has long offered tax advantages. One of the best known benefits is the **mortgage interest deduction**. With certain limitations, homeowners are able to reduce their taxable income by the mortgage interest paid, provided that the loan is secured by the principal residence. Furthermore, upon the sale of your primary residence, taxpayers may qualify to exclude a very significant portion of the realized capital gain, if relevant, from their taxable income. In other words, if you sell your home at a profit the **capital gain exclusion** may allow you to shelter some or all of that profit from tax. Up to $250,000 for individuals and $500,000 for married couples filing jointly may be excluded from your taxable income if certain conditions are met. First, you must have owned the home and used it as your residence for at least two out of the previous five years before the date of sale. The two year (or 24 month) requirement does not have to be fulfilled in a single block of time; the 24 month threshold is cumulative. Second, the home must also qualify as your "main home," meaning that, if you own multiple homes, the most important factor (among others) is where you spend the majority of your time.

For investment property, there are also ways to avoid paying capital gains tax

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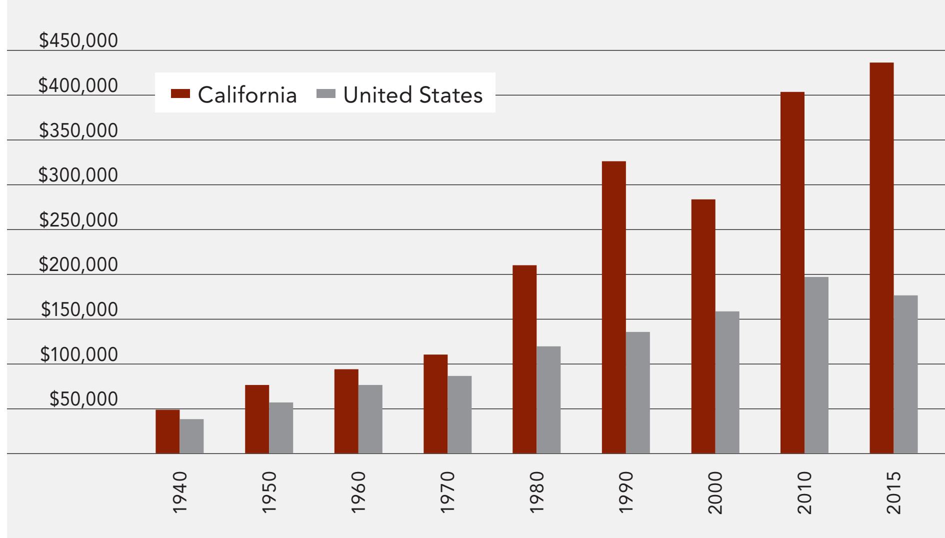
California Home Prices Have Grown Much Faster Than U.S. Prices



Source: Legislative Analyst's Office. Chas Alamo, and Brian Uhler. *California's High Housing Costs: Causes and Consequences.* Ed. Marianne O'Malley. www.lao.ca.gov. 17 March 2015.

upon sale. A **1031 Exchange** allows an investor to sell a property and reinvest the proceeds in another property to defer capital gains tax within a 180 day window. IRC Section 1031 (a)(1) states:

> *"No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment, if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment."*

This provision is not for personal use, so it will not apply to your primary residence. Otherwise, the definition of "like-kind" property is fairly broad. For real estate investors acting within certain guidelines, a 1031 Exchange can prove a powerful tool in lowering taxable income.

Turning back to primary residences, and specifically to those in California, there are a number of state propositions that may significantly reduce tax obligations as well. Passed in 1978 as an amendment to the California Constitution, **Proposition 13** established the concept of a base year value for property tax assessments. If your property has not changed ownership or has not had new construction since Proposition 13's passage, it received a base value rolled back to 1975. Otherwise, when property changes ownership, it is reassessed at current market value, establishing a new base year value for both land and improvements. Partial changes in ownership result in changes to the base year value exclusively for the portion of the property affected, where ownership has indeed changed. New construction also causes adjustments to the base year value.

The base year value concept is crucial because it establishes a floor from which your property tax increases are limited. First, under Proposition 13 the assessed value of the property may not increase by more than 2% each year (in the absence of ownership changes or new construction). Second, the property tax rate itself is limited to 1% of the assessed value. In reality, many California property owners actually experience tax rates above 1%, due to additional taxes approved by voters in different localities. However, Proposition 13 is clearly helpful in limiting tax obligations for California homeowners, particularly in the context of the significant increases in home prices that have occurred.

There are a number of California propositions that build upon the foundation of Proposition 13, which can be extremely beneficial especially for clients in or approaching retirement. **Proposition 60** allows for the transfer of base year values between properties. In other words, when selling a home and buying another, you may be able to retain the first home's base year value and transfer it to your next. This may be helpful where Proposition 13 has limited the increase in your home's base year value to less than the increase in home prices and, in particular, to less than the market value of your next property. To take advantage of Proposition 60, you or your spouse must be at least 55 years old when the original property is sold. The replacement property must become your principal residence and must be of equal or lesser market value than the original property. Therefore, Proposition 60 only works when an individual or couple is trading down in terms of market value. You are allowed a window of two years (before or after) the sale of your original property to purchase the replacement. Most importantly, this is a one-time benefit.

Proposition 90 offers the same benefit as Proposition 60 except it allows for the transfer of base year values between properties in different counties within California. Proposition 60 offers an intra-county benefit within all California counties, while Proposition 90 is for inter-county transactions. Not all California counties will accept inter-county transfers, so Proposition 90 currently only applies to replacement properties purchased in the counties listed in the table on this page.

Counties Covered by Proposition 90

Alameda	El Dorado
Los Angeles	Orange
Riverside	San Bernardino
San Diego	San Mateo
Santa Clara	Tuolumne
Ventura	

California propositions even assist with some intergenerational tax concerns, to the extent that they allow for the transfer of base year values between generations. **Proposition 58** excludes from tax reassessment transfers of real property between parents and children in certain circumstances, as does **Proposition 193**, in this case between grandparents and grandchildren (if the intermediate generation, the qualifying children of the grandparents, are deceased.) Both propositions allow for primary residences to be excluded from tax reassessment, along with up to $1 million of real property other than primary residences, applying separately to each eligible transfer. In other words, next generation property owners can avoid tax increases when acquiring the property of their parents or, in some circumstances, their grandparents. Importantly, it may not always be beneficial to forego tax reassessment, particularly in a declining market. Finally, it's crucial to separate reassessment for tax purposes from any adjustments in cost basis that may occur when inheriting property. They are distinct values, not to be conflated.

Understanding the intricacies of the tax code is a job for tax professionals with an acute grasp of your individual circumstances and the rules that govern them. Importantly, there are certain exceptions to the rules mentioned above that are beyond the scope of this article but that may apply to you (for example, disability often results in differing eligibility requirements when it comes to tax benefits). However, it's also clear that information is key in real estate decision making and investing, and the knowledgeable investor is at a significant advantage. To the extent that we can assist you with your wealth planning and real estate needs, please do not hesitate to reach out to your Clifford Swan Investment Counselor. ◆

INFLATION: IS THIS THE INFLECTION POINT?

By Randall L. Zaharia
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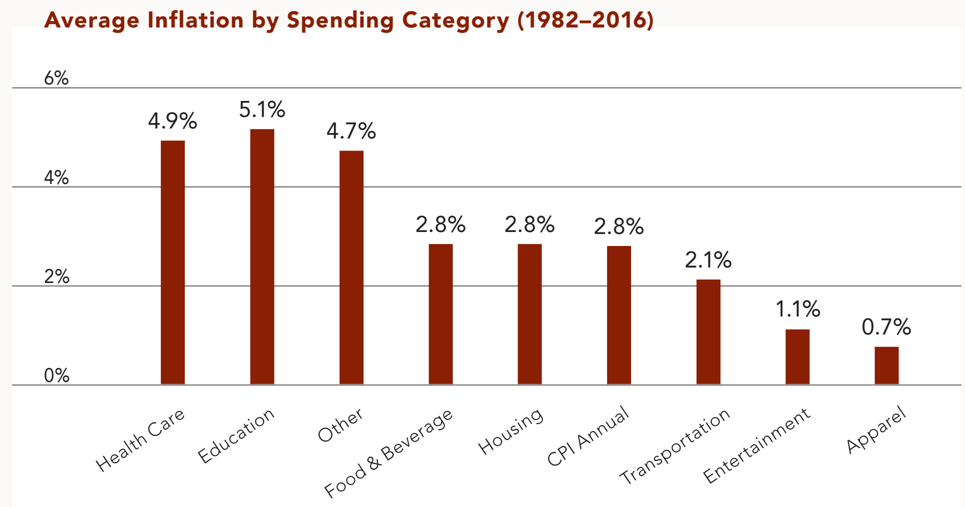

Sources: Bureau of Labor Statistics, J.P. Morgan, Clifford Swan Investment Counselors.

The U.S. economy may be at an inflation inflection point. Oil prices have doubled since February of 2016, and the election of Donald Trump as the President of the United States has added stimulus concerns. Expectations of substantial fiscal and tax initiatives could spur additional economic growth and subsequently increase inflation. However, the market is not at a consensus due to various economic cross currents.[1,2]

A starting point for considering whether inflation is at an inflection point is to review a newsletter article we published in the first quarter of 2010. Titled “The Inflation Contagion: An Analysis,” the article noted that inflation had been low, relative to recent history. Inflation changed materially from 1850 to 2010 (and subsequently into 2016). From 1850 to 1913, inflation was a minimal 0.4%. Following the establishment of the Federal Reserve in 1913 until the abolishment of gold- and silver-backed bank notes in 1934, inflation increased at a higher rate of 1.5%, suggesting that central bank involvement may have spurred higher levels. Once the U.S. completely converted to a “full faith and credit” paper currency for public use, inflation averaged 3.8% annually from 1934 until 2010 (3.6% overall average from 2010 to 2016).

There are several key concepts to understand before addressing where inflation may head. First, we note that inflation has three components: 1) actual inflation (a backward-looking measurement of reality); 2) expected inflation (inflation that is basically the market’s general expectation for the future); and 3) unexpected inflation (the difference between expectations and reality). As an example of unexpected inflation, imagine if expectations for future inflation are 1.5%, yet actual future inflation turns out to be 2.5%. The unexpected portion of inflation is the 1.0% additional inflation imbedded in that 2.5% (2.5% actual – 1.5% anticipated = 1.0% unexpected). Actual inflation, expected inflation, and unexpected inflation are quite dynamic, and what people perceive as happening is in constant flux. Finally, there are a number of economic forces that help to create unexpected inflation, which are discussed below.

The second concept we need to understand is: how does one actually measure inflation, and what, if any, are the criticisms of this measurement? That is, what is inflation and what does it really mean? Most people are familiar with the headline inflation number, the Consumer Price Index (CPI), which is published monthly by the U.S. Bureau of Labor Statistics (BLS). In particular, the CPI measures the changes in a basket of goods and services month-by-month and year-by-year. Alternatively, the Federal Reserve monitors the Personal Consumption Expenditure (PCE) inflation rate, which is published by the U.S. Bureau of Economic Analysis (BEA). Both have measured average inflation in the 1 to 2% range over the last several years.

However, there is some debate over whether inflation measurements under-report actual price changes. As noted above, the CPI measures changes in a basket of goods services; how that basket changes is subject to much discussion. One economic expert, John Williams of American Analytics & Research in San Francisco, has filed a number of dissenting public opinions[3] in response to BLS open commentaries. He argues that changes in CPI calculations since 1990 have biased the reported CPI numbers downward. The BLS introduced some key theoretical modifications, including *substitutionary effects* (which impact the specific goods and services in that basket because consumers will substitute one product for another in response to higher prices) and *hedonic effects*, which typically occur with technology goods (increased quality and/or effectiveness for the same expenditure—e.g. computers). Williams contends that CPI would be substantially higher without these modifications. It might be reasonable to assume that overall inflation is somewhat higher than currently reported.

In addition, CPI is a general spot estimate of inflation, and does not measure the same experience for everyone. As the chart above shows, inflation varies by spending category. One would

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expect the inflation perceived by college students to be different than that of elderly retired citizens. Each group purchases different products and services, each with different pricing influences (e.g., tuition, books, and computers vs. healthcare, food, and utility costs). Perhaps the key focus is the direction that inflation takes, however measured.

With these concepts as a backdrop, what might we expect with inflation going forward? In what direction might it be moving? First, over the last few years, CPI inflation has approached 2% while the economy averaged about 2 to 2.25% annual real growth. With the election of President Trump, if some or all of his proposals on fiscal and tax stimulus are implemented, we might see economic growth approach 3%. Given the very modest slack in unemployed and underemployed workers, there is a reasonable expectation of increasing wage growth. In addition, the demand for commodities may continue to increase, along with the commensurate price increases from that increased demand. If one includes the potential impacts from protectionism and tariffs, the price of domestic goods may also see upward inflationary pressure. Additionally, with the pickup in financial lending, money growth, and increasing interest rates, there are decent reasons to expect higher inflation levels due to monetary factors. So, what are markets expecting now?

Based on the current relationship between the U.S. Treasury 10-year yield and the U.S. Treasury 10-year TIP (inflation-protected bonds), the financial markets appear to be pricing in about 2% inflation over the intermediate term (a stated goal by the Federal Reserve). These expectations are above the roughly 1.4% rate seen just one year ago, but increased recently due to the factors discussed above. Can inflation go higher than 2%? Based on history, it could reach the 3 to 4% level and still be consistent with the eighty year average. In the last 25 years, inflation has been in the mid-single digits (3 to 6%). So, to ask again, could inflation go higher? Yes. And, there lies our possible inflection point.

Counter to this point, there are a number of financial and economic forces that are working against increased inflation. The high debt levels in the U.S. and around the world may exert a deflationary drag as people and governments attempt to reduce the growing debt levels. In the U.S. alone, we have seen a doubling of debt over the last eight years, from $10 trillion to roughly $20 trillion. Also, there is significant production capacity around the world. For example, in China, the steel industry is exhibiting excess capacity. Increasing levels of production may lead to lower prices.

However, keep in mind that heavy debt levels have multiple implications on financial and economic outcomes. Carmen Reinhart and Kenneth Rogoff's recent book,[4] *This Time is Different: Eight Centuries of Financial Folly*, reviews 800 years of financial world history. The results of their historical analysis suggest that elevated debt levels are strongly associated with higher inflation. In an earlier paper[5] by the same name, the authors "[found] that the same issue arises in the analysis of high inflation... the government's gain to unexpected inflation often derives at least as much from capital losses that are inflicted on holders of long-term bonds." The key takeaway may be that governments can decrease the burden of their debt by inflating their currency, and thereby reducing the real value of the debt. This might be a reflection of the old adage, "There are three ways to deal with government debt: increase taxes, decrease expenditures, and/or inflate the currency." Inflation could be a critical feature to reducing the burden of debt going forward, given the high U.S. debt level and increasing deficit, and a disinclination to raise taxes and cut expenditures. Tellingly, some have described inflation as a "stealth tax," as it decreases the real cost of debt over time.

So, are we at an inflection point? Clifford Swan believes we are, but the arguments in both directions appear convincing and have a valid set of bases. Therefore, a reasonable approach might be to hedge those expectations. If inflation could indeed increase another 1% over the next several years with a modest possibility of returning to the 1.5% expectation level, then owning some investment options to counter inflation might be prudent. However, if inflation cannot get much past the current 2% level, the value of these inflation-protection investments is minimal, at best.

In the CSIC article cited above, some of the investment options noted include U.S. Treasury TIPS, commodity funds and commodity-based companies, as well as manufacturing companies that have reasonably good pricing power as inflation increases. However, some of these options, such as commodities, have other risks that can arise apart from inflation, and which make them a difficult hedge. Nonetheless, many of these still remain potential options.

In the end, the question is, "what direction is inflation taking?" While the conclusion might not be overwhelming, there is a reasonable chance of inflation increasing modestly over the next several years. The 2010 Clifford Swan article anticipated 2 to 3% inflation by the mid 2010's and 5% or more by the end of the decade. We see that 2 to 2.5% level today, and foresee inflation levels rising modestly higher. While we are always vigilant on critical economic trends, it is sometimes easier to see inflection points in the rearview mirror. ◆

1. Durden, Tyler. 2017 *Will Be the Year of Inflation*. www.ZeroHedge.com. 14 December 2016.

2. Blitz, Steven. *Inflation Won't Take Off in 2017*. www.barrons.com. 21 January 2017.

3. Williams, John. No. 515- *Public Comment on Inflation Measurement and the Chained CPI (C-CPI)*. www.shadowstats.com. 8 April 2014.

4. Reinhart, Carmen, and Kenneth Rogoff. *This Time is Different: Eight Centuries of Financial Folly*. Princeton University Press, 2009.

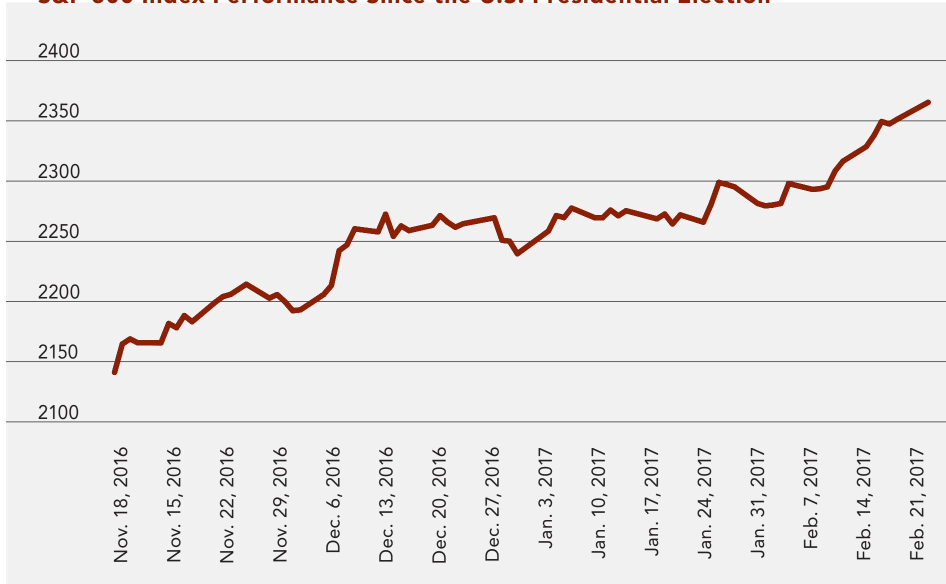
5.Reinhart, Carmen, and Kenneth Rogoff. "This Time is Different: Eight Centuries of Financial Folly." *National Bureau of Economic Research*, No. 13882, March 2008.

EQUITY MARKET OUTLOOK

By Maxwell R. Pray
CFA

As measured by the S&P 500 Index, the stock market has risen 10.6% since the U.S. Presidential election on November 8, 2016, including a 5.8% increase year-to-date through February 21, 2017. While there was considerable media attention when the Dow Jones Industrial Average broke through the 20,000 mark on January 25th, keep in mind that this number has no inherent value besides being a talking point for television pundits. Whether it's the S&P 500 (the 500 largest stocks by capitalization in the U.S. stock market) or the Dow (the 30 most well-known of those 500 stocks), the bottom line is that stocks have been performing well since the election.

S&P 500 Index Performance Since the U.S. Presidential Election



Source: Thomson Reuters Baseline.

The stock market has performed well over the long-term as well. In the 18 years since 1999, when the Dow hit 10,000 and was trading at a 25 Price-to-Earnings (P/E) ratio, the stock market index has doubled. The Dow's peak level in 1999 was a result of one of the strongest bull markets ever, when the stock market doubled twice (i.e. quadrupled) in the 10-year period from 1989 to 1999. This latest "doubling" in the stock market index is more impressive because, although it took 18 years, the market absorbed two major downturns during this time period. We first had the dot-com crash in 2001, followed by a financial crisis in 2008 that was largely attributable to the collapse of a bubble in the real estate market. On top of the market appreciation, investors also enjoyed strong income returns via the dividends that were paid out by corporations, with solid annual dividend yields of 2–3%.

The important question is, "Where do we go from here?" The answer to that question is, as always, "it depends." The direction of the market is the result of multi-factored interactions. On the corporate earnings side, about 80% of companies have reported their latest quarterly results; more than 50% of those in the S&P 500 that have reported have beaten revenue estimates, and approximately 75% have beaten EPS (earnings per share) estimates. This is good news, and as we proceed through 2017, the key to solid stock returns will be the trend in revenue, earnings and cash flow growth expectations for our companies. As policies start to take shape in Washington, we should begin to get visibility on the impact those policies will have as companies report quarterly results through the year and talk about expectations going forward. If business fundamentals continue to show solid signs of growth and meet or beat current expectations, it will be a positive for investment returns. However, if growth slows and companies reduce their expectations for later in 2017 and into 2018, we may see a difficult stock market environment. With expectations of solid employment and some wage growth, relatively low interest rates, normal rates of inflation, and no major geopolitical events, we anticipate a solid market environment. Valuations, as measured by P/E ratios, are not cheap in general, but are approximately 20% lower than the "bubble" area of the late 90's described above. Revenue, cash flow, and EPS growth will be most important to stock performance going forward. On average, we anticipate about 4–5% revenue growth and 12–13% EPS growth over the next year across our universe of companies. These growth numbers may be slightly higher than historical averages, but for all intents and purposes can be considered fairly normal.

In our fourth quarter 2016 market outlook, Peter Boyle talked about four policy areas that could potentially impact our economy positively: tax reductions, infrastructure spending, deregulation, and defense spending. With only a few months having passed since the inauguration, it is simply too early to know what the outcomes will be in those four areas. The important questions for the stock market are what specific policies and actions will be taken by the new administration, what impact those policies will have on the economy, and, more specifically, how corporate earnings will be affected?

On the regulatory front, a move to less stringent restrictions should benefit both revenue growth and profitability for some companies over time; especial-

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ly those in the finance, energy, and industrial sectors. Revenue growth could come from more opportunities as some restrictions are lifted, and profitability growth could come from fewer work hours spent internally by companies on regulation requirements. It will be difficult to point to which specific regulation will benefit which specific company, where, and over what time period.

Lower taxes could also benefit revenues and profitability for the companies in our clients' portfolios. As individuals' tax rates go down, there tend to be incremental increases in discretionary spending, which benefits many businesses. Corporations benefit from lower taxes, which increase their profitability and could lead to paying out more cash in dividends, buying back stock, or reinvesting in their business—all of which tend to benefit shareholders over time. With the upside to tax reform, there are also two risks to keep on the radar screen. There has been concern over growing income inequality over the past few years, and if the gap were to widen, some think this may have a negative impact on economic growth. Potentially the biggest unknown is the impact tax reform will have on the budget deficit. Will the theoretical benefit to growth offset the loss in revenues from the tax cuts?

An increase in infrastructure spending could generate opportunities for industrial companies, depending, again, on the timing and the type of work required. Currently, one of the biggest questions regarding the potential positive impact of infrastructure spending is where the dollars will come from to pay for the projects. A second unknown is the timing of the projects.

Lastly, it is intuitive that an increase in defense spending should benefit defense companies and some of the industrial companies that are on the relevant defense companies' supply chains.

Though not part of the "four factors," one of our biggest concerns is the talk of trade policy changes. Bringing more jobs to the U.S., particularly in the manufacturing sector, sounds great in theory, but the renegotiation of free-trade agreements could lead to global supply constraints, inflation, and rising prices to consumers. In turn, this could have a negative effect on the global economy and even result in a global trade war.

The investment outlook sounds promising, but there are areas to watch closely. Each of these policies has tangential effects on other areas of government and the economy; it is crucial for the success of any new policy to minimize the disruption to outside affected areas which can negate potential benefits—or worse. We continue to be wary of the geopolitical environment and the potential surprise factor inherent in our world today. We also need to learn and understand what could happen to corporate earnings if some of the policies changes in Washington hinder global trade. While monitoring the current environment, we will continue to invest according to our long-standing investment philosophy of seeking leading companies with increasing economic margins, as identified through our internal fundamental research. ◆

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MESSAGE FROM THE CHAIRMAN

By Linda Davis Taylor

We are very pleased to announce that Erica White has been named a principal of the firm. An Investment Counselor who joined Clifford Swan Investment Counselors in June of 2015, Erica has become an integral member of the investment team.

In January we welcomed two new colleagues to the firm. Daniel Mintz joined us as an Equity Research Analyst, and George Hasbun serves as an Investment Counselor.

Please join us in congratulating Erica and welcoming George and Dan. ◆

Daniel Mintz

George Hasbun