MP McShane Partners

December 2018 Insights

Investment Overview

The Global Debt Domino

Over the last two months, the market has experienced a noticeable uptick in volatility with many of our cautionary prognostications unfortunately substantiated by declining stock prices. The S&P 500® Index is down **-5.3%** quarter-to-date ("QTD") as we enter the final month of the fourth quarter of 2018 ("4Q18"), which is typically a seasonally strong quarter for equity markets, with average quarterly returns of ±**4.3%** over the past ±19 years.

Many of our concerns regarding the market this year centered on technical leading and lagging indicators approaching maturity alongside insatiable risk appetite driving irrational investor behavior. While monitoring these warning signals, we are attempting to determine a possible culprit that could turn concerning signs into a potential sustained market correction or economic recession.

Philosophically, we believe that debt-fueled bubbles emerge, and when they pop, the market and economy must assimilate the negative impact of working debt levels back to normalcy. The trick is determining *where* the leverage is located, so this newsletter attempts to draw a diagram of the global debt dilemma and highlight the critical intricacy of the global economy as a potential catalyst for a deceleration in debt accessibility and the potential domino effect.

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Wealth Advisory Overview

Estate Planning Under the New Tax Regime

The Internal Revenue Service ("IRS") announced on November 15th that the estate, gift, and GST transfer tax exemption for 2019 is $11.4 million per individual. This means that an individual can leave $11.4 million to heirs without paying an estate or gift tax, while a married couple can shelter $22.8 million. Even with these increased exemption amounts, tax planning is still vital for estates of all sizes.

Revisiting Estate Documents Containing Credit Shelter Trusts

While most people will not owe a transfer tax, it is more important than ever to revisit estate documents. Many documents executed prior to 2010 state that when the first spouse dies, his or her assets are divided into two shares: (1) the unified credit share through a credit shelter trust, also known as a bypass trust, and (2) the marital share through a marital trust. Under the increased estate exemption, the formula used to fund the credit shelter trust should be reviewed, particularly if the beneficiaries of the credit shelter trust are the children. For example, if the formula says to fund the credit shelter trust (for the children) with the maximum amount that can pass estate tax free and the rest in the marital trust (for the surviving spouse), under the new law, the children would benefit from the first $11.4 million of their parent's assets, whereas the marital trust may be underfunded or not funded at all. This could cause undesired consequences if not properly addressed.

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Investment Team

Daniele Donahoe, CFA
Chief Investment Officer
Elliott Van Ness, CFA
Director of Research | Portfolio Manager
Thomas Mack
Research Analyst

Wealth Advisory Team

Sandy Carlson, CFP®, CPA, CDFA™
President | Wealth Advisor
Leah Maybry, CPA
Director of Tax & Family Office Services
Lorri Tomlin, FPQP™
Wealth Advisor
Michael Means, CPA
Wealth Advisor
Ryan Vaudrin, CFP®
Wealth Associate
Lesley Burke
Client Service Associate

Special Points of Interest

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- Stock & Strategy Spotlight
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DEBT FUELS MARKET APPRECIATION

It is the Investment Team's belief that much of the appreciation in the stock market has been fueled by the consistent addition of layers of debt, both personal and government, given the assumption that the stock market should closely track economic growth. This hypothesis builds upon two fundamental suppositions. First, the stock market (e.g., the S&P 500® Index) represents the estimated value of the companies comprising the index, thus, in theory, earnings generated by these corporations should dictate movements in individual stock prices, culminating in broader equity market movements tracking cumulative earnings growth. Second, corporate earnings should mimic economic growth, as gaged by gross domestic product ("GDP") growth. Consequently, market growth should closely align with GDP growth. Supporting the initial supposition that the stock market should closely track GDP growth, any derivation from this relationship can be attributable to some exogenous factor: in this scenario, debt.

As a means of engineering stock market growth in excess of GDP growth, humankind has employed the laws of *leverage* (i.e., debt) in order to amplify outcomes. So far, this amplification has consistently swung toward the upside, with the S&P 500® Index growing at a compound annual growth rate ("CAGR") of **±10.7%** vs. U.S. GDP CAGR of **±9.0%** from January 1970 through September 2018. It is our belief that the difference (i.e., *delta*) between these two figures is the result of leverage, and that, once the marginal benefit of debt starts to wane, there will be a natural reversion to the mean wherein, optimistically, growth rates in GDP and equity markets realign. Pessimistically, the leverage pendulum swings harshly in the other direction: in this scenario, financial markets will be held accountable for the years of borrowed excess growth, as global debt levels are reduced and financial market returns potentially *lag* GDP growth as debt is paid down. The Federal Reserve has been an excellent arbiter of this pendulum, as it has historically buffered the correction by wielding its interest rate wand and utilizing the government balance sheet (i.e., inserting government debt as other areas of the economy de-lever). Eventually, every recession and market correction are a result of leverage reaching a tipping point where it must not only peak and decelerate but

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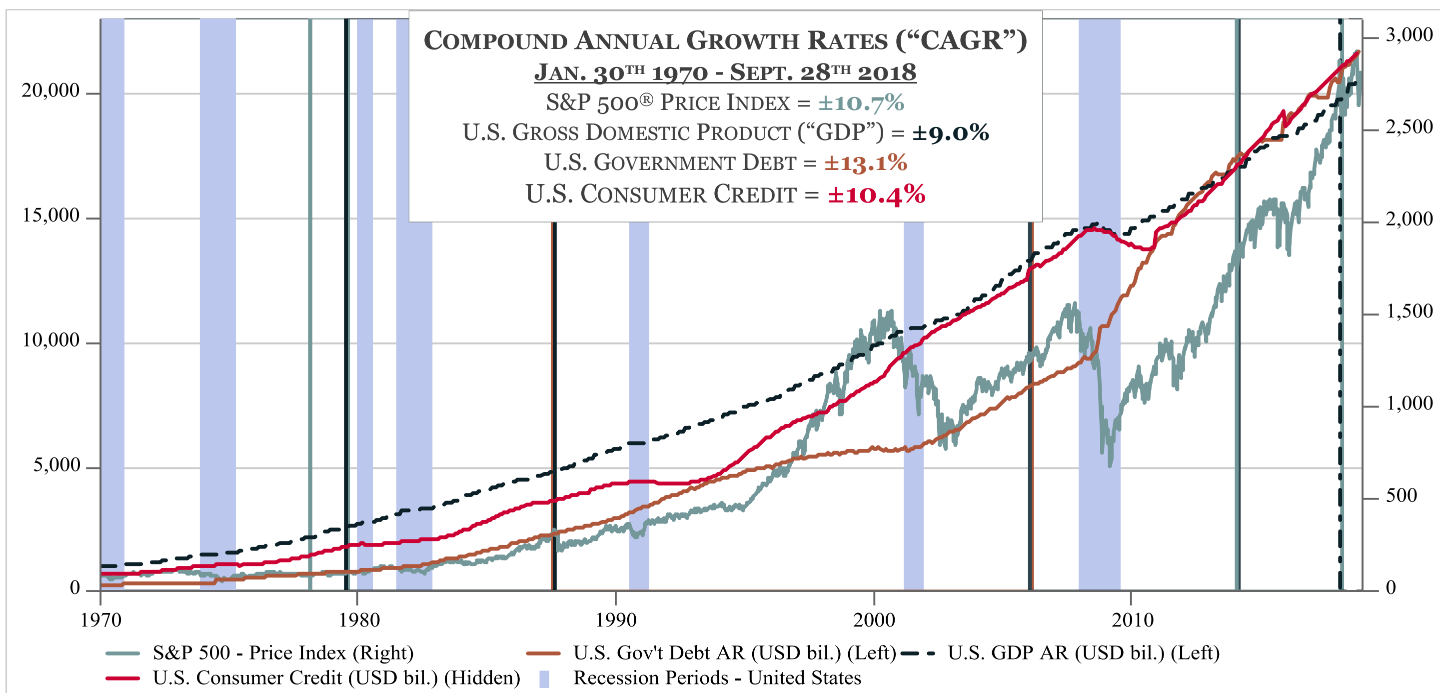
CHART I: U.S. GOVERNMENT DEBT & CONSUMER CREDIT VS. S&P 500® PRICE INDEX



Source: McShane Partners & FactSet Research Systems, Inc.

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correct, as well. It is the uncomfortable reduction of debt that causes economic growth to slow and equity markets to decline. The Investment Team is *not* in the business of predicting market declines, but it is our responsibility to identify, acknowledge, and manage these market-/ investment-related risks, and, in our humble opinion, this is a considerable risk that will manifest itself at some point.

On the previous page, Chart I provides a long-term illustration of the growth in both consumer and government debt relative to the S&P 500® Index and U.S. GDP growth, highlighting how growth rates in consumer credit and government debt have outpaced both equity market returns and GDP growth.

UNILATERAL UNITED STATES NO LONGER

The U.S. is not alone in its debt addiction, as the rest of the world ("ROW") has followed the U.S.'s lead in utilizing leverage to accentuate growth, and it has been a relatively successful strategy, especially for China, which now comprises almost **±19.0%** of global GDP: the cost of this economic success, however, can be seen in the growth in China's total debt-to-GDP ratio, which stood at **±310.5%** as of March 31st 2018 (See Chart IV).

As demonstrated below in Chart II, China and the ROW contribute a significantly *larger* portion to global GDP than the U.S. Thus, the Investment Team sees a far *larger* risk of the ROW challenging the status of the U.S. dollar ("USD") as the global reserve currency relative to the risk posed by any attempts made by the U.S. to exert unilateral control over global trade relations through the imposition of punitive tariffs on truculent trading partners.

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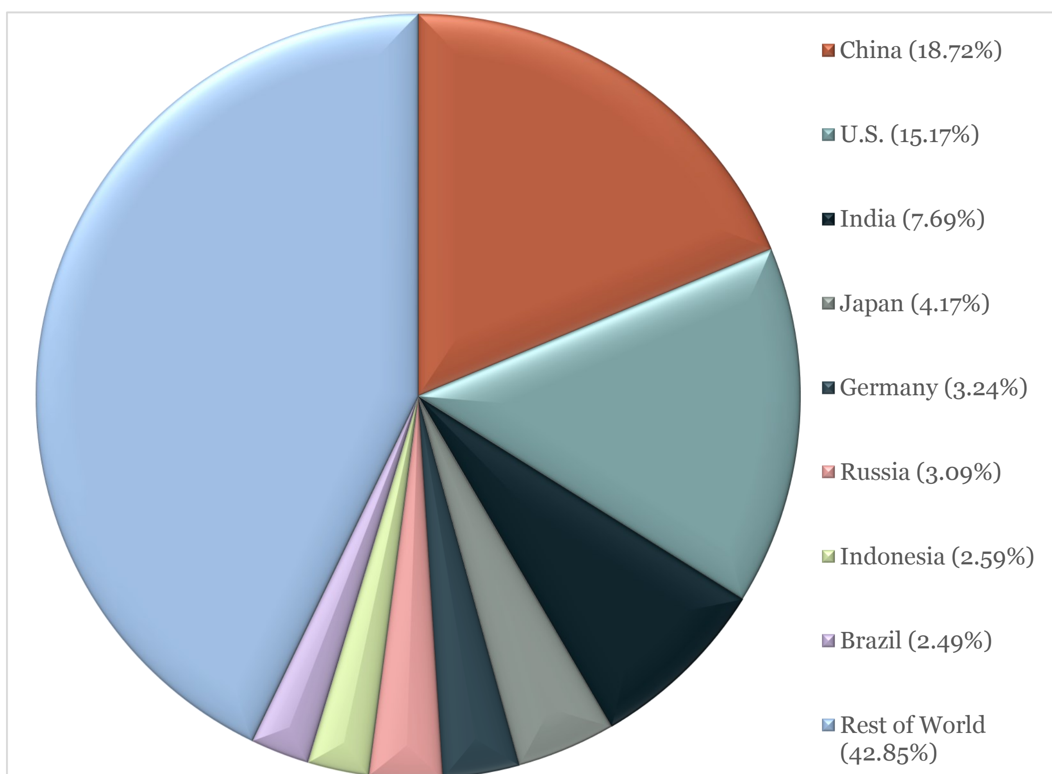
CHART II: GDP AS % OF GLOBAL GDP BASED ON PURCHASING POWER PARITY ("PPP")



Source: International Monetary Fund ("IMF") DataMapper

ABOUT MCSHANE PARTNERS

McShane Partners is an experienced, boutique registered investment advisor dedicated to independent, comprehensive wealth management. Founded over 30 years ago, the firm, from its inception, has had a singular focus: to provide highly customized investment management and financial planning solutions to clients.

Boutique Firm:

Being a boutique wealth management firm allows us the flexibility to provide more personalized service and offer unique investment solutions to clients in a Fee-Only environment.

Team Approach:

Because each client's situation is different, the team of advisors is hand-selected to ensure areas of expertise are appropriately aligned with the client's specific needs and interests.

Proprietary Investment Research:

The differentiating factor of our portfolio management process is the proprietary investment research driving the portfolio construction. All investment research and analysis is done entirely in-house by our Investment Team.

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Simply put, the real long-term risk of tariffs is *not* that they provoke retaliatory tariffs against the U.S., but, rather, they persuade the ROW to respond by challenging the longstanding deference to the USD and its denomination across global financial markets.

Further incentivizing the ROW to delink from the USD is the extraordinary amount of outstanding USD-denominated debt issued by the ROW, which endures daily vacillations in the amount of interest owed, depending on the fluctuations in the USD relative to local currency ("LC") markets: as the Investment Team has highlighted in prior newsletters, this is why emerging market ("EM") equities have such a pronounced inverse relationship relative to the USD, as can be seen below in Chart III. According to an article published in *The Wall Street Journal* earlier this quarter, EM governments, financial institutions, and corporations have a combined **±$2.7 trillion** in outstanding USD-denominated debt coming due between now and 2025 (*Source: The Wall Street Journal*). Furthermore, according to data published by the Bank for International Settlements ("BIS"), the USD

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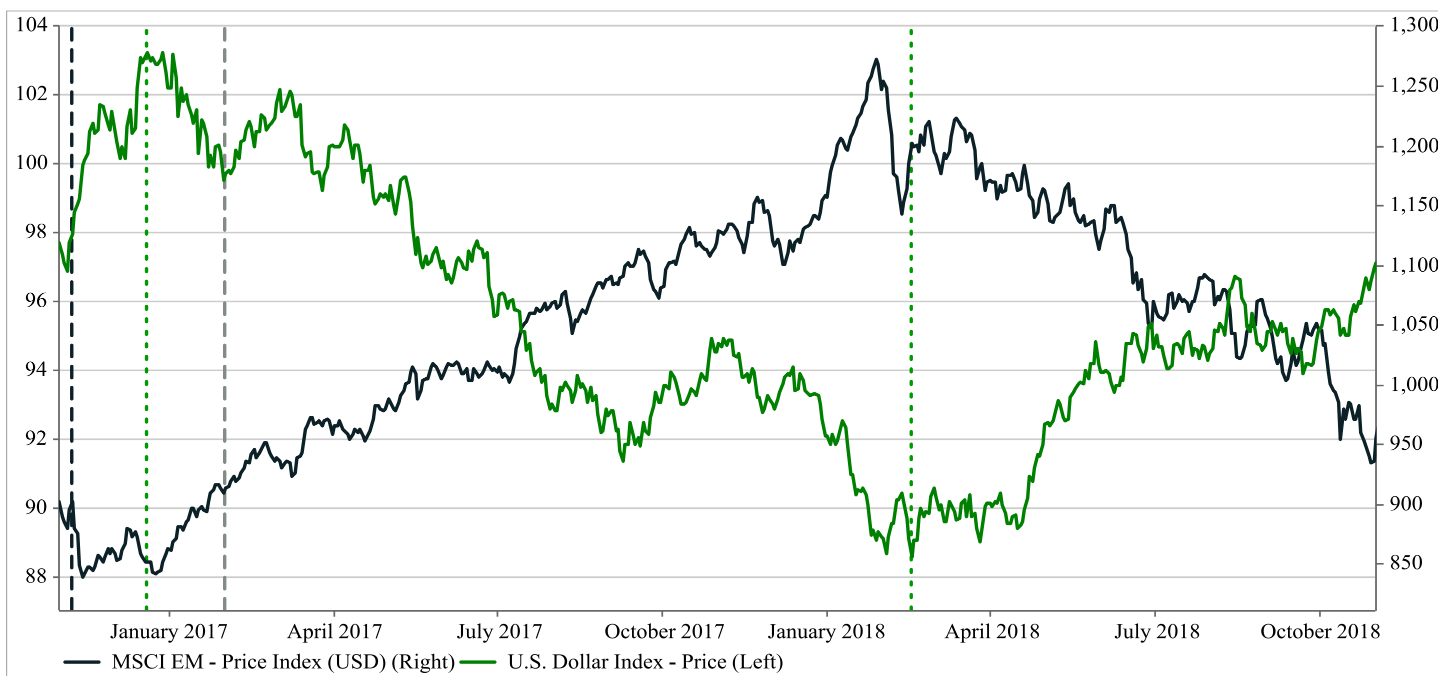
CHART III: MSCI EMERGING MARKET INDEX VS. U.S. DOLLAR INDEX



Source: McShane Partners & FactSet Research Systems, Inc.

MONTHLY INDEX REVIEW
USD TOTAL RETURN

DATA AS OF NOVEMBER 30TH 2018	NOVEMBER 2018	2018 YTD	2017	2016
S&P 500®	+2.04%	+5.11%	+21.83%	+11.96%
Dow Jones Industrial Average	+2.11%	+5.59%	+28.11%	+16.50%
NASDAQ Composite	+0.49%	**+7.24%**	+29.64%	+8.87%
Russell 2000	+1.59%	+0.98%	+14.65%	**+21.31%**
MSCI Emerging Markets	**+4.13%**	**-11.96%**	**+37.75%**	+11.60%
MSCI EAFE	**-0.11%**	**-8.96%**	+25.62%	+1.51%
Bloomberg Barclays U.S. Aggregate Bond Index	+0.60%	**-1.79%**	+3.54%	+2.65%

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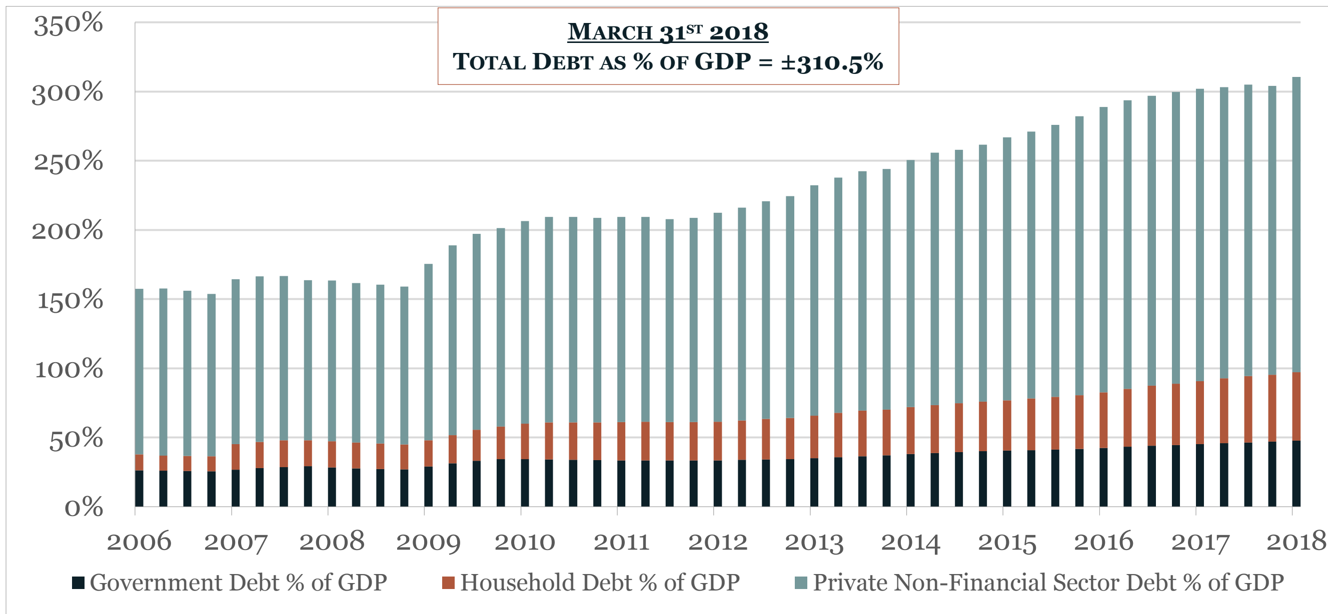
accounted for, by far, the largest share of outstanding foreign currency credit to non-bank borrowers in EM economies, at **±$3.7 trillion** as of March 2018, followed by the euro ("EUR") with **±€790.0 billion**, and the Japanese yen ("JPY") with **±¥70.0 billion** (*Source: Bank for International Settlements*).

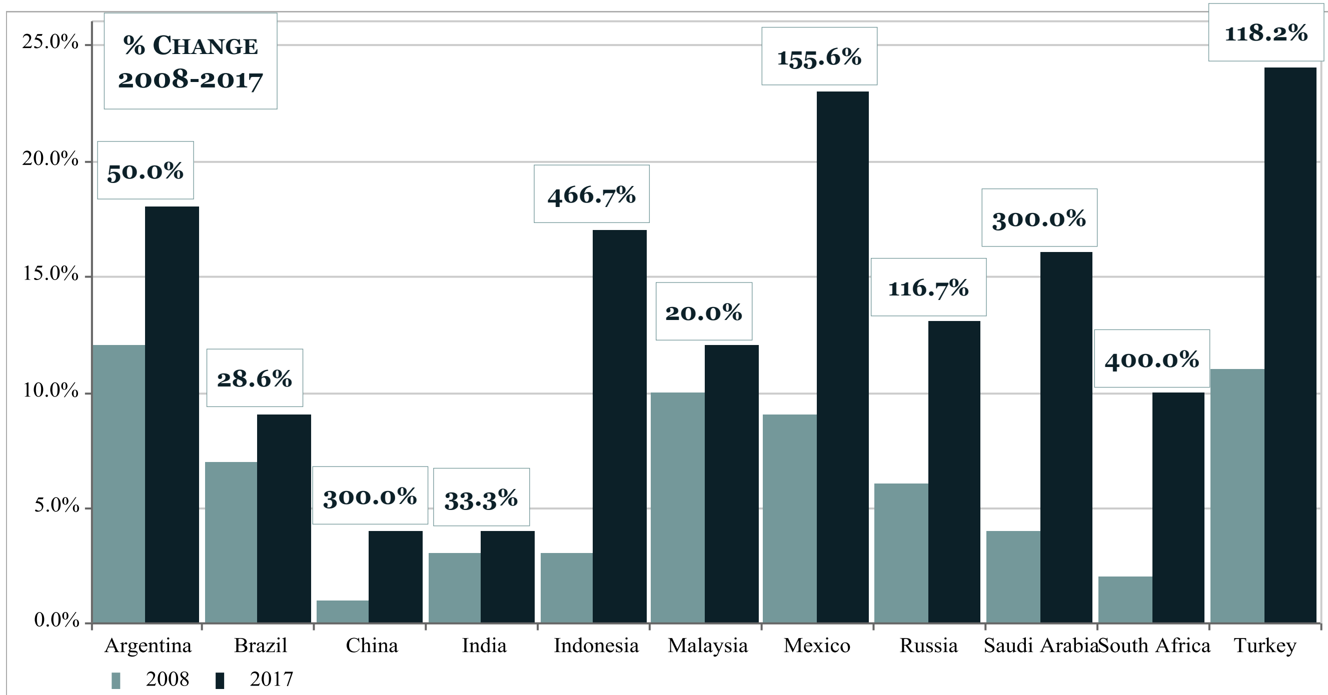
Charts IV & V, below, highlight the massive growth in debt across China and various other EM countries over the past decade. As can be seen in Chart IV, the slow, steady growth in Chinese debt has Continued on next page

Chart IV: Chinese Debt Levels as % of GDP



Source: McShane Partners & FactSet Research Systems, Inc.

Chart V: U.S. Dollar Debt to Non-Bank Borrowers as % of GDP



Source: NBF Economics

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taken the country's total debt-to-GDP ratio well above **±300%**, creating a very real concern that slowing GDP growth will translate into a steep equity market correction by triggering an immediate need to drastically reduce national debt levels.

As China is not alone in its reliance on debt-fueled growth, Chart V highlights the growth in USD-denominated debt by country, which is a particularly dangerous debt predicament because it can quickly become caustic, based on sudden movements in the USD, which are unpredictable and impossible for a country with USD-denominated debt to control, much like being held responsible for the safety and security of your own car while one passenger is steering and another passenger is controlling the pedals.

"The serious investor knows that among the many signposts that point to corporate and investment growth, a rising dividend trend is perhaps the most significant."

- Geraldine Weiss

CONCLUSION

Despite our dour view on the levels of debt in the economy, the economy continues to grow steadily and remaining invested, albeit, prudently is still the best course of action. Acknowledging, understanding, and tracking debt levels across global financial markets gives us the tools to navigate potential downturns, and given, our aforementioned concerns, the Investment Team continues to position portfolios conservatively from an asset allocation and individual-security perspective.

As highlighted in our "Stock & Strategy Spotlight" section, below, we believe we can continue to identify individual companies with solid balance sheets and quantifiable cyclicality to outperform the broader market over a full market cycle, particularly during a downturn. As volatility increases, fundamental research and active management are more valuable than ever, and, in the near term, we expect this to persist.

STOCK & STRATEGY SPOTLIGHT

NAME	TICKER	2018 YTD
Daktronics, Inc.	DAKT	**+0.33%**

DESCRIPTION & INVESTMENT THESIS

Daktronics, Inc. ("DAKT") is a leading manufacturer of digital signage and scoreboards, with a market capitalization of ±$405 million, minimal debt, and a strong cash position. Given the recent underperformance of small cap U.S. equities relative to the broader market, the Investment Team is incrementally positive on shares of DAKT and the company's near-term outlook, despite the recent **±22.4%** jump in share price this past month. Furthermore, the company's aforementioned debt-free balance sheet and robust ±3.2% dividend yield make shares of DAKT more attractive, even after adjusting for rising volatility and potential downside/drawdown risks. The market for digital signage is increasingly competitive, and the company has experienced margin pressure as larger industry peers/competitors have become increasingly aggressive on price-based competition, which we anticipate will continue. The Investment Team believes, however, that the late-cycle stadium scoreboard and construction business, as well as more-robust municipal/regional budgets, will drive higher volumes to - at least partially - offset pricing pressures. The company's most-recent earnings results exhibited a positive reversal in segment-level trends, with DAKT beating consensus estimates and expectations. The Investment Team is currently using a 12-month price target of **$10.00** for shares of DAKT based on a price-to-tangible book value ("P/TBV") multiple of **±2.0x**, which we believe is relatively conservative given the company's history of navigating multiple economic recessions, while also exercising disciplined, responsible balance sheet management through various business/market cycles.

Wealth Advisory Overview

Estate Planning Under the New Tax Regime

Managing the Step-Up in Basis for Estates Less than $11.4 Million

For those with nontaxable estates, the focus has shifted to income tax planning vs. traditional estate planning. Upon death, heirs inherit assets with a basis equal to the fair market value ("FMV") at the time of death. Since most assets appreciate in value over time, this benefit is called the "basis step-up." The heir's basis becomes the FMV of the asset at the time of death and can reduce or eliminate the income tax due when the heir sells the asset. The basis step-up is not permitted for assets held within a credit shelter trust. If the beneficiary of the credit shelter trust is an elderly or ill surviving spouse, it may be worthwhile to distribute the appreciated assets to the surviving spouse prior to his or her death in order for the surviving spouse's heirs to get a basis step-up. This would have to be weighed against the benefits of using a trust. An alternative would be to leave the assets in the credit shelter trust and modify the terms of the trust to provide the primary beneficiary with a general power of appointment.

With the higher gift tax exclusion, it may make sense for a child to gift appreciated property to a terminally-ill parent in order for the child to receive a stepped-up basis when the parent bequests the property back to the child. Under this scenario, the child uses part of his or her gift tax exclusion, but incurs no gift tax, and could avoid a future negative income tax consequence upon sale of the asset due to the stepped-up basis. There are a couple of things to consider: 1) The child must trust that the parent will bequeath the asset back to him or her and 2) the parent must live for at least a year before the asset is transferred back to the child. A way to avoid the one-year requirement is for the parent to bequeath the property to an irrevocable trust for the child. This would preserve the stepped-up basis and also provides legal protection against creditors.

Avoiding a Basis Step-Down

In the case of assets that have declined in value, the income tax basis could "step down" to the FMV at the date of death. A terminally-ill person with an estate under $11.4 million should consider gifting these assets prior to death since the recipient would retain the donor's cost basis and could either take advantage of a capital loss or recover the donor's basis.

"Business as Usual" for Estates Above $11.4 Million

A few people will die owning assets in excess of the estate tax exemption. If Congress does not change the law, after 2025, the exemption amounts revert back to $5.49 million ($10.98 million for married couples), adjusted for inflation. There was some initial concern around whether or not there would be a "clawback," which meant that gifts made between 2018 and 2025 might result in an estate tax being due if the gifts made during these years were more than the estate tax exclusion amount if the exemption reverted back to the lower amounts in 2025. The IRS issued a proposed regulation on November 20th that stated it will not seek such retroactive taxes and that making large gifts now will not harm estates after 2025. The IRS will hold a hearing on this proposed regulation on March 13th 2019.

Those who will likely be subject to estate taxes should continue to explore the traditional estate tax avoidance techniques used to remove appreciating assets from the estate during life by establishing irrevocable trusts for the spouse (spousal lifetime access trusts), children (qualified personal residence trusts), and charities (charitable remainder trusts). They should consider placing life insurance within irrevocable life insurance trusts. In addition, they should possibly form entities such as family LLCs to freeze the value of appreciating assets and take advantage of discount opportunities. The annual gift tax exclusion will remain at $15,000 during 2019, therefore individuals should take full advantage of this "freebie" way to move money out of their estates. For example, a grandmother and grandfather with two married children and four grandchildren could transfer $240,000 out of their joint estate in 2019 just by using the $15,000 annual exclusion allowance.

There are estate and income tax planning opportunities under the new tax law for everyone. We continue to work with our clients, their estate planning attorneys, and their CPAs to ensure that we seize all relative planning opportunities over the next seven years .

Around McShane Partners

McShane Partners Supports Verse & Vino

2018 was our fourth year sponsoring this premier event, which supports the Charlotte Mecklenburg Library Foundation. Verse & Vino was an extraordinary event featuring multiple New York Times best-selling authors.

Mint Auxiliary Fall Event with Bobbi Brown

The Fall Enrichment Forum, *A Morning with Bobbi Brown,* was held at the Mint Museum Uptown at the Levine Center for the Arts on November 15th..

Clients and guests enjoyed an inspiring interview with Bobbi Brown followed by an intimate luncheon honoring the world-renowned makeup artist.

McShane Partners Supports the Learning Society at Queens University

The *Learning Society* of *Queens* leads the way in influencing intellectual dialogue in the Charlotte region. Member, Daniele Donahoe recently attended, *A Conversation with J.D. Vance*, the New York Times Best-Selling Author of *Hillbilly Elegy*.

Strategic Planning & Celebrating

The McShane Partners team hosted its annual offsite meeting on November 27h. This meeting was held at The Duke Mansion Library. We reviewed a successful 2018 and set new initiatives and goals for 2019. Ryan Vaudrin, CFP® won the coveted Most Valuable Employee ("MVE") award this year!

We will celebrate our accomplishments at this year's office holiday party on December 20th at Poplar, located in the historic Morrison House.

Holiday Hours

McShane Partners will be closed Tuesday, December 25th and Wednesday, December 26th, as well as Tuesday January 1st.

Please provide any planning needs or cash distribution requests accordingly.

We Wish You & Your Loved Ones
A Very Happy Holiday Season and
A Peaceful & Prosperous New Year!

McShane Partners

Wealth management is our only business; therefore, our attention is undivided and our intentions are transparent.

521 East Morehead Street | Suite 580
Charlotte, NC 28202
Phone: (980) 585-3373
Fax: (980) 265-1274
Email: mcshane@mcshanepartners.com

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