

AUGUST 2018 INSIGHTS

INVESTMENT OVERVIEW

DOLLAR DRAMA DAMPENS GLOBAL ASSET PERFORMANCE

After hitting a near-term nadir of **\$88.59** in mid-February 2018, the U.S. dollar (“USD”) index rapidly reversed course through the end of 2Q18, rallying **+7.7%** and reaching its highest level in almost a year. This rebound in the USD can largely be attributed to the convergence of several cyclical tailwinds and a heightened sensitivity to headline risks, such as increased uncertainty regarding the Trump administration’s trade policy agenda and a relative slowdown in the pace of international economic growth. The recent rally in the USD is reminiscent of the period immediately following the 2016 U.S. election, where the stage and cast of characters are the same (e.g., protectionist trade policy, rising short-term interest rates, etc.).

Rapid appreciation of the USD tends to have pervasively negative investment implications for certain asset classes, sectors, and segments - such as large cap U.S. multinational equities, commodities, and emerging market (“EM”) equities - because of the USD’s role as the globally-accepted common currency, with most globally-traded assets and liabilities priced in USD. The Investment Team believes that the currency-related, foreign exchange (“FX”) headwinds from a strong USD will likely be transitory and should adjust as markets progress through the later stages of the economic cycle.

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WEALTH ADVISORY OVERVIEW

THE EFFECT OF TAX REFORM ON DEPENDENT CHILDREN’S INCOME

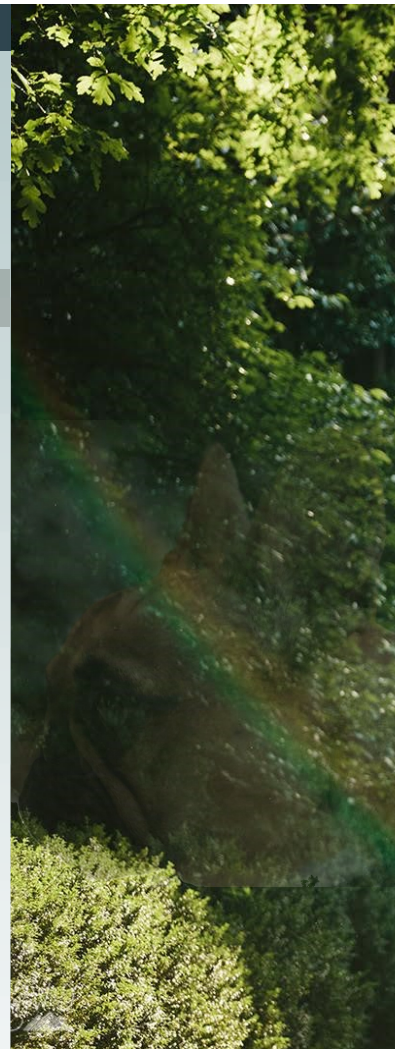
The Tax Cuts and Jobs Act (“Act”) made several changes to the way dependent children’s earned and unearned income are taxed for years 2018 to 2025. It is important to understand the changes which can be helpful in reducing taxes.

THE POSITIVE EFFECT

It is important to understand the difference in taxation between earned income and unearned income. Earned income includes any amounts received as compensation for services and is always taxed at the child’s corresponding tax rate. Unearned income includes investment income such as interest, dividends, and capital gains. It is unearned income that can be potentially subject to the “Kiddie Tax” when it is associated with dependent children. Congress enacted the Kiddie Tax rules to prevent parents and grandparents in high tax brackets from shifting investment income to children in lower tax brackets.

Currently, a child is treated as a dependent if they are under the age of 19 (or 24 if they are a full-time student) and do not provide more than half of their support. Under the new tax law, dependent children with earned income are generally in a better position due to the increase in the standard deduction from \$6,350 in 2017 to \$12,000 in 2018. Therefore, this changes decreases the amount of compensation

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SPECIAL POINTS OF INTEREST

- [Monthly Index Review](#)
- [Stock & Strategy Spotlight](#)
- [Around McShane Partners](#)

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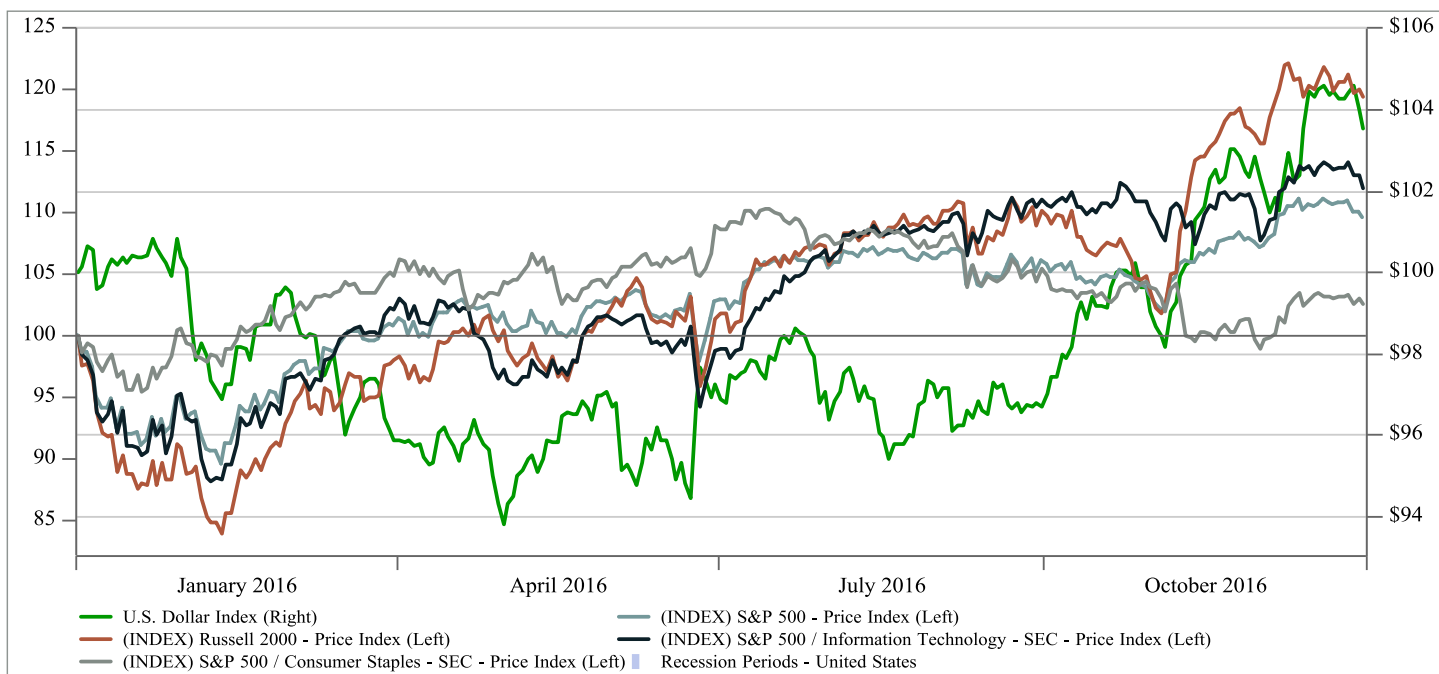
U.S. LARGE CAP MULTINATIONALS

With respect to U.S. large cap multinational corporations, the investment implications of a strong(er) USD are largely independent of sector-/industry-level factors and are predominantly stock-specific and dependent on the respective company's revenue exposure to international markets, although certain sectors and industries tend to have a greater number of multinational component companies with *higher* international revenue exposures (e.g., Consumer Staples, Health Care, Information Technology, etc.). Consequently, those sectors and industries tend to *overreact* and sell off more steeply than the broader market in response to outsized gains in the USD; conversely, those sectors/industries and market segments with little-to-no revenue exposure to international markets, such as U.S. small cap equities, are often relative beneficiaries of an appreciating USD.

Similar to late-2016, when the surprise outcome of the 2016 U.S. presidential election triggered a sharp spike in inflation expectations and short-term interest rates, the USD hit its highest level in **±14 years**, jumping **+5.4%** through December 20th 2016 after appreciating **+5.8%** over the preceding six months. This, in turn, resulted in differentiated performance across U.S. equity markets, as large cap equities with *higher* relative sensitivities to a *stronger* USD due to international revenue exposure underperformed the broader S&P 500® Index, which gained **+4.6%** through year-end 2016. As can be seen below in Chart I, the S&P 500® Consumer Staples Sector Index *declined* **-1.7%**, while the S&P 500® Information Technology Sector Index gained approximately **+1.1%**, underperforming the S&P 500® Index by roughly **-629** and **-359** basis points ("bps"), respectively, through the end of 2016. At the same time, U.S. small cap equities, as represented by the Russell 2000® Index, exhibited significant relative outperformance vs. the S&P 500® Index through year-end 2016, gaining **+13.6%**, as investors favored equity market segments with higher relative *domestic* revenue exposure, assuming incremental protection from implied currency-related headwinds. The Investment Team believes the recent underperformance of U.S. large cap multinationals in response to the rapid appreciation of the USD and the current market conditions are comparable to those from the post-election market of late-2016.

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CHART I: 2016 PERFORMANCE ANALYSIS - U.S. EQUITIES VS. USD INDEX



Source: FactSet Research Systems, Inc.

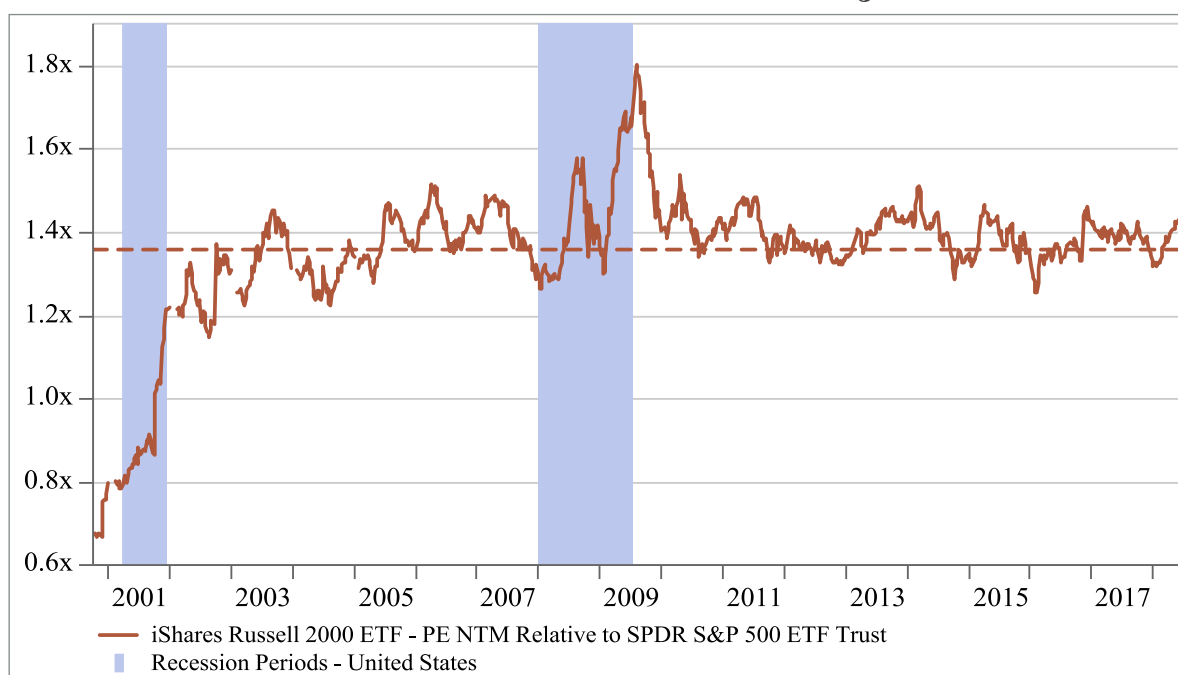
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Chart II, below, shows how the appreciation in U.S. small cap equities has resulted in an unfavorable valuation paradigm, wherein the relative premium of the Russell 2000® Index, as measured by the relative price-to-earnings next twelve months (“PE NTM”) multiple of the iShares Russell 2000® ETF (“IWM”) vs. that of the SPDR® S&P 500® ETF (“SPY”), appears *extended* relative to the long-term average (**+35.0%**), with the Russell 2000® Index trading at an implied premium as high as **+44.0%** vs. the S&P 500® Index (June 20th 2018) - comparable to the index’s **+44.0%** relative premium seen in December 2016 (December 8th 2016). Following the retreat of the USD from its December 20th peak after the November election, the combined excessive valuation and reduced concern of international revenue exposures resulted in U.S. small cap equities underperforming larger cap equities by **-7.2%** through May 31st 2017, as currency conditions normalized. Given relative valuations, the Investment Team believes that the U.S. small cap equity market is susceptible to outsized downside risk if the USD stabilizes, weakens, and/or depreciates on a relative basis.

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CHART II: RELATIVE VALUATION - RUSSELL 2000® INDEX VS. S&P 500® INDEX



Source: FactSet Research Systems, Inc.

MONTHLY INDEX REVIEW
USD TOTAL RETURN

DATA AS OF JULY 31 ST 2018	JULY 2018	2018 YTD	2017	2016
S&P 500®	+3.72%	+6.47%	+21.83%	+11.96%
Dow Jones Industrial Average	+4.83%	+4.07%	+28.11%	+16.50%
NASDAQ Composite	+2.19%	+11.77%	+29.64%	+8.87%
Russell 2000	+1.74%	+9.54%	+14.65%	+21.31%
MSCI Emerging Markets	+2.28%	-4.37%	+37.75%	+11.60%
MSCI EAFE	+2.47%	+0.04%	+25.62%	+1.51%
Bloomberg Barclays U.S. Agg. Bond Index	+0.02%	-1.59%	+3.54%	+2.65%

ABOUT
MC SHANE 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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DOLLAR DRAMA DAMPENS GLOBAL ASSET PERFORMANCE

COMMODITIES

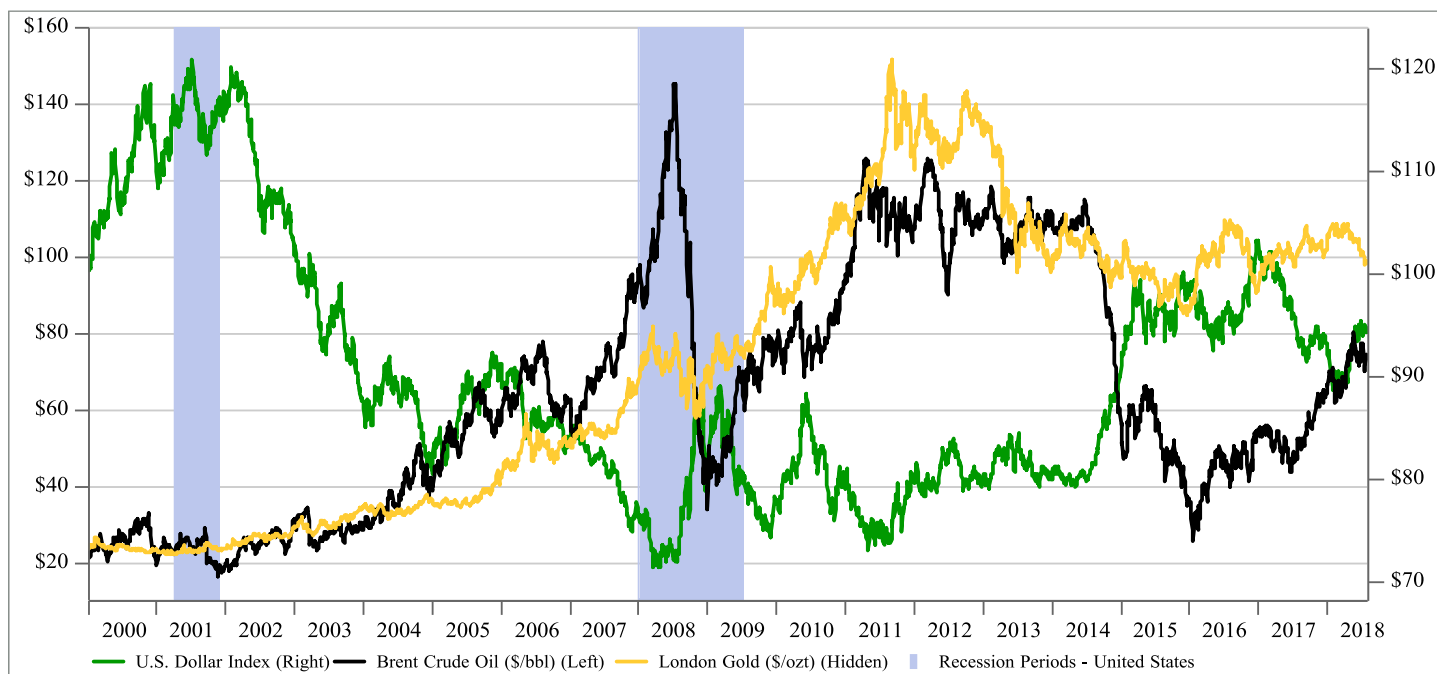
Similarly, the Investment Team believes that the recent strengthening in the USD is having a correspondingly *negative* effect on the prices of certain commodities, comparable to reactions witnessed following the 2016 U.S. presidential election. Because the majority of commodities are priced and quoted in USD-terms, the relative strength of the USD has a pronounced impact on certain commodity prices around the world, although the respective impact is *not* uniform across the entire commodity complex. As can be seen below in Chart III, the prices of both Brent Crude Oil and gold have historically exhibited *inverse* relationships with the price and relative strength of the USD, although for slightly different reasons.

Sharp increases in the USD trigger a *disproportionate* increase in oil prices quoted in USD when converted into local currency (“LC”) denominations, making oil *more expensive* for foreign buyers and implying a negative future supply-demand dynamic (i.e., *lower/reduced* demand vs. *excess/surplus* supply). Because gold and other precious metals are *relative stores-of-value commodities* vs. *input commodities* (e.g., copper, aluminum, crude oil, etc.), when the USD jumps in response to a sudden spike in short-term interest rates, gold prices typically *decline* in USD-terms, as the store-of-value proposition for gold and other precious metals *declines* relative to other lower-risk assets and financial instruments with higher and/or rising yields (e.g., Treasury bills).

In the immediate aftermath of the 2016 U.S. presidential election, despite the aforementioned historical inverse relationship between oil prices and the USD, the price of Brent Crude Oil actually *increased +23.4%* alongside the sharp post-election spike in the USD, as markets began pricing in a multitude of exogenous factors, such as a higher degree of geopolitical risk, higher economic growth and inflationary pressures from fiscal stimulus, and the positive impact/effects of deregulation on the energy sector (e.g., fossil fuel production) within the U.S. This unique, positive correlation between oil prices and the USD held through late-June 2017, with oil prices retrenching *-19.0%* from 2016 year-end levels as the USD continued to decline from December 2016 peak levels, while gold prices stabilized from a

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CHART III: COMMODITY PRICES VS. USD INDEX



Source: FactSet Research Systems, Inc.

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DOLLAR DRAMA DAMPENS GLOBAL ASSET PERFORMANCE

post-election decline of **-9.7%**, recovering **+7.9%**. As with most exogenous events that trigger excessive corrections or appreciations in unique asset classes, patience will often afford prudent investors the opportunity to revisit those asset classes after a return to more normalized levels (i.e., *mean reversion*) over a given period of time.

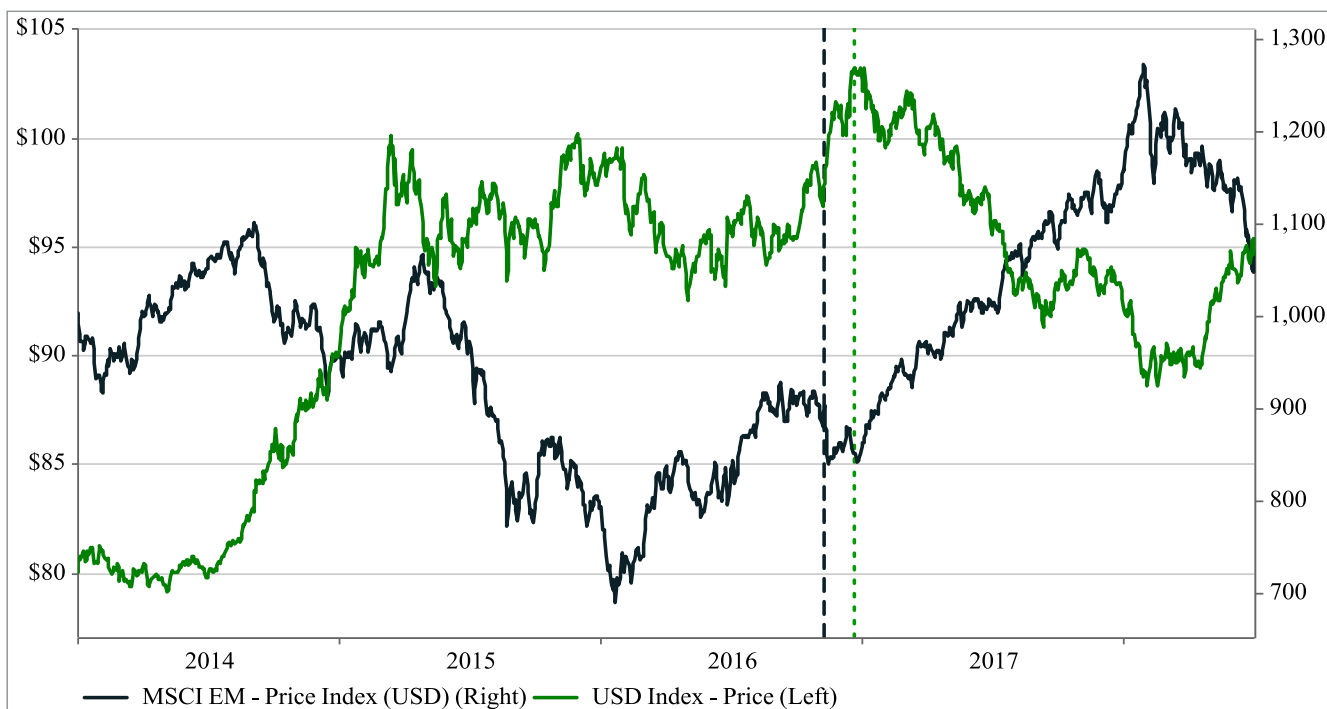
EMERGING MARKET EQUITIES

The acute appreciation in the USD over the past 3-4 months triggered a dramatic decline in emerging market (“EM”) equities, comparable to the sharp drawdown experienced in late-2016. In both instances, the sell-off across EM equity markets can be partially attributed to rising concerns regarding the Trump administration’s protectionist trade policy agenda and the negative impact of a strong USD on the LC cost of servicing USD-denominated debt issued by EM entities. As can be seen below in Chart IV, there is a pronounced long-term inverse relationship between the performance of EM equities, as represented by the MSCI Emerging Markets Price Index (i.e., the dark blue line) and the USD (i.e., the green line) due, in part, to EM’s historical reliance on low(er)-cost USD-denominated debt to stimulate higher economic growth.

While the Investment Team acknowledges that lingering trade policy uncertainty and a strong(er) USD represent tangible near-term headwinds, it continues to believe that EM equities are relatively attractive from both a cyclical and secular perspective. Given the tendency to outperform during the later stages of the market cycle, EM equities should gain relative strength deeper into the economic cycle, while EM exporters with exposure to the U.S. should be net beneficiaries of a stronger USD, as revenues generated and recorded in USD will be translated into local currencies at higher exchange rates, although this may be partially offset by the respective impact of U.S.-imposed tariffs, making any real benefit transitory. Furthermore, the long-term secular growth drivers of relatively favorable demographic trends and a burgeoning middle class across EM economies remain intact and supportive of measured allocations to EM equities within long-term diversified investment portfolios.

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CHART IV: MSCI EM INDEX VS. USD INDEX



Source: FactSet Research Systems, Inc.

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For more information on the strong, long-term secular investment thesis for EM equity outperformance, please contact your Portfolio Manager or Wealth Advisor and request a copy of the Investment Team's 2017 White Paper, *Emerging Markets in an Era of Protectionism*.

SECOND QUARTER 2018 ECONOMIC OVERVIEW WEBINAR

As always, we look forward to discussing our thoughts on how these issues, as well as how other significant financial, economic, and geopolitical developments, are influencing our global investment outlook for the U.S. economy and financial markets around the world, during our Second Quarter 2018 Economic Overview Webinar: details and registration information are provided, below.

Please feel free to contact us at (980) 585-3390 or evanness@mcshanepartners.com if you have any questions or concerns ahead of the webinar.

SECOND QUARTER 2018 ECONOMIC OVERVIEW WEBINAR

DATE: Tuesday, August 14th

TIME: 10:00 AM EST

REGISTRATION INFORMATION

Please refer to the following link, which can also be found in the original registration email, or look for additional registration reminders, which will be sent out in the days leading up to the webinar.

To register for the webinar, please click [here](#).

A recording will be available on our website after August 15th.

STOCK & STRATEGY SPOTLIGHT

NAME	TICKER	2018 YTD
Badger Meter, Inc.	BMI	+9.64%

DESCRIPTION & INVESTMENT THESIS

Badger Meter, Inc. ("BMI") is one of the largest pure-play, publicly-traded producers and manufacturers of specialized flow measurement instrumentation and technologies. As an industry leader in the North American water utility metering market, BMI has demonstrated a long and successful operational track record of generating stable, consistent revenue growth, maintaining a high-quality balance sheet, and delivering meaningful returns to shareholders via a sustainable dividend policy. Last year, the Investment Team highlighted how, given the company's positive fundamental outlook, it had decided to add BMI to our firm-wide stock buy list after shares sold off sharply (-12.2%) in response to disappointing quarterly earnings results and had begun initiating appropriately-sized positions across applicable client investment portfolios, as well as our RWIA/MP Core 20 Equity Portfolios ([November 2017 INSIGHTS](#)). Since then, however, shares of BMI have rallied +20.6% and returned +21.6%, with the majority of the relative outperformance during this timeframe coming just this past month. The stock has jumped +16.7% throughout the month of July, with shares surging as much as +8.6% in a single session the day after the company reported better-than-expected 2Q18 earnings and provided upbeat/positive commentary regarding existing/quarter-end orders backlog through year-end 2018. Given the stock's propensity for outsized price swings and volatility around quarterly earnings, the Investment Team is currently awaiting more attractive entry points in shares of BMI before adding to existing positions, as it continues to believe in the secular, fundamental investment thesis and long-term outlook for the company as a "best-of-breed" operator within the highly-specialized water metering and flow instrumentation industry. Although BMI does warrant a premium valuation, current multiples are extended relative to historical averages, which may represent a temporary headwind to near-/intermediate-term performance - as such, the Investment Team is not currently "chasing" the stock, as it believes it will be able to purchase shares of BMI at more reasonable and attractive relative and absolute valuations.

WEALTH ADVISORY OVERVIEW

THE EFFECT OF TAX REFORM ON DEPENDENT CHILDREN'S INCOME

that would be subject to federal income taxation creating a planning opportunity for self-employed parents to hire their children. Generally, children are in a lower tax bracket than their parents allowing a shift of income from the parent's higher tax bracket to the child's lower tax bracket.

Children who earn income and are not employed by a parent are subject to payroll taxes. However, if they are under the age of 18 and their employer is a parent, no withholding for Social Security, Medicare or Federal Unemployment taxes are required by the parent. Because of this favorable tax treatment, wages paid by parents to children are reviewed closely by the IRS. Therefore, it is important to be sure that the wages paid are directly connected to the parent's business, reasonable in amount, and for services the parent can prove were provided by the child.

For example, assuming that wages of \$12,000 were paid by a parent to a child and the parent was in a 24% tax bracket, the family would realize a tax savings of \$4,716 computed as follows: Federal \$2,880 ($\$12,000 \times 24$ percent) plus self-employment tax of \$1,836 ($\$12,000 \times 15.3$ percent). Since the child would have a standard deduction in the amount of \$12,000, there would be no federal or payroll tax due. Additionally, having earned income affords the child the ability to contribute to an IRA (traditional or Roth). For 2018, IRA contributions can be made up to the amount of \$5,500.

"The only way to make money buying overpriced stocks is if they become even more overpriced."

- Michael Metz

THE EFFECT ON INVESTMENT INCOME

The Act only revises the kiddie tax rate structure, the rest of the kiddie tax rules remain the same as before. Prior law taxed unearned income over \$2,100 at the parents' tax rate. However, under the new law each child's tax is calculated using the compressed estate and trust tax rates rather than the parents' tax rates. The trust and estate tax structure is unfavorable because the rate brackets are compressed compared to the brackets for single individuals. Whether the new approach results in lower tax than under old law depends on the parents' and child's income levels.

The battle between a parent and a child regarding who should claim the child as a dependent after the age of 18 has diminished under the new law with the repeal of the exemption deduction, and the child tax credit only being available until a child reaches the age of 17. Parents claiming head-of-household filing status or claiming credits for the payment of college expenses may still benefit from claiming their child as a dependent. However, not claiming the child as a dependent allows the child to claim the full standard deduction, avoid the Kiddie Tax, claim the college tax credits, and possibly qualify for college financial aid.

The kiddie tax is somewhat easier to calculate under the Act but it can still be confusing. Depending on your circumstances, your children or grandchildren may be negatively impacted by the new rules. Your McShane Partners Wealth Advisor can help analyze the pros and cons of multiple strategies and assist families in reaching the most beneficial outcome.

AROUND MCSHANE PARTNERS

39TH ANNUAL ESTATE PLANNING & FIDUCIARY LAW PROGRAM— KIAWAH ISLAND, SC

Daniele and Leah returned to Kiawah Island for the 39th Annual Estate Planning & Fiduciary Law Program which is a two-day event attended by attorneys, CPAs, trust companies, and other estate planning professionals from North Carolina. McShane Partners and Pendleton Square Trust teamed up to host a memorable networking dinner at the Ocean Room. According to one guest, wonderful camaraderie and a gastronomical experience was had by all!



CHARLOTTE SQUAWKS

McShane Partners and guests attended the fourteenth edition of Charlotte Squawks on Wednesday, June 20th. Charlotte Squawks has become a local must see, think- Saturday Night Live meets Broadway meets our beloved Queen City! The performance was held at the Booth Playhouse in the Blumenthal Performing Arts Center.



ONE GREAT DAY OF D.E.A.R.

Leah Maybry and Lorri Tomlin took the time to “Drop Everything And Read” with a Freedom School Scholar on Wednesday, July 18th! During this citywide *One Great Day of D.E.A.R.* (*Drop Everything and Read*), each volunteer is paired with a scholar to spend an hour reading books. It is a wonderful opportunity to share your love of reading and connect scholars to a broader community supporting the critical mission of Freedom School.



REBRANDING AT MCSHANE PARTNERS



HAPPY BIRTHDAY LEAH!

We celebrated Leah's 43 years young at the office with a group offsite to Menchie's for fro-yo!



MCSHANE PARTNERS WEALTH & INVESTMENT ADVISORY

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

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