FOURTH QUARTER
DECEMBER 31, 2017

DEIGHAN
WEALTH ADVISORS

Objective, unbiased *advice*

24 Years

Deighan Wealth Advisors
1994-2018

MARKET COMMENTARY

The term "irrational exuberance" was first coined in a speech on December 5, 1996 by then-chairman of the Federal Reserve Board, Alan Greenspan. In the speech, Greenspan essentially asked the question, how do we know when asset prices have "unduly risen" because of irrational, rather than rational, behavior?

Just a few years later, Robert Shiller, the Yale Professor who would eventually go on to win the Nobel Prize in Economics, used the term as the title for his best-selling book, Irrational Exuberance. The book, published in 2000 at the height of the dot-com bubble, argued against the lofty equity valuations of the time. It was almost immediately proven accurate.

In the years since, the term "irrational exuberance" has become ubiquitous among investors. In truth, the phrase is used too much. Akin to the fable of the boy who cried wolf, investors tend to cry "irrational exuberance" whenever asset valuations rise higher and faster than expected. As such, the phrase has lost some of its usefulness as a warning cry.

First, let's clear the air by saying that there's nothing wrong with being exuberant. A rise in asset prices should make investors exuberant, and being exuberant doesn't have to come with being irrational. Asset prices can increase significantly for rational reasons.

For example, since its initial public offering five and a half years ago, Facebook (ticker: FB) stock has increased by nearly 500%. That's enough to make any investor exuberant. But, over that same period of time, Facebook's revenues have increased over 700%, and its earnings per share have increased just under 1,000%. In addition, Facebook's price-to-earnings (P/E) ratio is right in-line with peers, meaning shares appear to be fairly valued. Thus, while Facebook's stock has increased exuberantly, it has done so for what appear to be rational reasons.

Compare this with Bitcoin, the virtual currency that has increased in value (relative to the U.S. dollar) by nearly 1,400% this year. Even the most avid Bitcoin supporter is having difficulty explaining the currency's meteoric rise, given that the increase hasn't been driven by a commensurate increase in the use of Bitcoin for commercial transactions – not to mention that currencies rarely rally against other currencies to such a degree.

When it's more difficult to explain the increase in an asset's price, as is the case with Bitcoin, it becomes more likely that the increase is being driven by irrational investor behavior. Although there are valid reasons for some increase in Bitcoin relative to the dollar, the current market for Bitcoin appears to be irrationally exuberant.

When markets become irrationally exuberant, investors stand to make (and lose!) significant sums of money. In the past month, Bitcoin has seen two major decreases in value relative to the U.S. dollar. In just five days, from December 18th to December 22nd, Bitcoin fell by 26.3%. It then rallied briefly before falling again by 14.5%. It has fallen precisely because it has "unduly risen," to borrow Greenspan's words.

It is the undue rise that puts investor money at risk in an irrational market, because markets always revert to the mean. In other words, although markets can be irrational in the short term, they tend to be rational in the long term. Rational markets are pretty darn good at valuing assets, and, as a market transitions from irrational to rational behavior, prices become saner – they revert to a rational level based on facts, not wishes and dreams.

Therefore, the trick is not in identifying whether or not a market is exuberant. The trick is identifying whether or not a market is rational.

> "The trick is not in identifying whether or not a market is exuberant. The trick is identifying whether or not a market is rational."

Right now, many investors want to know whether the U.S. stock market has unduly risen. Since the depths of the financial crisis, the S&P 500 Index has risen a whopping 337.6% on a total return basis. That's equivalent to an annual return of 18.2%, which is significantly higher than the market's long-term historical average annual return of about 11%. In 2017 alone, the S&P 500 Index increased by 21.8%. What gives? Is the stock market in a bubble? Are investors irrationally exuberant?

We would argue that no, the U.S. stock market has not yet become irrationally exuberant. It is not in a bubble. Don't get us wrong – stocks aren't necessarily cheap; the market's current price-to-earnings ratio (P/E) is 22.9 compared to an average historical P/E of 15.7. But, at the same time, the market's one-year forward P/E is 18.7, when taking into account expected earnings growth over the next year. The market's two-year forward P/E is just 16.9 – a relatively sane multiple.

For context, the dot-com era was the poster child for irrational exuberance. Back then, at its peak, the S&P 500 Index had a P/E multiple of 32.9. If the market today were similarly valued, the price on the S&P 500 Index would be 3,920 points, rather than 2,726 points (at the time of this writing).

Unlike the dot-com bubble, when stocks were driven upward by the irrational belief that any and all internet-based companies would become great successes, today's stock market has been driven upward by steady, real improvements in the U.S. economy. One can rationally explain most of what's been driving stock returns by looking at economic indicators:

- The U-3 unemployment rate is now at 4.3%, the lowest it's been since the start of the millennium. This measure of total unemployment has only been lower one other time since 1970.
- The U-6 unemployment rate, which accounts for discouraged workers, marginally attached workers, and part-time workers who want to work full-time, is at its lowest level since the height of the housing boom.
- Consumer confidence remains near a 17-year high, which it reached in November. Consumer confidence has only been higher two other times since the Conference Board started tracking it in 1967.
- Manufacturing jobs, though still well below levels in the early 2000's, continue to increase. Likewise, though they lag historical levels, building permits continue to increase and are significantly higher than they were post-housing bust.
- Corporate earnings are now at their highest levels in history, and, in aggregate, analysts expect earnings to grow another 9% in the coming year.
- Inflation continues to be relatively contained, with the consumer price index (CPI) expected to increase 2.1% in the coming year.
- Interest rates, though increasing, remain historically low, which should continue to provide a tailwind for businesses and consumers alike, and incoming Fed Chair, Jerome Powell, is expected to keep the Federal Open Market Committee (FOMC) on a steady interest rate path.

> "Sometimes the stock market goes up, because it should go up."

Sometimes the stock market goes up, because it should go up. We believe that is the case today, and we believe it has been the case for the past several years.

In addition to the above, Congress managed to squeak through its tax bill, the Tax Cuts and Jobs Act, in December. Though the tax bill's long-term economic impact remains unclear, it contains definite benefits for corporations and business owners. Specifically, the bill:

- Lowers the corporate income tax rate permanently to 21%;
- Establishes a 20% deduction of qualified business income for certain pass-through businesses;
- Allows full and immediate expensing of short-lived capital investments for five years;
- Taxes repatriated foreign profits at a rate of 15.5% for cash and cash-equivalent profits and 8% for reinvested foreign earnings;
- Moves to a territorial tax system, and;
- Eliminates the corporate alternative minimum tax (AMT).

The above changes are likely to be of significant financial benefit to corporations, especially large, multinational corporations, and this is a good thing for corporate shareholders. What's less certain is whether this handout to corporations will have any lasting effect on workers and the economy at large. Some analysts expect significant increases in jobs, wages, and gross domestic product (GDP), while others are less convinced.

When it comes to individuals, the tax bill is a bit of a mixed bag. The bill generally reduces tax rates across most tax brackets, but it does little, if anything, to simplify the tax code. While it increases the standard deduction from $6,500 to $12,000 for single filers and from $13,000 to $24,000 for joint filers, it eliminates the personal exemption, limits the mortgage interest deduction, and limits deductions for state and local income, sales, and property taxes.

For affluent people with significant income and/or personal wealth, the bill does contain some clear benefits. For example, the bill raises the AMT exemption from $86,200 to $109,400 for married filers and increases the phase-out threshold to $1 million. It also increases the estate tax exemption to $11.2 million for individuals and $22.4 million for couples.

At the same time, the bill eliminates the ability to deduct miscellaneous itemized deductions subject to the 2% of AGI floor, meaning that investment advisory fees will no longer be tax deductible. Also, although the deduction for charitable contributions remains in place, the higher standard deduction threshold may force affluent investors to "lump" their charitable contributions into certain tax years but not others.

Despite its mixed-bag approach, the Tax Cuts and Jobs Act appears to be the tax plan that Wall Street (if not Main Street) wanted. Therefore, we expect that it will, in addition to the economic indicators listed earlier, underpin the stock market as we head into 2018.

> "Despite its mixed-bag approach, the Tax Cuts and Jobs Act appears to be the tax plan that Wall Street (if not Main Street) wanted."

Of course, it's our job to never become too exuberant. This is not a market without risk. Anytime interest rates rise, there's a risk that the economy slows down and stocks fall. Importantly, the yield curve has been flattening. A flat yield curve presages an inverted yield curve, and an inverted yield curve presages recession.

There also exist tail threats, such as natural disasters or acts of terrorism. The situation in North Korea is particularly alarming and represents a significant tail threat.

> "…the higher standard deduction threshold may force affluent investors to "lump" their charitable contributions into certain tax years but not others."

That said, on the whole, we remain cautiously optimistic and have positioned client portfolios accordingly. When appropriate, we've trimmed winners, such as Apple and Amazon. But, for the most part, we remain fully invested. This market appears rational, despite its significant increase, and, based on the strength of the U.S. economy, we think stocks have room to run.

To close, as we head into 2018, everyone here at Deighan Wealth Advisors would like to thank you for the trust you've placed in us. It is a pleasure helping you invest for the future. May you and yours have a truly Happy New Year, and may 2018 prove to be a year where rational thinking prevails.

Our sincere gratitude to Matthew T. Skaves for authoring our Market Commentary.

– Deighan Wealth Advisors

PORTFOLIO CHANGES

ADDED: MLM

REMOVED: RTM

We have added Martin Marietta Materials, Inc. (MLM) to portfolios that hold individual equities. MLM is a top producer of aggregates for highway, infrastructure, commercial and residential construction. We think that the current environment for building materials is favorable with residential construction growing, non-residential on an upswing, and US transportation spending increasing. MLM shares show strong free cash flow, low debt, and an estimated long term growth rate of nearly 20%. The shares are trading at an attractive valuation and are replacing the Guggenheim S&P 500 Equal Weight Materials ETF in client portfolios.

SOUNDBYTES

Jean Deighan will be honored at the Bangor Region Chamber of Commerce annual dinner with its highest honor, the Norbert X. Dowd award, which is given each year to "a member of the business community whose commitment of time, resources and talent has made the Bangor region a better place to pursue one's livelihood and dreams." We are all so proud of you for receiving this well-deserved honor, Jean!

Tyler Hoxie successfully completed the second of three required examinations toward his Chartered Financial Analyst (CFA) designation. The CFA exam is considered the most rigorous in the financial industry. Congratulations, Tyler!

Our Seasons of Maine art appreciation event this past September was again a huge hit! Thank you to all of our friends and colleagues for attending, and to the wonderful artists who make this annual gathering so successful.

We were thrilled to be chosen for a Maine Public testimonial video. Visit our website at www.deighan.com for a link to the video if you'd like to hear why we support this wonderful organization.

PLANNING CORNER

Optimizing Charitable Giving after Passage of the Tax Cuts and Job Acts Bill

As if the holiday season and year end scramble were not enough stimulation, the last few weeks of 2017 were fraught with suspense surrounding a new tax bill. It was a thick tome, and until the last few days of the year, it was unclear whether it would pass and few knew what it contained. The bill passed at the eleventh hour resulting in massive changes to many traditional itemized deductions. Charitable deductions survived the bill, but now they may be of limited tax benefit given the dramatically increased standard deduction, which was raised to $12,000 for single persons and $24,000 for married couples. In Maine, the bulk of most taxpayers' deductions have been state and local taxes. Under the new law, state income taxes are no longer deductible and property taxes are deductible up to a $10,000 ceiling. Consequently, many taxpayers, especially married taxpayers, will never accumulate enough itemized deductions to surpass the standard deduction of $24,000.

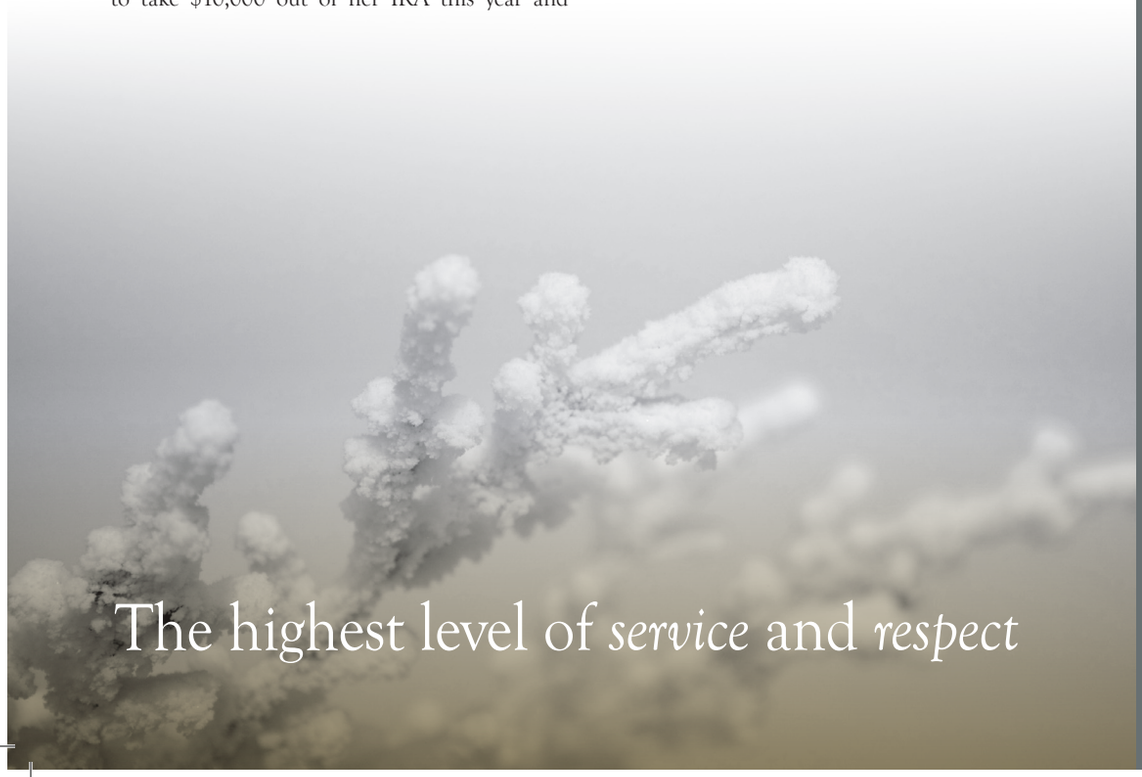
Some worry that this will negatively impact charitable giving. While studies show that donors will give regardless of whether they receive a tax break, this new law will be the true test of those studies. Anecdotally, we must report that donors with whom we work seem to have a keen interest in doing well while doing good. Thus, we think it might be useful to point out two ways that donors can still gift to charity on a tax advantaged basis.

First, for IRA owners over the age of 70½, it makes sense to make a qualified charitable IRA distribution (QCD) of their annual required minimum distribution (RMD) directly to charity. Last quarter, our colleague Michele Depew, CPA, wrote a detailed article illustrating the benefits of using a QCD to make charitable donations. Although the tax calculations will change somewhat, the benefit remains. Simply put, assume a charitably inclined donor is required to take $10,000 out of her IRA this year and recognize it as taxable income. Instead, if the donor gifts the RMD amount directly to charity, she need not include the donated amount as taxable RMD income.

While QCD's are great for IRA owners over age 70½, many charitably inclined people are younger. Donors of all ages may hold low cost basis stock positions that they would like to gift to charity. Enter the Donor Advised Fund! A contribution to a Donor Advised Fund (DAF) constitutes a gift to a qualified charity at the time the DAF contribution is made. Later, gifts may be directed from the DAF to qualified charities over ensuing years.

For example, a charitably inclined couple generally contributes $5,000 a year sprinkled among eight to ten charities. They establish a DAF in 2018 with $25,000, deduct the gift against 2018 income, and choose to stretch their annual gifting from the DAF over five years, again sprinkling $5,000 among their favorite charities each year. By using a DAF to "clump" the funds destined for charity into one year, the couple can plan for an itemized deduction amount that exceeds the new increased standard deduction of $24,000 for that one year. DAFs can be established with a number of financial services companies including Schwab, Fidelity, Vanguard and the Maine Community Foundation. Features and minimums vary, but establishment minimums can be as low as $5,000 with a $50 minimum gift to individual charities. There are rules of course. The DAF cannot be used to satisfy a pledge. Our advice in this case is, don't pledge; just gift as you wish. Grateful charities will understand.

For more details on DAF's and QCD's, please give us a call. We are more than happy to work with you and your tax advisor to determine the best way for you to do well as you do good!



DEIGHAN
WEALTH ADVISORS

TELEPHONE 207-990-1117

www.deighan.com

DEIGHAN WEALTH ADVISORS
455 HARLOW STREET
BANGOR, ME 04401

JEAN M. DEIGHAN, JD, CFP®
CHIEF EXECUTIVE OFFICER
jeandeighan@deighan.com

JENIFER L. BUTLER, CFA, CFP®
PRESIDENT
CHIEF INVESTMENT OFFICER
jeniferbutler@deighan.com

LUCIE E. ESTABROOK, CTFA
VICE PRESIDENT
CHIEF OPERATING OFFICER
lucieestabrook@deighan.com

TYLER D. HOXIE
PORTFOLIO ADMINISTRATOR
ASSOCIATE ANALYST
tylerhoxie@deighan.com

KAREN S. MITCHELL, CAP
OFFICE MANAGER
karenmitchell@deighan.com