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THE ADVISOR

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Is the Banking System's Recent Liquidity Crunch a Potential 'Iceberg'?

For the most part, September was another month of nervous stability for the financial markets — until the very end. As September gave way to October, the stock market took another big dip, with the Dow Jones Industrial Average falling around 900 points in two days. This latest swoon was attributed mainly to news that the U.S. manufacturing index posted its weakest reading since 2009.[1] While President Trump blamed the Federal Reserve, many economists blamed the Trump-China trade war — all while most of the headlines continued to focus on Congress's new impeachment inquiry into the president.

So far, Wall Street seems to be shrugging off the impeachment issue, and the stock market remains basically locked in the same nervous holding pattern it's been in since the start of 2018. However, that could change — particularly when you factor in all the other uncertainties affecting the markets these days, which include recession fears, new Middle East tensions, and a partially flat yield curve.

Liquidity Mystery

Another new uncertainty also emerged in September that didn't get a lot of attention — though it may be just as significant as any of the other potential warning signs. On September 16, the U.S. banking system experienced an overnight liquidity crunch in which, suddenly, banks didn't have enough cash on hand for repurchase agreements, a.k.a. repos. As a result, the Fed Funds Rate momentarily spiked to 10%. This occurred just days before the Fed was set to lower the rate from 2.25 to 2%. With no other choice, the Fed had to step in and immediately pump cash into the banking system, pledging to allow roughly two weeks of overnight repo transactions, each injecting around $75 billion daily into the economy.[2]

What's so unsettling about this development is that no one really has a definitive explanation for how it happened. Fed Chairman Jerome Powell tried to attribute it largely to massive cash withdrawals from bank accounts to pay their September 15 tax estimates.[3] That theory doesn't hold water for several reasons. One is that such with-

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When Should You Consider a 401(k) Plan?

In 1981, tax laws established the 401(k) plan, a form of defined-contribution retirement plan. The government's motivation was to encourage Americans to increase their private savings as a supplement to Social Security. For employers, the appeal was that defined-contribution plans are simpler to administer and less troublesome to fund than pension plans. For workers, the advantages include an immediate reduction in taxable income, a potential investment boost in the form of employer matching contributions, and the potential for higher earnings accumulation from tax deferrals on capital gains and income.

No wonder, then, that defined-contribution plans are among the most recognized and prized benefits in the American workplace. Employers have learned that the range, quality, and performance of their plan's investment choices matter, as do the ability to make frequent changes in investment choices, take out loans, and flexibility to tap plan assets when employees experience financial hardship. They have also learned that a generous employer-matching contribution is the single most valued feature for employees.

But, is your employer-sponsored 401(k) always the best place for your money? The answer may not be an unequivocal yes. Here are five questions to answer when deciding whether and how much you should contribute:

1. Do you have an emergency fund? Typically, every household's

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Potential 'Iceberg'?

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drawals occur annually every September 15 without creating a liquidity crunch. Another is that Trump's corporate tax cuts should have made a crunch even less likely, not more.

Others have blamed the incident on new rules stemming from the Financial Crisis, which say banks must keep more reserves in U.S. treasuries, leaving them less available cash to meet customer demands. However, those rules have been in place for over 10 years now without a sudden crunch like this occurring — so that theory doesn't cut it, either.

The main point here is that somebody probably does know exactly what caused the incident, but no one is talking about it. As advisors, we because this kind of situation feels eerily familiar.

Iceberg Ahead?

Remember that in 2008, it wasn't until it was too late that we learned how the banks had all tied themselves together with credit default swaps. They had all reinsured one another so that once one bank failed, they all came down together. Until that point, many analysts were predicting the subprime mortgage crisis might cause a bump in the road for the economy, but nothing more. It was like an iceberg: some danger was visible above the surface, but the extreme extent of it remained hidden until we crashed into it!

Is it possible this liquidity emergency in September is evidence that banks have tied themselves together again in some other way — with interest rate swaps, for example? It seems unlikely that a majority of banks would have suddenly all run out of cash at the same time. It seems more likely that the crunch would have started with just a few banks but impacted the entire system due to an underlying connection that we may not yet know about.

The bottom line is that, even though this incident didn't grab a lot of headlines, it should give investors pause. Could it be early evidence that another financial crisis of some kind is brewing? No one knows, of course. However, with the third major correction of our current long-term secular bear market cycle long overdue, and with so many other red flags out there now, it's important to at least be aware of it — particularly if you're still not sure you've adequately reduced your own stock market risk.

As always, we encourage you to share this information — and this newsletter — with friends or family members you feel may be in danger of getting caught in the next sustained market downdraft. While it's possible (although unlikely) that this incident could merely be a financial fluke, it could also be the proverbial tip of the iceberg.

[1] "US Factory Gauge Hits 10-Year Low as World Slowdown Widens," Yahoo Finance, Oct. 1, 2019

[2] "Why the Repo Market is Such a Big Deal — and Why its $400 Billion Bailout is So Unnerving," fortune.com, Sept. 23, 2019

[3] "Fed Actions and Statements This Week Indicate Major Risk of Near-Term Economic Downturn," Numismatic News, September 29, 2019

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Help Beneficiaries Avoid IRA Mistakes

While annual contributions to IRAs are still relatively modest, the ability to roll over 401(k) balances to an IRA can result in significant IRA balances. IRAs are thus becoming estate planning tools. If this is your situation, help your beneficiaries avoid these common IRA mistakes:

- **Using the IRA balance too quickly.** Your beneficiaries' goal should be to extend this growth for as long as possible. If the IRA has a designated beneficiary, the balance can be paid out over the beneficiary's life expectancy. Spouses have additional options which can stretch payments even longer. You should stress the importance of taking withdrawals as slowly as possible.
- **Not splitting the IRA when there are multiple beneficiaries.** When there are multiple beneficiaries, it is typically best to split the IRA into separate accounts by December 31 of the year following the original owner's death. If the account is not split, distributions must be taken by all beneficiaries over the life expectancy of the oldest beneficiary. By splitting the IRA into separate accounts, each beneficiary can take distributions over his/her life expectancy. This is especially important for a surviving spouse, who can only roll over the IRA to his/her own account if he/she is the sole beneficiary. With the rollover IRA, the surviving spouse can name his/her own beneficiary, thus extending the IRA's life, and can defer distributions until age 70½. When other than an individual or qualifying trust is named as one of the beneficiaries, the IRA must be distributed within five years when the owner dies before required distributions begin, or over the owner's life expectancy when the owner dies after required distributions begin.
- **Rolling the balance over to a spouse's IRA too quickly.** Once a spouse rolls over the balance to his/her own IRA, some planning opportunities are eliminated. While the IRA balance can typically be spread out over a longer period when the balance is rolled over, the spouse may need distributions. Spouses under age 59½ can take withdrawals from the original IRA without paying the 10% federal income tax penalty. Also, spouses who are older than the original owner can delay distributions by retaining the original IRA. The surviving spouse does not have to take distributions until the deceased spouse would have attained age 70½, even if the surviving spouse is past that age. The spouse may want to disclaim a portion of the IRA, which must be done within nine months of the original owner's death. If the account is rolled over, that disclaimer can't be made.
- **Not properly establishing the inherited IRA.** An inherited IRA must be retitled to include the decedent's name, the words individual retirement account, and the beneficiary's name.

When Should You?

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first priority is to establish an emergency fund equal to three to six months of earned income. While there are ways to access funds in your 401(k) plan (loans and hardship withdrawals), it is generally easier to use an emergency fund.

2. Are you properly insured? If you have dependents, life insurance is a much more cost-effective way to provide for their needs than a savings plan.

3. Does your employer match your contributions? An employer-matching contribution is the single most compelling reason to participate in a workplace defined-contribution plan. So, if your plan features a match, it's generally a good idea to participate at least up to the maximum matching amount.

That said, over the past few years, many employers have been forced to cut back or eliminate their ongoing matching contributions. If your plan doesn't offer one, it's not necessarily a reason to stay away from it. But it does mean you should research other ways to save for your retirement.

4. Does your plan offer enough diversification? Some plans offer very few investment choices. There may be nothing wrong with these choices, but limited choices may not offer the kind of diversification you need. You may need to open your own individual retirement account (IRA) to find the wider range of opportunities that will maximize your returns while controlling for risk.

5. Are the funds well managed? Not all funds perform equally well, and some charge more than others. While you shouldn't blame a fund when the financial markets underperform, you should evaluate a fund's performance relative to the markets in which it invests.

Is your employer's 401(k) the best place for your next retirement savings dollar? Only a thorough review of the plan and your needs can answer that question. Please call if you'd like to discuss your 401(k) plan in more detail.

Converting to a Roth IRA

Roth IRAs are a valuable retirement-planning tool, as they offer a source of tax-free income after you retire. And since the federal government relaxed conversion rules in 2010, even high-income earners have been able convert to Roth IRAs. Despite some advantages, Roth IRA conversions aren't right for everyone.

What Is a Roth IRA Conversion?

In simplest terms, a Roth conversion involves changing the tax treatment of your retirement savings. Generally, contributions to a traditional IRA are tax deductible in the year you make them (contributions may be allowed but not deductible if your income exceeds certain limits). The money you contribute grows over time; when you start making withdrawals in retirement, you pay taxes on the money you take out.

Contributions to Roth IRAs, on the other hand, aren't tax deductible in the year they are made. But earnings grow tax free; when you withdraw the money, you don't pay any federal income taxes. A Roth IRA conversion involves taking funds from a traditional IRA, paying tax on any previously untaxed funds, and then putting the funds in a Roth IRA so that you can have tax-free income in retirement.

Pros of Roth Conversions

For anyone who suspects they may be in a higher tax bracket in retirement, converting to a Roth IRA may be appealing. Roth IRA conversions may also be a smart move if the value of your IRA has recently dropped, because you'll pay less tax on the conversion, or if you have other deductions or credits you can claim to help offset the tax on the converted amount. If you're young and in a relatively low tax bracket, Roth IRAs are also advantageous since you won't get much of a tax break from current deductible contributions and your taxes are likely to be higher in the future.

People who have significant assets may also use Roth IRA conversions as an estate-planning tool. If your other assets will be sufficient for your retirement income needs and you don't anticipate a need to make withdrawals from your Roth IRA during your lifetime, you may want to use it as a way to leave tax-free income to your heirs. Since there are no required minimum distributions from a Roth IRA, the money can grow undisturbed during your lifetime, plus the distributions to your heirs should be free of income tax.

Cons of Roth Conversions

When is it not a good idea to convert to a Roth IRA? If the steep tax bill for converting makes you squirm, a Roth IRA conversion may not be for you. After all, if you're in the 32% tax bracket and convert a $100,000 IRA, you'll owe $32,000 in taxes. Plus, most experts recommend using cash outside the plan to pay the tax on conversion to avoid depleting your retirement savings. Paying the taxes with cash is especially critical if you are under age 59½, because if you use money from your IRA to pay the tax, you'll owe a 10% penalty on the amount not rolled over into the Roth IRA. Likewise, if you plan on spending the Roth IRA funds early on in retirement (within five years of the conversion), you may not have enough time for earnings in the Roth IRA to make up for taxes paid on the conversion.

Roth IRA conversions are complicated. If you're considering converting, don't attempt to go it alone. The tax- and estate-planning consequences of a Roth IRA conversion can be significant, so please call if you'd like to discuss this in more detail.

Business Data

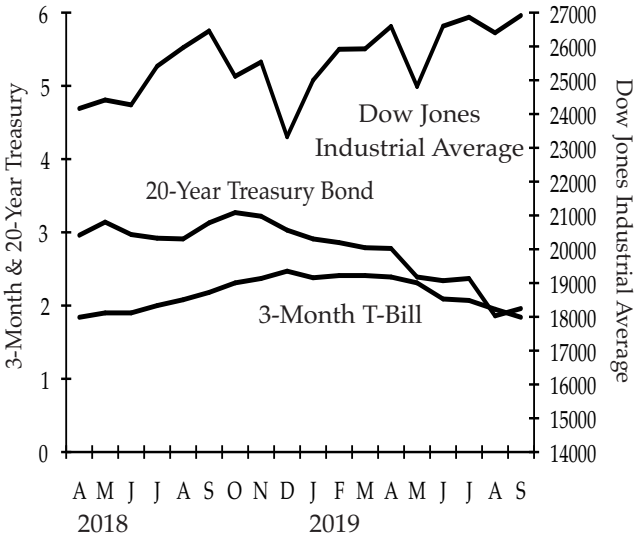
Indicator	Month-end Jul-19	Aug-19	Sep-19	Dec-18	Sep-18
Prime rate	5.50	5.25	5.00	5.50	5.25
3-month T-bill yield	2.07	1.95	1.84	2.47	2.18
10-year T-note yield	2.07	1.58	1.70	2.89	3.05
20-year T-bond yield	2.37	1.86	1.96	3.03	3.13
Dow Jones Corp.	3.21	2.86	2.94	4.40	4.14
GDP (adj. annual rate)#	+2.20	+3.10	+2.00	+2.20	+4.20

Indicator	Month-end Jul-19	Aug-19	Sep-19	% Change YTD	12-Mon.
Dow Jones Industrials	26864.27	26403.28	26916.83	15.4%	1.7%
Standard & Poor's 500	2980.38	2926.46	2976.74	18.7%	2.2%
Nasdaq Composite	8175.42	7962.88	7999.34	20.6%	-0.6%
Gold	1427.55	1528.40	1485.30	15.9%	25.1%
Unemployment rate@	3.70	3.70	3.70	0.0%	-5.1%
Consumer price index@	256.14	256.57	256.56	1.8%	1.7%

— 4th, 1st, 2nd quarter @ — Jun, Jul, Aug Sources: *Barron's, Wall Street Journal*
Past performance is not a guarantee of future results.

18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield

April 2018 to September 2019



Your 401(k) Contribution Amount

Before deciding how much to contribute to your 401(k) plan, find out three key figures:

What is the maximum percentage of your pay that can be contributed? The maximum legal contribution limit in 2019 is $19,000 plus an additional $6,000 catch-up contribution for participants age 50 and over, if permitted by the plan. However, most employers set limits in terms of a percentage of your pay to comply with government regulations. This limit ensures the plan does not discriminate in favor of highly-compensated employees.

How much of your contribution is matched by your employer? Employers are not required to provide matching contributions, but many do. A common match is 50 cents for every dollar contributed, but many other variations also exist.

Up to what percentage of your pay does your employer match? Most plans only match contributions up to a certain percentage of your pay. Assume your 401(k) plan allows contributions up to 10% of your pay annually, with a 50 cent match on every dollar contributed, up to a maximum of 6% of your pay. With a $100,000 salary, you can contribute up to $10,000 to the plan. Your employer will match up to the first $6,000 of contributions ($100,000 times 6%), contributing a maximum of $3,000 (50 cents for every one dollar).

How much should you contribute to your 401(k) plan? If at all possible, contribute the maximum allowed. In the above example, that would be 10% of your pay. At a minimum, contribute enough to receive the maximum matching contribution. That would be 6% of your pay in the above example. Please call if you'd like help deciding how much you should contribute to your 401(k) plan. FR2019-0612-0073

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