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2017 Review and 2018 Outlook

Looking Forward to Tax Reform's Impacts

January 18, 2018

Executive Summary

- 2017 provided strong equity returns, rising short-term rates, and stagnant long-term yields
- The economic cycle is accelerating. US tax reform is a potential "game-changer" with far-reaching effects
- Equities appear primed for higher prices in anticipation of rising earnings; bonds primed for lower prices as rates rise. But exuberance is growing
- Risks to our bullish equity outlook include accelerating inflation leading to higher rates, monetary policy over-tightening, Central bank balance sheet reduction, and the risk of a trade war.

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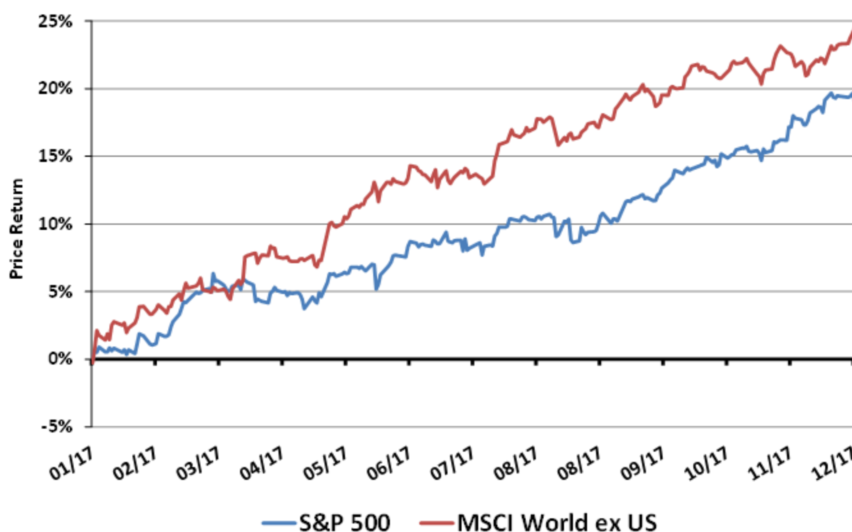
2017 Review

Equities

Global stock indices saw strong gains in 2017. The S&P 500's solid price return of 19.1% was overshadowed by international equities' 24.5% price return (MSCI World ex US). The international vs. domestic outperformance was only the second such instance in the past decade, due in part to a 7% decline in the trade weighted US Dollar.

S&P 500 and MSCI World ex US Price Returns

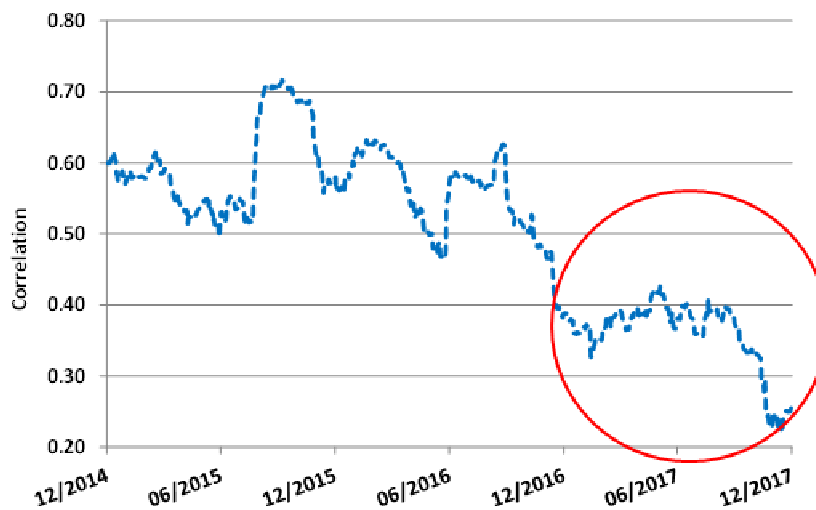


Source: Bloomberg

These returns were paired with low market volatility. The S&P 500 had more than 70 record-high closes out of 200 total trading days, a maximum intra-year decline of only 3%, and positive total returns in every month (a first in the index's 94 year history). Talk about an impressive investment year.

This low overall volatility, however, belied significant volatility within different sectors and companies, producing low correlations between stocks.

S&P 500 65-Day Rolling Correlations

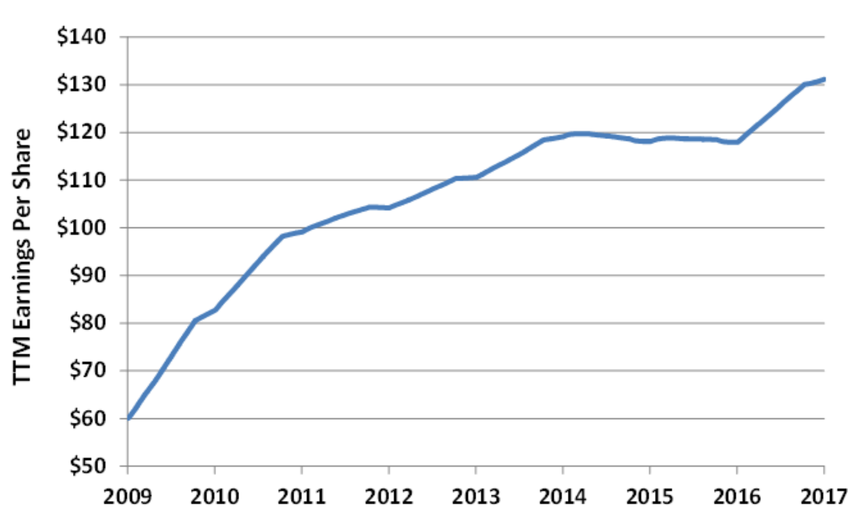


Source: Strategas

As a result, actively managed strategies and hedge funds had opportunities for outperformance.

Favorable global economic fundamentals were key. For the first time since the 1960s we experienced "synchronized" growth, in which each of the world's major economies was expanding. The US continued to benefit from accelerating GDP (3.2% as of Q3 2017), jobs growth and low unemployment (now at 4.1%), low headline inflation (2.2%), and rising corporate earnings.

S&P 500 Trailing 12 Months Earnings Per Share



Source: Bloomberg

In addition, in the fourth quarter the effects of the federal government's push towards tax reform began to influence equity markets (detailed below in the 2018 Outlook section).

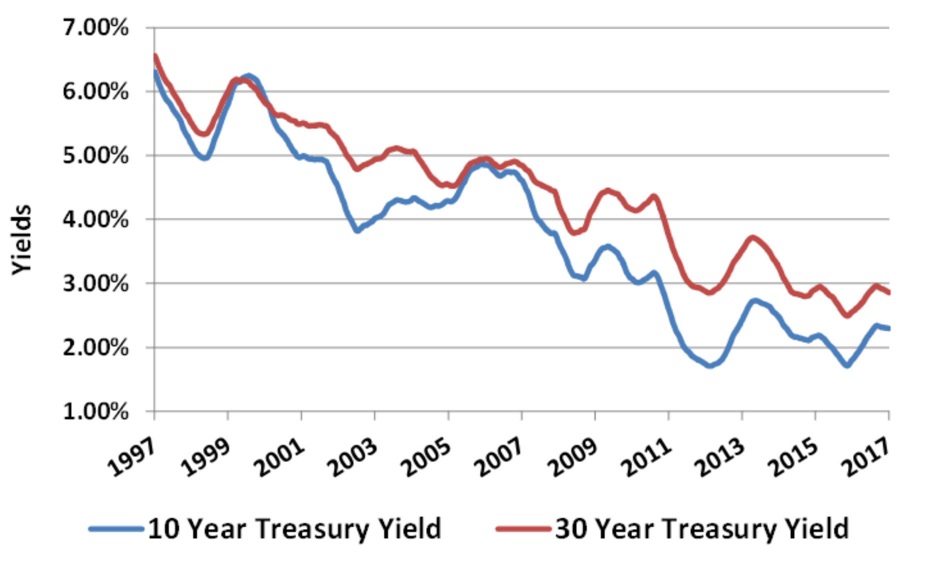
Fixed Income

The strong economic fundamentals were both direct and indirect drivers of the fixed income markets.

Directly, the environment of best-in-years growth with little inflationary pressure fostered a largely "status quo" narrative for long-term rates. Ten and thirty-year treasury yields moved sideways at historically low levels.

Maturity	Treasury Yield as of 1/1/17	Treasury Yield as of 12/31/17	Change Through 2017
10 Year	2.45%	2.40%	-0.05%
30 Year	3.04%	2.74%	-0.30%

Long-Term Treasury Yields, Trailing 20 Years (200 Day Moving Average)



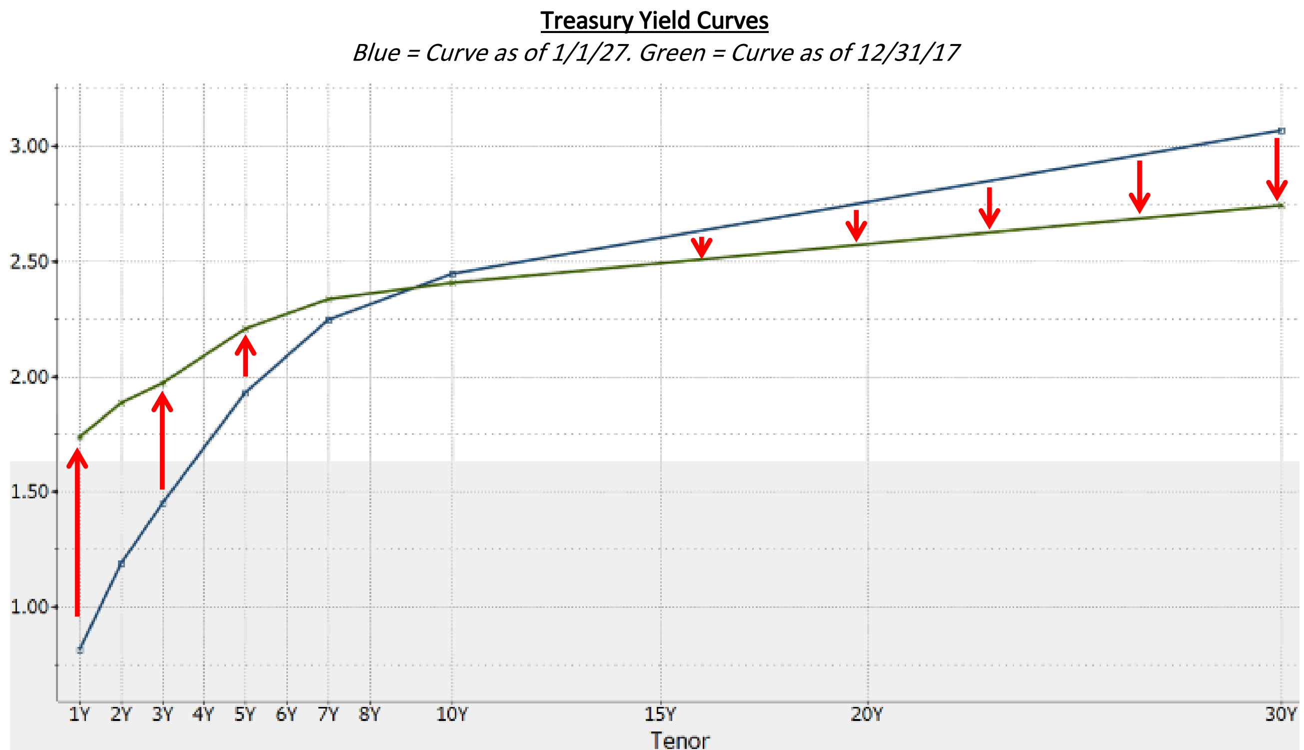
Source: Bloomberg

This calm environment reinforced the Federal Reserve's outlook for a slow but steady pace of rate hikes. After the long post-crisis period of ultra-low rates, the Fed was (and remains) highly motivated to normalize interest rates. The Fed raised rates three times in 2017, bringing the overnight rate to 1.25-1.50% by year's-end, and projected another 3 hikes in 2018. As usual, the Fed's actions had their greatest impact on short-term rates, which rose dramatically. Nonetheless, short-term yields remain well below historical norms.

Maturity	Treasury Yield as of 1/1/17	Treasury Yield as of 12/31/17	Change Through 2017
1 Year	0.89%	1.76%	+0.87%
2 Year	1.22%	1.89%	+0.67%
5 Year	1.94%	2.20%	+0.26%

Source: Bloomberg

This caused 2017 to end with a much flatter yield curve, as short-term rates rose to close much of the gap with long-term rates. A flattening curve has historically predicted economic slowdown; however, we do not believe this is accurate in the current period.



Source: Bloomberg

2018 Outlook

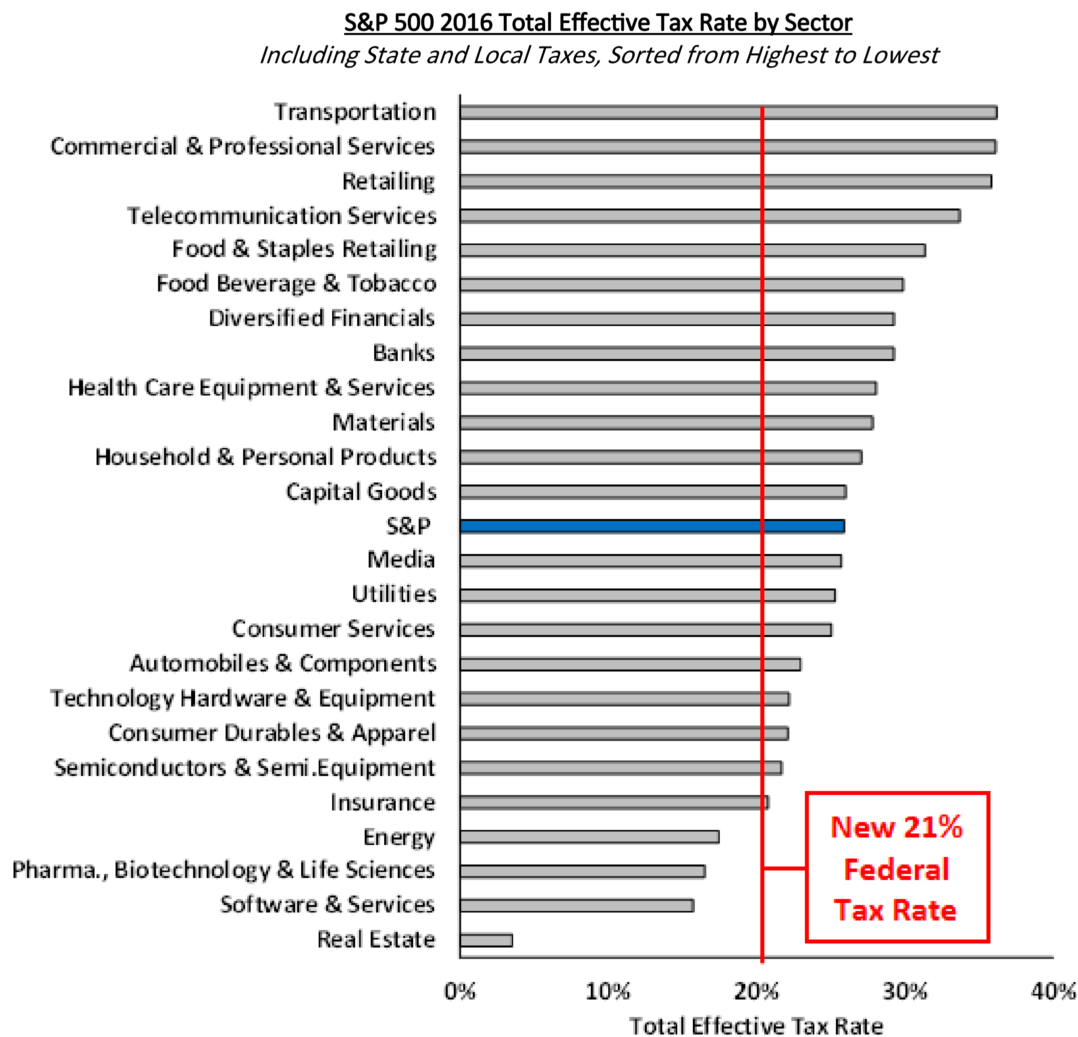
Equities

The 2017 tax reform made major changes to the code for both businesses and individuals. The effects will ripple through every industry and market sector.

News coverage has focused on changes to the individual side. While these shouldn't be ignored, predicting their effect is hard. Most Americans will see reduced income taxes. However, the elimination of many itemized deductions means higher-income households in high-tax states like New York and California may see little net benefit. As a result, the direct economic impact from the *individual* side may prove patchy.

The focus should be on the changes for businesses. Congressional Republicans' goal was to reduce the tax burden on corporate America, and in doing so, make the US a more attractive place to do business. That in turn should spark more domestic investment, and higher growth. To achieve that end, the legislation significantly changes the code:

- **Statutory Tax Rate Lowered.** The 35% statutory corporate income tax rate was cut to 21%, the lowest in the G7. Under the old system, many companies in asset-light industries were already paying less than 35% because of deductions. However, these have now been reduced or eliminated which will make it hard for effective rates to dive far below 21%. The playing field has been leveled. There will be winners and losers.

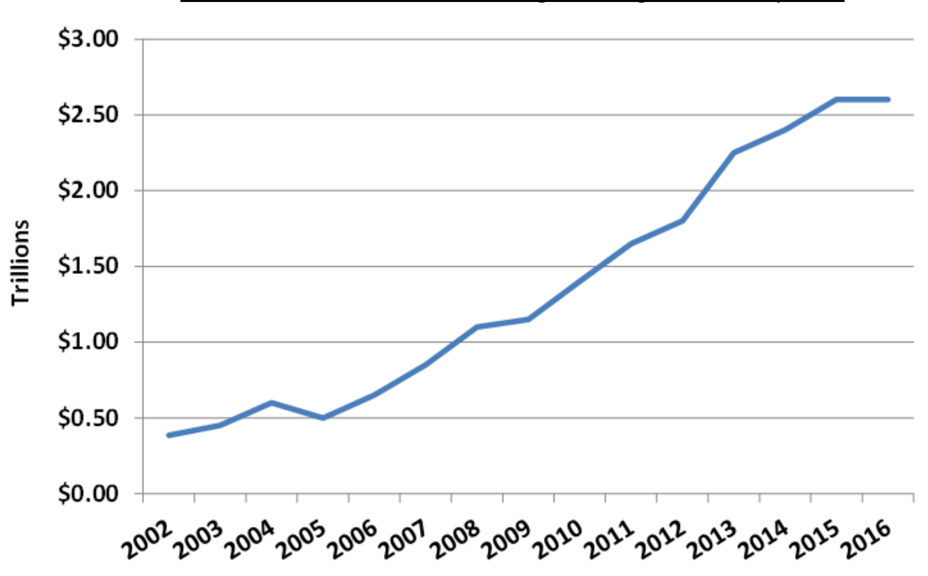


Source: Strategas

- **Shift to Territorial Tax System.** The old US corporate tax code was based on a "worldwide" system that taxed US corporations' earnings across the globe - *regardless of whether those earnings had already been taxed by other countries*. The new code is based on a "territorial" system: only income earned within the United States will be subject to US taxes.

- **Deemed Repatriation.** The old system encouraged companies with foreign operations to retain foreign profits offshore, as the US would not tax them until the money was "repatriated." As part of the shift to a territorial system, these sums, which are estimated to total $2.5 trillion, or a staggering 13% of US nominal GDP - are "deemed" repatriated: in other words, they are declared to be in the US regardless of whether they are moved. They will be taxed at rates ranging from 9% to 15%.

Total Estimated Unremitted Foreign Earnings of US Companies



Source: Strategas

This means there will no longer be any incentive to keep surplus funds offshore. Thus, we may see a large sum of money injected into the US economy by American multinationals.

S&P 500 Sectors Unremitted Foreign Earnings

$ Billions

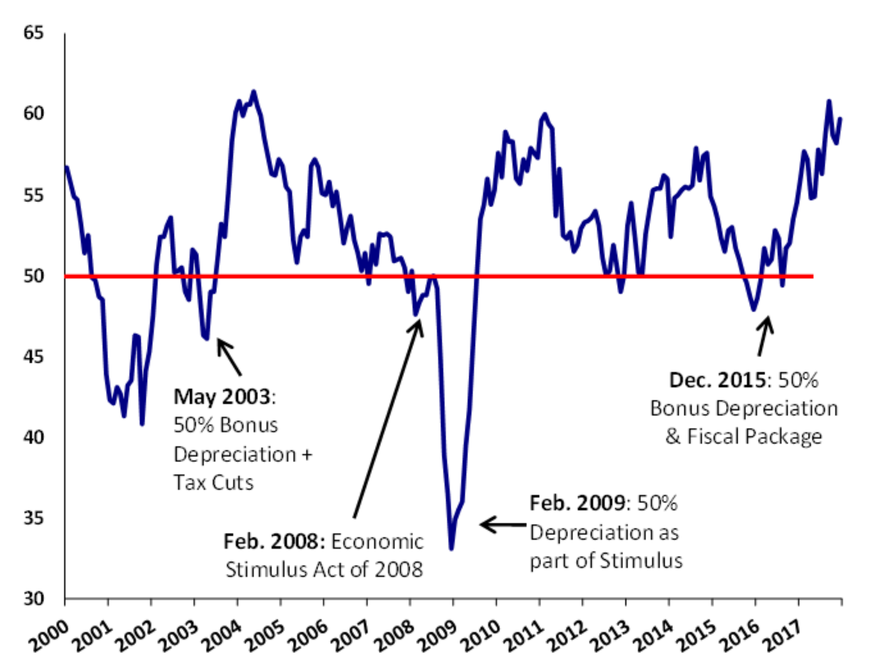
Sector	Market Value	Unremitted Foreign Earnings	Percentage
Health Care	$2,734	$543	19.86%
Information Technology	$4,245	$782	18.43%
Materials	$506	$77	15.13%
Consumer Staples	$1,980	$246	12.43%
Energy	$1,430	$146	10.20%
Financials	$3,089	$231	7.49%
Industrials	$2,059	$149	7.23%
Consumer Discretionary	$2,507	$139	5.53%
Utilities	$612	$14	2.31%
Telecommunication Services	$512	$2	0.45%
Real Estate	$613	$3	0.42%
Total	**$20,286**	**$2,331**	**11.49%**

Source: Strategas

- **100% Expensing of Capital Expenditures.** For the next 5 years, corporations will be allowed to deduct the cost of new investments in long-term productive assets. This is effectively a subsidy for capital expenditures, and encourages reinvestment in the business itself. The legislative intent is to spur a growth in American manufacturing, and thus growth in jobs. Past incentives of this sort have resulted in detectable increases in manufacturing activity.

US ISM Manufacturing Index (PMI)

Over 50 = Expanding Manufacturing Activity, Under 50 = Contracting Manufacturing Activity



Source: Strategas

Potential Impact of Tax Reform

As a base case, the lower tax rate and shift to a territorial system reduces incentives for corporations to relocate abroad. It could attract relocations from overseas, as the tax burden no longer offsets the advantages of America's large, wealthy consumer base, stable government, and established legal system. There will no longer be a compelling reason to keep foreign profits offshore; they will instead be repatriated and put to use. And the strong incentive to push-forward capital expenditures ought to lead to an expansion in the US's manufacturing capacity, and good times for producers of capital goods and machinery. In combination, these measures are tailor-made to boost corporate spending and reinvestment within the US.

What Does This Mean for Equity Investors?

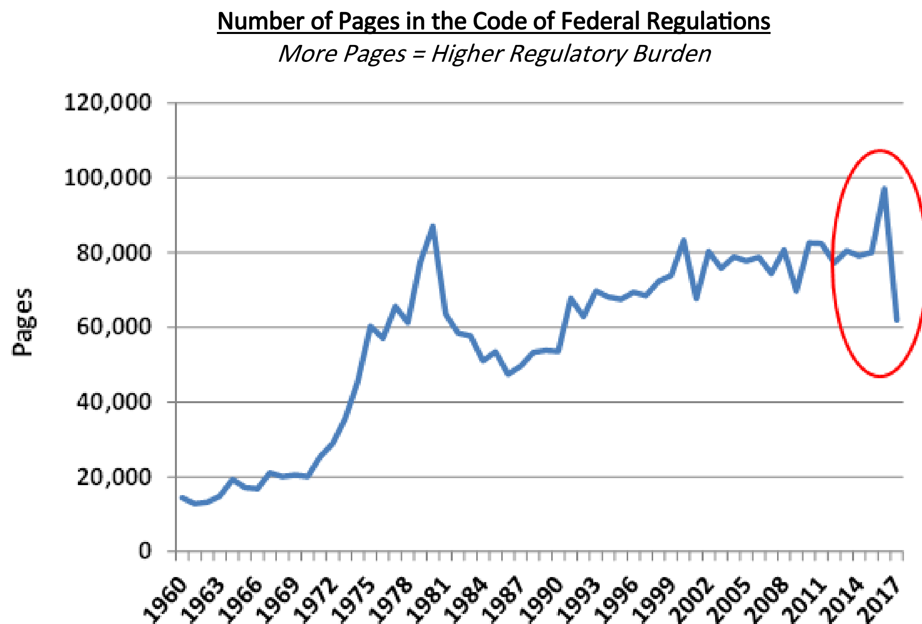
We believe these measures are not fully priced into current stock valuations.

To put it into perspective: the S&P 500 ended 2017 at 2,675, with a trailing 12-month Earnings-Per-Share (EPS) of an estimated $131 and a corresponding Price/Earnings (P/E) multiple of approximately 20.4x. We expect that tax reform's effects alone could add $10 in 2018 EPS. If the current 20.4x equity multiple is maintained and earnings also organically grow a modest 5%, that would result in the S&P 500 reaching 3,000, a 12% gain.

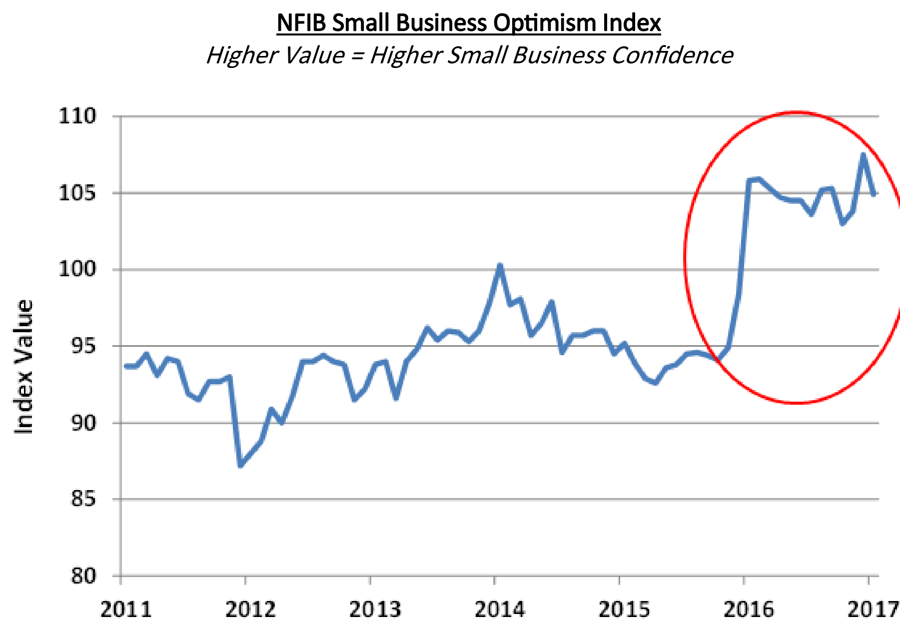
We expect this growth to be concentrated in those companies which stand to benefit most from the new tax code: the losers under the old system. This means small- and mid-cap companies, value stocks as opposed to growth stocks, and companies with a domestic focus vs. internationally-oriented multinationals.

Importantly, this doesn't factor in additional tailwinds:

- The Trump Administration has succeeded in reducing regulations. This is consistently cited as a primary driver behind the current high levels of business confidence. The trend is likely to continue, and may even accelerate, further reducing the burden on business dynamism.



Source: Treasury Partners

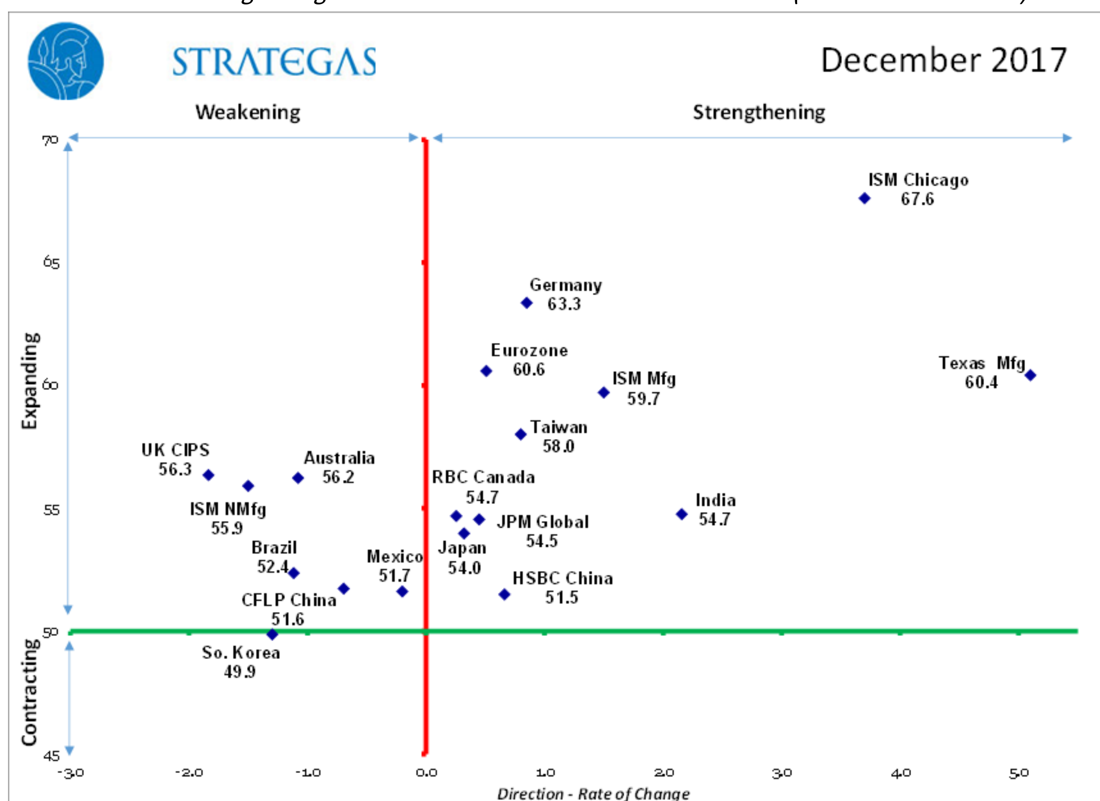


Source: Bloomberg

- Congress may pass an infrastructure bill, which could be structured to offer both short and long-term stimuli.
- Global economic fundamentals suggest expansionary conditions remain intact. Inflation and unemployment are low, and other major global economies appear to be in stable upswings as well.

Strategas Survey of Global Growth

Matrix Categorizing International Economic Growth Indicators (PMI and ISM Indices)



Source: Strategas

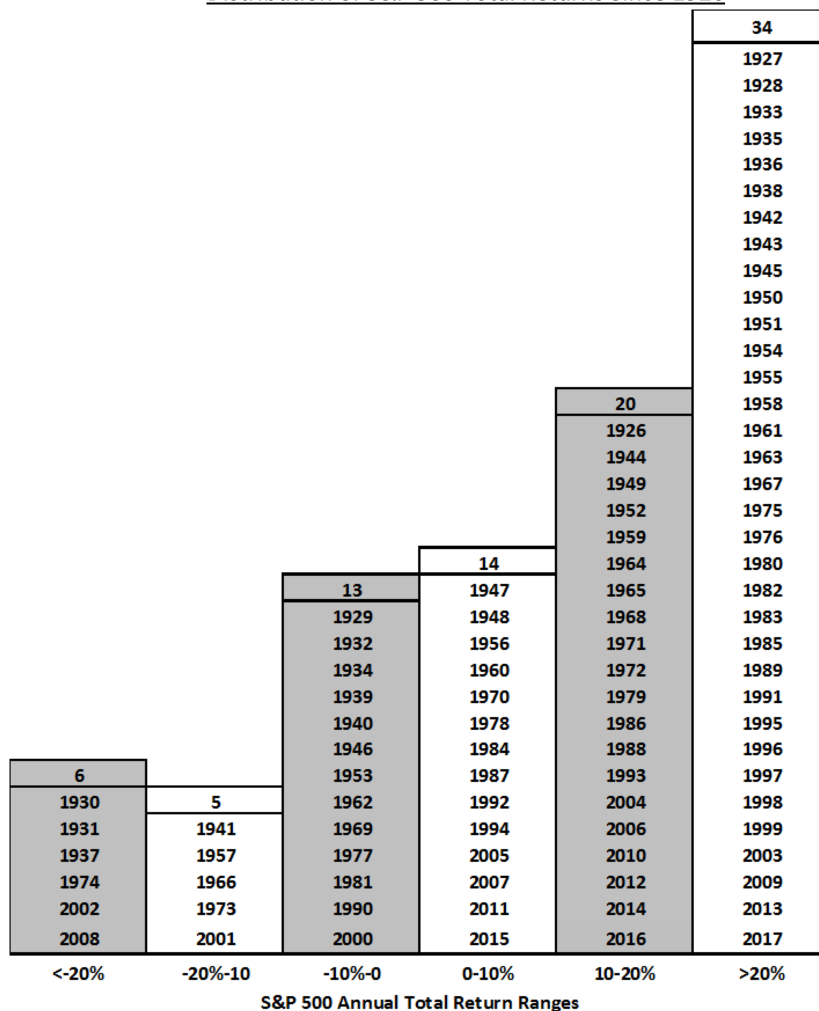
- 2017 corporate profit growth was especially encouraging, as it was the result of true top-line revenue growth - not cost-cutting or financial engineering. This was "healthy" growth that appears well-positioned to accelerate, translating into higher EPS in 2018.

Clearly our outlook is optimistic. However, we don't foresee a smooth ride. Last year's low volatility may be an aberration. Low volatility years have a demonstrated tendency to be followed by several years of higher volatility. This means lower stock correlations, similar to 2017, as opposed to the post-crisis norm of "a rising tide lifting all boats." Nonetheless, we believe the underlying fundamental strength justifies staying the course, particularly given our outlook on fixed income.

Post-1945 S&P 500 Performance After "Low Volatility" Years

Year	Intra-Year Drawdown	Performance	Next Year's Drawdown	Next Year's Performance
1995	-3%	34%	-8%	20%
2017	-3%	19%	?	?
1964	-4%	13%	-10%	9%
1958	-4%	38%	-9%	8%
1954	-4%	45%	-11%	26%
1961	-4%	23%	-26%	-12%
1993	-5%	7%	-9%	-2%
1972	-5%	16%	-23%	-17%
1991	-6%	26%	-6%	4%
2013	-6%	30%	-7%	11%
Average	*-4%*	*25%*	*-12%*	*5%*

Source: Strategas

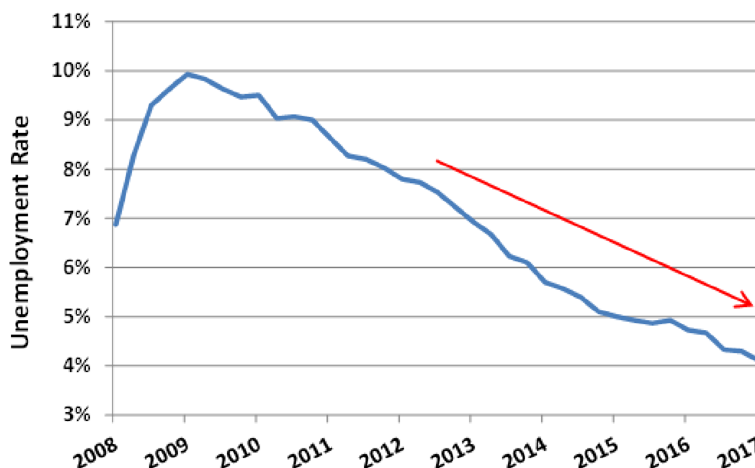


Source: Strategas

Fixed Income

As noted above, domestic rates ended the year with a flatter curve structure but still at the low levels that have become the post-crisis norm. However, conditions appear favorable for a spike in rates:

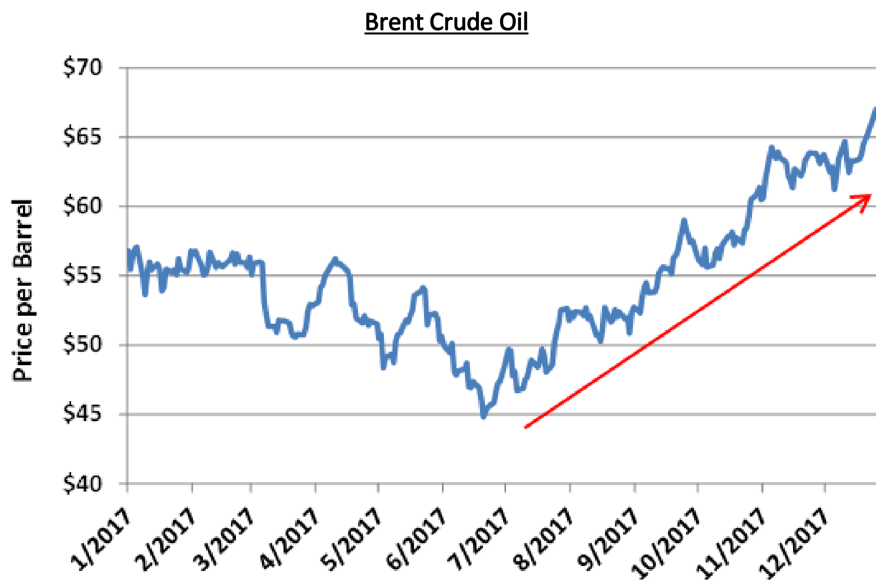
- Wages have been rising only modestly despite persistently low unemployment, which is atypical. Low unemployment has historically resulted in wage pressure building up. Recent corporate announcements of broad-based wage increases suggest this has begun to happen.



Source: Bloomberg

- Global inflation appears tame. However, as the global synchronized recovery continues apace, rising commodity prices are coming into focus. This is another harbinger of inflation.

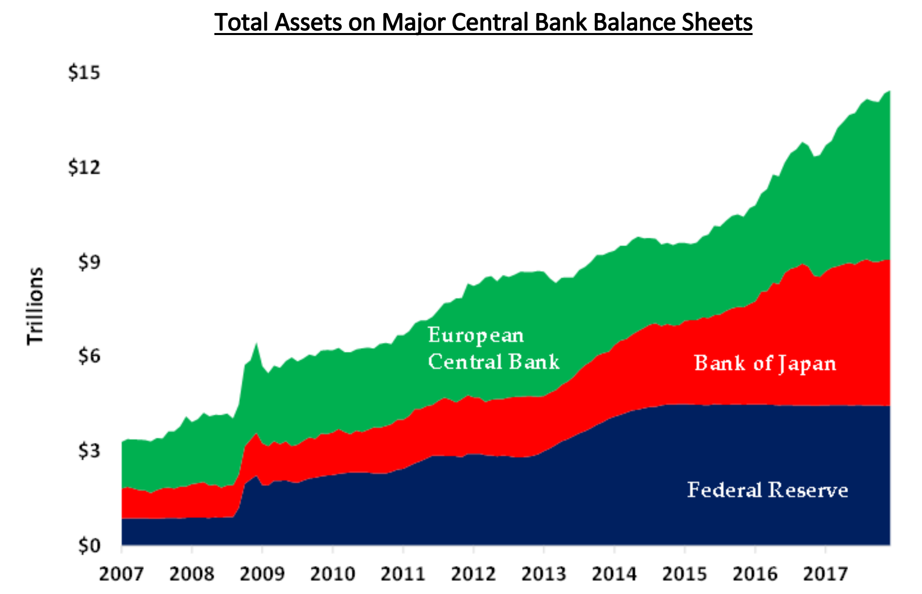
Brent Crude Oil



Source: Bloomberg

- Major global central bank balance sheets are still large. Should one of them make a policy error in their moves to reduce their holdings, the effects could ripple across the world.

Total Assets on Major Central Bank Balance Sheets



Source: Strategas

- Should the economic stimulus measures from US tax reform prove successful, this fiscal policy shift may also begin to influence inflation upwards.

Each of these risks could cause bond prices to decline as rates rise. As a result, we are remaining defensively positioned in client bond portfolios.

The greatest uncertainty for bonds will ultimately rest on the actions of global central banks as they proceed to unwind post-crisis market interventions. Despite the upcoming transition from Chair Yellen to Chair Powell, the Fed is signaling a slow but steady pace of future rate hikes. It is also beginning the process of reducing its huge balance sheet ($4 Trillion), still bloated from bond purchases made during its 3 quantitative easing programs. Continuing economic expansion should cause the Fed to keep tightening monetary policy. However, the combination of simultaneously raising the Fed Funds rate while reducing the balance sheet is an unprecedented challenge for the Fed. The direction of rates in 2018 will largely be impacted by these actions.

As a result of these monetary policy changes, the impact of tax reform, and the underlying strength in the economy, we've shortened the average life in fixed income portfolios.

One fixed income sector we believe will outperform, though, is municipal bonds. The tax reform legislation will result in lower municipal bond issuance going forward, reducing the net supply. Additionally, since the highest marginal income tax bracket is barely changed, the demand for municipals is likely to remain unchanged (or even increase, particularly for bonds in high-tax states). This supply-demand imbalance may cause a protracted trend of increasing muni prices. We have reacted by increasing in-state municipal bond allocations in client portfolios, and look to continue doing so into 2018.

Conclusion

A common concern is that the economic expansion is "long in the tooth" - and in calendar terms, it is one of the longest stretches of growth in American history. However, this is irrelevant - expansions don't die of old age. Expansions transition to recessions not from the passage of time, but from the gradual accumulation of market excesses and their slow corrosive effect on economic fundamentals. At this time, we don't see any of the usual signs of such corrosion, which would include rising corporate credit spreads, tighter lending conditions, overextended consumer balance sheets, or sharply rising commodity prices, among other indicators. Accordingly, we foresee the US growth cycle continuing apace for as long as these observations hold.

We expect domestic equities to perform well under support from tax reform and a steadily expanding economy. Moreover, we think there is the possibility of a further upside surprise based on acceleration in corporate earnings, particularly for small and mid-cap companies. Synchronized global growth suggests there may be worthwhile opportunities in international equities as well, particularly in those economies which are still in the initial upswing of their cycles. This calls for maintaining full equity allocations, with a tilt towards actively-managed strategies.

Continued low bond yields provide further justification for high equity valuations, but point towards remaining watchful for interest rate risk within bond portfolios, which could then alter our otherwise positive view for stocks.

As always, we remain wary of risks to this Outlook and are prepared to shift strategies as changing circumstances warrant. In no particular order, our key risks are:

- **A Spike in Inflation.** Although another year has passed without signs of inflationary pressures, the risk is ever-present and cannot be ignored. With low unemployment leading to rising wages and tighter supply chains causing price increases in goods and services, we remain watchful for signs of a pickup in inflation. The knock-on effects of an inflation surprise would be far-reaching - spurring the Fed to hike rates faster, leading to spiking yields/falling bond prices, and bleeding over into declining equity valuations.

- **Equity Multiples Contract.** While current equity P/E multiples aren't at "extreme" levels, they are certainly elevated due to the current favorable investment conditions. Unlike EPS forecasts which have a basis in corporate fundamentals, future P/E multiples are impossible to accurately predict; it is possible the positive stock price tailwinds from EPS growth will be reduced (or even negated) by the risk of multiple contraction.
- **Increasing Cost of Credit.** Both investment grade and high-yield corporations continue to fund their operations and capital spending with bountiful and cheap financing. If (or more likely, when) this begins to reverse, elevated corporate debt burdens will grow heavy, as interest costs rise to service debt. This may lead to rising defaults and reduced business dynamism, stoking equity market anxiety.
- **Unintended Consequences of Central Bank Interventions.** Over the years we've frequently brought up the risks that came with global central banks' unprecedented post-crisis market interventions (indefinite 0% interest rates, quantitative easing, etc.). Although no serious consequences have yet arisen, the fact is we have no prior history to lean on when forecasting the potential pitfalls that come with the gradual unwinding of these policies. As the Fed and European Central Bank slowly bring monetary policy back to normal, there is elevated risk that the accumulated excesses and imbalances that arose during the previous several years may lead to market shocks.
- **Geopolitical Shock.** The ever-present threat of something "out from left field," particularly in trade: a US withdrawal from NAFTA, a Eurozone crackdown on the US tech sector, a trade war between the US and China, or an election-driven lurch toward “state capitalism” in the UK or Italy. That is of course in addition to the well-known tensions on the Korean Peninsula and in the Middle East.

Our best wishes to all our clients and friends for a happy, healthy, and peaceful new year.

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