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Investment Outlook

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Tax Reform and the Return of Irrational Exuberance

As we enter the final month of 2017, all eyes are focused on the Halls of Congress as the much anticipated Tax Bill approaches the finish line. Last week the Senate passed its version of the bill that will now be sent to the Congressional Conference Committee for reconciliation with the House version. A final version of the bill is expected to emerge from committee sometime before Christmas. Upon passage, it goes to the president's desk for signing. We were hopeful the Tax Reform Bill would be ratified prior to the 2018 Easter recess, so this comes as a pleasant surprise to us. The question to be asked is how this news will be received by the markets.

It's Real News, Not Noise

In our previous Outlook, we identified this bill as being integral to fiscal policy formation and the type of event that would shape investors' longer term view of the economy and the outlook for the stock market. This is also happening at a time when the economies of Europe and Asia are showing improvement in their emergence from the throes of 2008. This marks the first time since the late 90's that we've seen a synchronized expansion of all three theaters of the Global Economy. The world's markets have taken note and moved steadily higher through most of 2016 and all of this year to date.

The tax bill had been initially advertised as "pro-growth" and deficit neutral. In reality, it has the potential to be the former but is by no means the latter. It's likely to emerge from the Conference Committee with a price tag of roughly $1.4 trillion added to the deficit. Democrats and Socialists characterize it as a transfer from the middle class to Big Corporations and the wealthy. Nancy Pelosi termed it "Armageddon." Republicans view it as a tax cut for the middle class and corporations, the idea being that lower taxes would boost consumption and capital investment by companies in people, plant, and equipment. They point to the $1.4 trillion as an investment in pursuit of a future increase in tax revenues that would more than pay for itself and ultimately reduce the deficit.

While rejecting the typical, hysterical response from the left, we're not fully buying the "pro-growth" mantra being pitched by Republicans. The bill provides hope for a successful outcome for the middle class, but not a certainty. We view the addition to the deficit as an investment that should boost consumption but the return on investment emanating from lower corporate tax rates remains uncertain. Lower taxes for corporations will make more capital available for investment, and allowing companies to immediately and fully deduct the expense of equipment does provide an incentive for an increase in CAPEX. However, any positive impact on employment could be negligible. Public companies are beholden to shareholders, first and foremost. That's us, our clients, and anyone with an IRA or a 401k Plan. The most proximate source of return for companies and their shareholders are dividends and appreciating stock prices. There are no incentives in either version of the tax bill that lead companies to prioritize hiring over dividends and stock buybacks that benefit only their shareholders.

When we hear "pro-growth," the economist in us thinks of it in terms of a longer term benefit to the broader economy and not just the shareholder community. As investors, we're happy at this point to see any stimulative package enacted with respect to tax and fiscal policy. We thought that the current bill could have benefitted from adding incentives for hiring that would benefit the broader economy and the middle class. As it stands now, this bill will likely be viewed through the same prism as ACA/Obamacare, a purely partisan piece of legislation that could have been improved by the critical thinking arising from even limited bi-partisanship. As we had to endure Republicans' "Repeal and Replace" mantra these past eight years, much the same will likely be said by the Dems of this bill during the upcoming election campaign.

Investors Anticipate a Good Result from Tax Reform

The US stock market has been pricing in high expectations for the economy since Election Day. The averages have moved steadily higher on optimism around the government's promise of a pro-growth policy that would stimulate both CAPEX and productivity and propel the economy to the next stage of its recovery. As the tax bill nears enactment, the markets are grinding to record highs, leaving investors with 12-month returns from the major indexes ranging from 20% to 30%. This will be the first legislative act of fiscal stimulus coming from Congress in more than a decade and should lead investors to take any thoughts of Recession off the table for 2018. That could provide stock prices with some added momentum early next year. After that, focus will turn to the mid-term elections and we could see a return of headline risk to the markets.

As of today, large-cap growth stocks in Tech and a few other sectors are leading the way into year-end. The large-cap value stocks, typically your higher dividend payers, have as a group posted performance below the bottom of the range of returns. Through most of 2016 and all of 2017, the US stock market hasn't posted a decline of more than 5% during any period. This advance is shaping up to be the longest bull market in history and we're approaching two years since the last correction of more than 10%. Once again we quote John Templeton: "Bull markets are born on pessimism (2009), grow on skepticism (2010-2015), mature on optimism (2016-2017), and die on Euphoria (2018-2020???)." Stocks appear to be firmly entrenched in the mature stage of this bull market.

This year, we've seen several occasions where equity capital rotated from the better performing sectors within the market to those that are under performing. The lack of decent returns from alternative asset classes can explain part of that. However, investors are still seeing opportunities in sectors such as Energy, Telecom, some Healthcare, Financials, and Retail. Profits taken from Technology, Consumer Discretionary, Industrials, and Staples are migrating to those under-valued sectors rather than going to the sidelines. Companies that missed earnings were severely punished while those making or exceeding estimates were handsomely rewarded. We view this divergence among sectors as a sign of a healthy equity market. We think this "rational investing" will persist through the first half of 2018. Nevertheless, we'll be on the lookout for an end of that rotation and the day that irrationally high-priced stocks begin to correlate as one. That would mark the beginning of the last stage of this bull market and a time to reevaluate liquidity needs and asset allocations.

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