Market Commentary - December 2017

The U.S. stock market continues to give very mixed signals to investors. According to Goldman Sachs, the P/E ratio of the median S&P 500 stock is in the extremely rich 99th percentile when compared historically. It should be no surprise then that valuations are weighing heavily on many stocks-30% of S&P 500 stocks are in correction mode (down at least 10% from their highs as of mid-November). Yet the major averages are at or near all-time highs, volatility is eerily low, and we have not had a 2% down week in 64 weeks-representing the longest streak in over 50 years. Even though the market continues to be propped up by a small number of stocks, 2017 has been a very good year for many investors and may continue given the possibility of tax reform.

The Powerful Effects of Tax Reform for Investors

The Senate is expected to vote on its version of the tax overhaul package soon. The House recently approved its own bill. GOP leaders expect the two chambers to hash out a deal by year end. “The Washington Post” reports that about 75% of reform benefits will go to big business, about 25% to individuals. Just how beneficial would a tax package be for investors? This could be a potential windfall for the stock market likely pushing prices higher. In our opinion, because of the widespread skepticism surrounding its passage, the potential tax reform benefits are not yet fully discounted in share prices.

Here are four main ways investors could benefit:

- First, the House bill would reduce corporate taxes from 35% to 20%, the biggest one-time drop in big business tax rates ever. This would have an enormous impact for highly taxed firms. For example, a company with annual earnings growth of 10% and in the maximum tax bracket, would see after-tax earnings grow by over 35% in the first year of reform.

  In addition, the lower tax rate should lead both U.S. and foreign firms to invest more in the United States. And U.S. multinational firms would face a reduced incentive to shift profits abroad.

- Second, the tax on the repatriation of cash (the return of overseas company cash to the U.S.) would be reduced from 35% to 12% on about $2 trillion stashed outside the U.S. Economists estimate approximately 1/3 to 1/2 of that cash would actually be transferred home and could be used for share buybacks, dividends, equipment purchases, and other infrastructure investments.

- Third, companies could deduct all the costs of purchasing new equipment for five years which, in effect, reduces its user cost of capital and raises output according to extensive economic research.

- And fourth, lower individual tax rates would place more spending money in consumers’ pockets, increasing the bottom line of companies even more.

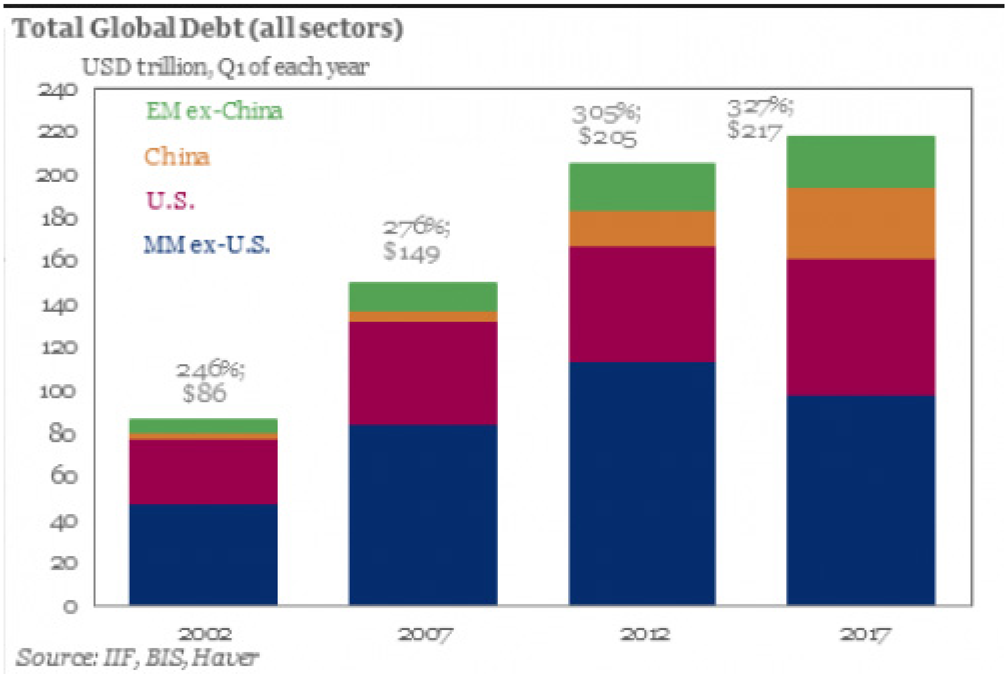
We stated earlier that potential tax reform benefits don’t seem to be fully discounted in share prices. Profit estimates for 2018 are expected to rise an impressive 10.9% but tax reform could double that figure (keep in mind all companies don’t benefit as much as our earlier example). This could be a Christmas present for investors, perhaps even sparking a Santa Claus rally later this month.

The Threat Posed by Debt

While recovery from the housing debt crisis appears complete, it may be temporary because debt has actually grown. Worldwide global debt now represents 327% of GDP (or $217 Trillion) – compared to 246% just 15 years ago (see illustration below).

A reversal of the nearly 40-year-old bond bull market appears to be upon us. Interest rates are rising and the Fed stands prepared to raise short rates by 1% in 2018.

The potential of harmful effects from extraordinarily high debt levels among corporations, households and government will likely remain for decades. Debt service reduces economic growth and when combined with rising interest rates, could threaten already stretched asset valuations.



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