Second Quarter Market Outlook 2017

From Expectations to Actualities

The first quarter of 2017 was an action packed period which saw both the Dow Jones Industrial Average and the S & P 500 price levels increase by 4% year to date, while bond and real estate investments were flat. In this commentary, we will talk about some of the factors which we believe have helped drive the market higher, why the market may be ahead of itself, as well as address some of the major policy issues of the new administration affecting the market.

We believe the markets have rallied for several reasons. First, markets hate uncertainty, and after the election we had better clarity on the next administration. Moreover, after the election, data began to show that the economy was improving, and the markets began to price in a more pro-business administration in Washington, backed up by less regulation, infrastructure spending and tax cuts that would directly benefit the bottom line of most American companies.

Concurrently, the business climate has been improving based on the health of the U.S. labor market. As of March 2017, the unemployment rate stood at 4.5%, the lowest level since May 2007 (before the Great Recession began). Average hourly earnings for the private-sector workers rose 2.7% in March on a year-over-year basis, better than the 2% wage gains seen during much of the past several years. Moreover, the prospect of lower corporate taxes should bode well for corporate earnings. Indeed, according to FactSet, corporate earnings in the fourth quarter grew by 5%, the fastest quarterly growth in over two years. Furthermore, if the implementation of a repatriation of profits held by corporations overseas is enacted, we can expect an increase in corporate stock buybacks, higher dividends, increased acquisition activity, and higher capital expenditures, all of which help the economy.

So, on the surface the business outlook is good. The bad news is the stock market has risen over the last six months, and priced a lot of good news into stock valuations. The stock rally has also pushed forward price earnings multiples of stocks to relatively high levels (currently 18x projected earnings vs 16x normally- WSJ Market Data Group). In addition, while the above actions are very supportive to the economy, there is an increasing risk that Congress may not pass these measures, as the inability to modify The Affordable Care Act demonstrated. Moreover, the longer that it takes to modify The Affordable Care Act, the less likely the market will see the legislation this year that it is hoping for- namely tax and regulation reform.

Another risk is that these pro-business proposals are expensive, and could lower tax revenue to the Federal government. Lower revenues could further increase our already large deficits and debt. At the end of fiscal year 2016, U.S. Federal debt is estimated to be $20.1 trillion, roughly 100% of U.S. gross domestic product. Moreover, unsustainable debt problems are not only limited to the United States. The Institute of International Finance reports that global debt rose to 325% of the worldôs gross domestic product last year. In other words, future growth is being held back by servicing old debt, and the debt looks like it is going to get bigger.

Earlier this year, leading Wall Street brokers issued reports indicating their year-end target for the S & P 500 for this year 2017. The average of these firms was only looking for a

4.05% return (not including dividends). Since the market is already up by 4% (as mentioned earlier), our concern is that the market has potentially run up too far too fast.

In addition, we see gridlock in Washington making it harder to tackle some of the major challenges facing the country, especially debt. This has created recent market activity of starts and stops, reflecting skepticism on whether the government will pass measured legislation, or just drift within a deeply polarized Congress, unable to pass any meaningful pro-business legislation that the market is hoping for.

Next, in regards to the new administration, we would like to comment on some of their major policy agendas and their potential effect on the market.

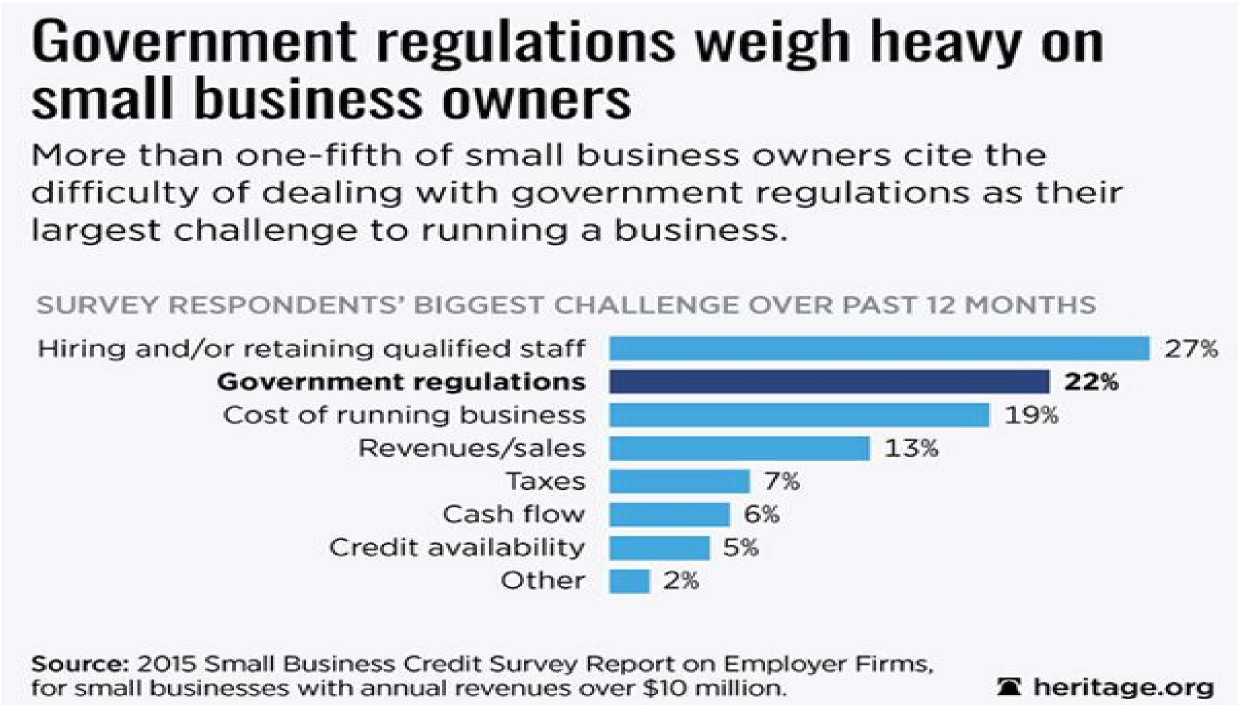
Trump/ Ryan Healthcare Plan

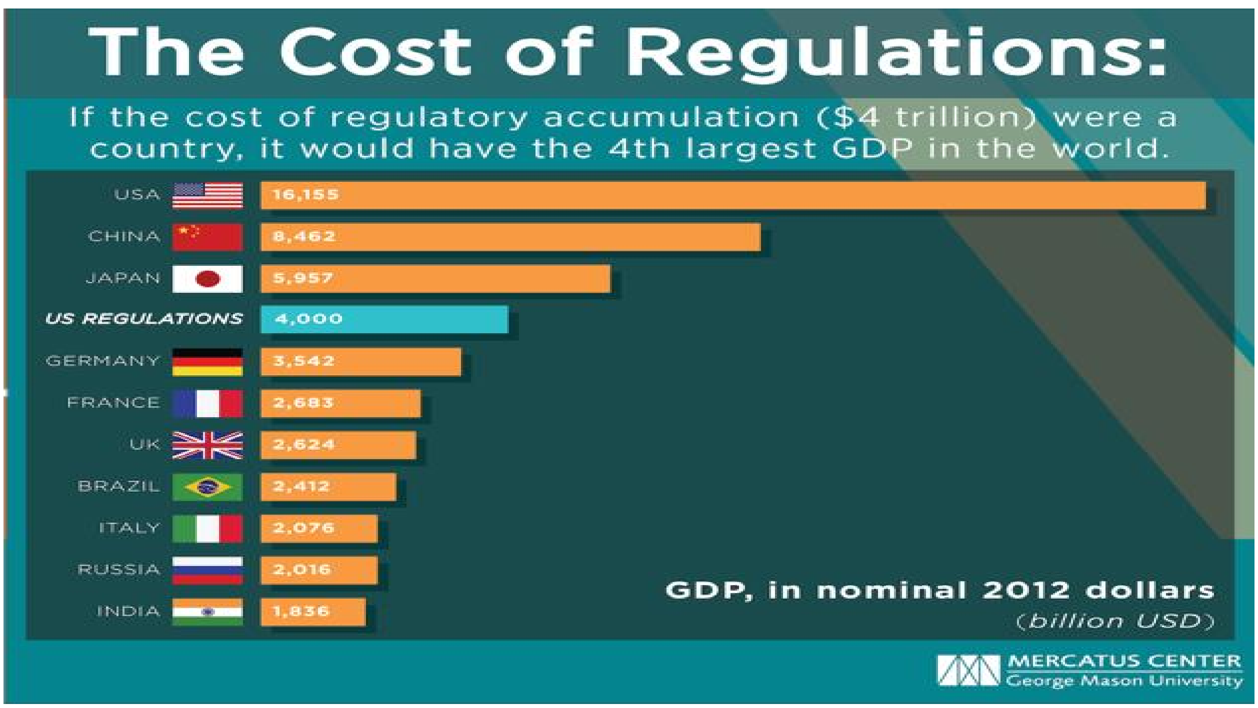
Any policy that creates confusion and causes business to hold off on investment until they know the new rules is bad and that is what Trump/ Ryan care has become. General consensus is that the Affordable Care Act has some flaws that could be improved, but unfortunately the plan that was originally put forth by house speaker Ryan created even more uncertainty as its details were quite vague, even though there were some good conceptional ideas on how to cut cost and improve service.

For instance, during House Speaker Ryanȇs 34 minute PowerPoint presentation explaining the new plan, Ryan gave the example of his three children who each had their tonsils removed in three succeeding years. In each case Ryan asked what the cost of the procedure would be and he could not get an answer, and did not know the true cost until several months later when the bill arrived. After the bill arrived, insurance paid most of the tab (including an $800 bill for his sons recovery room stay for 6 hours in the waiting room). Ryan said that since people are paying healthcare with other peopleøs money (i.e. insurance), and since they cannot shop around or compare prices, service declines and prices increase. He compared his service of laser eye surgery where the prices were known upfront, and individuals paid the cost out of pocket. Consequently, laser eye surgeries have become cheaper over time, and the service has improved. Ryan wants a more free market approach to healthcare to improve service and lower cost. We agree with that statement, but the devil lies in the details. Part of Ryanøs plan to improve service is a proposal that HSA (Health Savings Accounts) be used to encourage more free markets in healthcare. However, the criticism of the Ryan plan seemed justified because Ryanøs plan did not detail how HSA would be expanded, how they would be funded, what new procedures they could be used for, or what to do with people who have no HSA accounts.

Reducing Regulation

According to the Economist Magazine, Federal edicts have risen steadily from 400,000 in 1970 to over 1.1 million last year. So Trumpøs promise to reduce regulation has been greeted positively by American businesses. Most new jobs are still created by small business, and the number two problem most small business complain about is government regulation. Moreover, the cost of regulation continues to climb.





The rise in regulation is twofold. First, bureaucrats much prefer to write new rules than delete old ones. However, businesses are stuck with the cost of figuring which rules still apply to them. Next, political gridlock also causes regulatory sprawl. When a president is blocked by a divided congress, then the temptation is to govern through the Federal bureaucracy. The current proposal to cancel two regulations for every new regulation proposed may sound crude to some, but according to the Economist Magazine, it has worked well in Canada and Britain where it has also been implemented (Economist Magazine 3-4-17).

In January the new president installed a regulation freeze, a hiring slowdown on all Federal employees, a 5 year lobbyistôs ban on former government employees, and cancelled the Trans-Pacific Partnership (TPP) (more regulation) which was to be modeled after the NAFTA style trade treaty, but was to include much of South East Asia. Trump campaigned against NAFTA as a major job killer in the United States, and said the TPP would do the same. In addition, the market rallied at pro-job creating activities such as passing the Keystone and Dakota access pipelines and demanding that they use American made steel in new pipelines. So, the new administrationôs ñEconomy Firstò policy of reducing regulations has made corporate America happy, but on the other hand environmentalists are not pleased.

Trade

On March 3rd, Commerce Secretary Wilbur Ross, a billionaire investor himself, handed down a $892 million dollar penalty to Chinese cellphone equipment maker ZTE for selling U.S. licensed technology to Iran. What is interesting about this penalty is that Ross is using the accesses to the U.S. market to enforce U.S. laws. Had ZTE not complied, they could have been prevented from selling products to the lucrative American market. The fines are for breaking the sanctions on Iran AND for not paying for U.S. licensed technology.

A big problem for American companies is that they design a new technology, license it to foreign manufactures, and then do not get paid the full royalties they deserve on subsequent sales by those foreign firms. So, is this administration going to get tough on foreign manufactures who steal American technology and do not pay royalties back to America? Or, is this a one-off fine for breaking a sanction on Iran, or is it both? Time will tell.

On March 31st Trump ordered a large-scale review of the causes of the U.S.'s trade deficits with some of its largest trading partners and ordered stricter enforcement of U.S. anti-dumping laws. Dumping is when a country and/or company is accused of selling products in the United States at cost below the cost of production. Dumping is usually done with the intention of forcing the American producers out of business and then raising prices once the competition is gone. The most famous case of dumping occurred in the 1980ōs when the smaller Japanese DRAM (Dynamic Random Access Memory) chip manufacturers gutted the much larger U.S. DRAM industry and took over the memory semiconductor market. Only one U.S. manufacturer (Micron) survived this time period. Usually dumping is done with state support. Recently, Saudi Arabia was accused of dumping oil on the worldwide markets in an effort to cause the U.S. Oil frackers to go out of business. That did not work. Currently, China is under investigation for dumping steel on the U.S. markets.

Wilbur Ross took the executive order one step further and said that this Commerce Department would actually collect $2.8 billion in dumping fines that have been previously awarded to U.S. companies since 2001 against foreign competitors, but which have not been collected (CNN -3-31-17).

The manufacturing sector has applauded the Commerce Departmentōs recent decisions, and the stock prices of many basic manufacturing companies have actually been leading the market higher over the last few months on expectations of greater support in Washington. However, more conservative investments like utilities and REITS are up only slightly. We hope basic manufacturing does stage a comeback in this country, but we are cautious to invest in such possibilities until we actually see earnings and revenue begin to improve.

As we start the new quarter we see a market in a wait and see attitude. Stocks are no longer cheap, but the prospect of lower corporate taxes, less regulation, and an improving economy mean investors do not really want to take money off the table either. Interest rates are still low historically, so investors still need to stick with equities if they want any meaningful returns. If Washington can convince investors that real pro-business reform is at hand, the market can move higher. However, the longer it takes to address the issues investors want to concentrate on, the more likely the market will take a correction. As a result, we plan to continue to buy stocks opportunistically, realizing that in the near term stocks may be overbought. Long term, we think America is still the best investment opportunity.

As always we thank you for your continued support. Please call with any questions you might have.

Sincerely,

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