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# First Quarter Market Outlook 2017
# Expectations and Actualities

There are several major themes in play as we enter the New Year, and we will give our current thoughts on some of these themes in this report. Foremost has been the election. We think itœs too early to render an opinion on how a Trump presidency will fare, but the post-election rally in stocks was forecasting a brighter business outlook insofar as the President-elect campaigned on a lower tax, less legislation, and more business oriented platform. In this report, we will comment on Trumpœs stated business polices in regards to taxes and earnings repatriation, interest rates, trade, energy and infrastructure, and Wall Streetœs expectations for the stock market this year. How Trumpœs actual policies play out and how the market responds has yet to be seen.

## Taxes and Earnings Repatriation

We believe the recent stock market rally was partially due to the expectation of lower tax rates for major businesses. Current U.S. business income tax at 35% (and in some cases higher) is among the highest in the world (Tax Foundation- 2017). Many corporations have set up subsidiary companies in foreign countries, not only to address sales opportunity in these c ountries, but also to avoid paying 35% tax to repatriate funds held abroad. Itœs estimated that over $2 trillion in U.S. dollars are held in overseas accounts for U.S. business (Value Walk).

One of Trumpœs proposals was to invite those companies that are holding U.S. dollars abroad to return them to the U.S. and only pay 10% tax, as a one-time program. Former president George W. Bush offered the same incentive in 2004 and those funds helped finance an economic expansion under his watch, but government deficits swelled as well.

If this transfer occurs, it will not only create an earnings jump from these companies which participate, but it also allows the U.S. based banks which will receive the funds to create significant loans against those deposits, further expanding business here in the U.S. An example of how an earnings jump occurs is when company A, which holds $100 million overseas, also will likely have an unfunded liability of $35 million (at an assumed 35% tax rate) on its balance sheet. If and as it brings the money back to the U.S. under Trumpôs proposal, it pays 10% or $10 million to Uncle Sam, and the other $25 million falls into reported income (by reducing the liability), and then applied to earnings per share. We believe this is likely to pass a Republican Congress and should provide a one-time jump in stock prices.

The negative aspect to this is that the price jump in stocks since the election may already have occurred, and that failure for Congress to pass it could lead to a one time drop in stocks.

Lowering the corporate tax rate has some supporters, but proponents differ on the amounts. For instance, Barronôs magazine recommends a 22% tax for corporations. Trump has proposed a 15% corporate tax rate for large and small business alike, and tax reductions for individuals and married taxpayers.

Proponents of the lower corporate tax, however, believe there is a direct relationship between lower taxes that will lead to higher spending on capital projects for business, and higher consumption for individuals. They believe this correlation is sufficient to jump start economic growth, such that GDP growth will increase from its current 1% malaise, to a 2-3% growth; the incremental taxes from which will go a long way to cover the front end spending.

In the long term, those proponents may well be correct. In the short term, however, we believe, if the lower tax rates described above are implemented, it will be inflationary, lead to higher short term deficits as existing government revenue streams are cut, and cause interest rates to rise.

## Interest Rates

The most critical component in the above equation is interest rates. We have been in a 30 year secular decline in interest rates. This is the real news story of the day, in that we may have reached a 30 year bottom on rates. Expansionary policies will almost certainly cause this trend to reverse; and if so, higher borrowing costs will have to be integrated into planning, and may lead to a longer time period for spending proposals to pay for themselves thorough more rapid growth.

An interesting side note to this was aired on CNBC recently, wherein it was postulated that if one were to have invested equal sums into the S&P 500 stock index and the Barclays (AGG) Bond Index at the beginning of the last quarter (4th quarter 2016) not including dividends and interest; the results at the end of the quarter would have been essentially flat. Thatôs because the rise in interest rates (albeit small in numbers) was large in percentage terms. Remember that when rates rise, bond prices go down. The 10 year Treasury was at 1.6% a few months ago; now itôs 2.5% in a relatively short period of time. Bottom line, we view this variable as critical for Trump being able to implement some of his growth objectives. The expectations are high, but the actualities will stifle or lengthen the amount of time it will take to get things done.

## Energy and Environment

Another of Trumpôs proposals is to ñrev upò production of oil and gas in the United States, and particularly in the shale producing areas of North Dakota, the Marcellus Shale in

Pennsylvania, Ohio and parts of Colorado and Texas. At the same time, he wants to cut imports of energy from the Middle East in general, and Saudi Arabia in particular. That would also help our trade balance.

Generally speaking, Trump favors traditional fossil fuel companies and his energy policy will help the traditional fossil fuel companies in several ways. First, Trump plans to reduce existing and planned regulations on domestic energy development. For example, Trump cited the cost of the Clean Power Plan, which directs states to cut carbon emissions from existing power plants by 30% by year 2030, as the main reason for eliminating it. Trumpœs fact sheet stated it would essentially shut down most coal power plants. Moreover, Trump is also not a fan of the stricter standards for ozone pollution, which require communities to limit ozone pollution to 70 parts per billion. According to Trump, "The new ozone standard will push hundreds of communities out of compliance, and force states to devise plans to limit industrial activity and transportation projects, as well as replace existing emissions control equipment with more advanced (and costly) emissions equipmentò (CNBC). Trump said the regulations harm U.S. businesses and getting rid of them would help kick-start the economy. While the Clean Power Plan is not in effect yet (itœs being held up in court), Trump has several options to weaken or block it. According to the legal experts at Resources for the Future, Trump could decline to defend the rule, or he could send the rule back to the EPA (Environmental Protection Agency) to completely rewrite the rule. Either way, the trend seems clear that Trump will be pushing for job growth over environmental protection.

## Trade

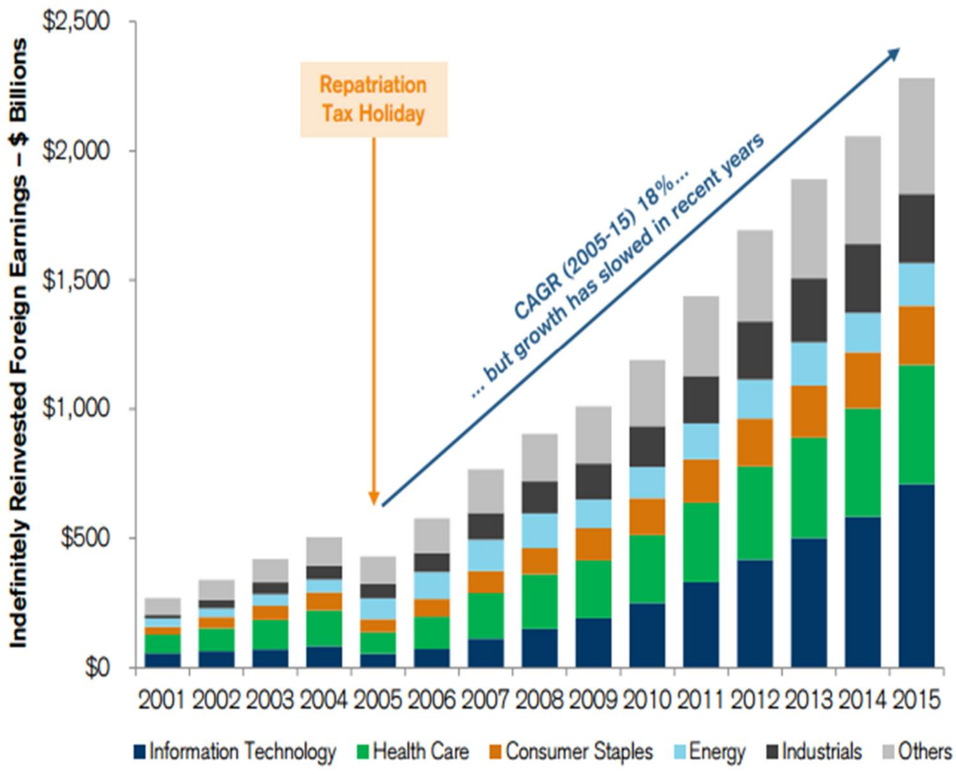
The U.S. is running a trade deficit with other countries to the tune of $531 billion per year (for 2015, Commerce Dept.). A significant part of this is oil. Trump believes a reversal in our trade policy with the Middle East would create a significant number of jobs in the shale areas listed above, while reducing our purchases from the volatile Middle East. Part of our trade deficit also is a result of a high price for the dollar.

A rising dollar is a headwind for U.S. exporters, causing our products to be priced higher to consuming nations. This is at the heart of Trump's trade proposal. He believes China's currency is 35% cheaper than it should be, allowing them to sell lower priced goods into the U.S.; the same is applicable to Mexico, and other nations as well. In an interview on CNBC, Wilbur Ross, Trump's new Commerce Secretary, and a well-respected billionaire stock investor himself, suggested his approach to the trade deficit is to tell countries like China that they have several options. First, they can let their countries currency appreciate so that they no longer undercut American made products. Second, the United States could slap tariffs on countries that keep their currencies low in order to gain a trade advantage, or third, the countries with low currencies could keep their currencies low if they allow for import substitution for products they are currently buying. For instance, China is a large buyer of natural gas, but they are buying Middle Eastern gas. Wilbur Ross said that China could keep their low currency if they buy American natural gas as a way to lower the trade deficit and stop buying natural gas from countries like Iran. Moreover, he stated that America imports lots of Chinese textiles, but China has quotas on American cotton. Ross said he would press China to take more American cotton exports, and we would keep buying their textiles. He said tariffs would be the last option to use.

## Infrastructure

Since the election, shares of construction companies have soared. However, we believe most of these stocks are ahead of themselves, and that the true winners of Trumps infrastructure spending will most likely be in select areas with clearly defined revenue streams. Trumps $1 trillion worth of infrastructure plan is over ten years and relies heavily on private financing. Of the $1 trillion in infrastructure spending, Trumpôs plan offers only $137 billion in federal tax credits to private investors who back infrastructure projects. So the headline is bigger than reality. Rather than government spending, Trumpôs team sees an opportunity and a synergistic benefit of tax reform on companies repatriating foreign profits back to the U.S. Companies paying the 10% tax on repatriation of overseas retained earnings mentioned earlier could use the tax credit on infrastructure equity investment to offset their tax liability on bringing the money back to the United States. Since the 2004 tax holiday, corporate profits overseas have grown from $500 billion to over $2 trillion.

**Exhibit 1: Earnings[18] Parked Overseas Keep On Growing, 2001-2015, S&P 500[17]**




Source: Value Walk

Traditionally infrastructure projects are delayed for years by red tape and financed by the government. Trump wants to take steps to reduce red tape (i.e. less regulation), and believes private investors will run spending projects cheaper and more quickly than the government. While this may be true, private investors need revenue streams to recoup their investments. Thus, we can see energy pipelines, LNG export terminals, toll roads, and bridges benefiting; while other forms of infrastructure with less clear revenue streams will most likely remain unchanged.

## Market Outlook

In 2016, while the market finished on a strong note, Wall Street analysts have been cautious in their earnings estimates for this year, and correspondingly see the current market at relatively high valuation levels. Much depends on a myriad of policies emanating from Washington and the new administration, and how any new policies are received by investors.

The key dynamics will be (a) whether corporations can maintain an increase in earnings, and (b) what happens to interest rates as noted above.

At the present time, brokerage estimates for the S&P pricing range fall into a broad spectrum, from a high of 10% to a low of 1% (see chart next page). This wide range reflects some skepticism about the earnings outlook, and how new rules and regulation might affect this earnings model.

**2017 Wall Street Year-End S&P 500 Targets**

| Firm | 2017 Year-End Target at Start of Year | % From Current S&P 500 Level |
|---|---|---|
| RBC | 2,500 | 10.13 |
| Oppenheimer | 2,450 | 7.93 |
| Citigroup | 2,425 | 6.83 |
| Barclays | 2,400 | 5.73 |
| Deutsche Bank | 2,400 | 5.73 |
| JP Morgan | 2,400 | 5.73 |
| Bank of Montreal | 2,350 | 3.52 |
| Scotiabank | 2,350 | 3.52 |
| Weeden | 2,350 | 3.52 |
| Canaccord | 2,340 | 3.08 |
| Jefferies | 2,325 | 2.42 |
| Bank of America | 2,300 | 1.32 |
| Credit Suisse | 2,300 | 1.32 |
| Goldman Sachs | 2,300 | 1.32 |
| Stifel Nicolaus | 2,300 | 1.32 |
| UBS | 2,300 | 1.32 |
| **Average** | **2,362** | **4.05** |

If the pro-business changes the market is expecting actually happen, we may see a continuation of the current rally. If future earnings growth does not materialize, then we may fall back to pre-election levels.

Potential political uncertainty also exists. This year Germany and France both hold national elections, and a transitional government is forming in Italy. Will populism sweep Europe like it has in Britain and America, and if so what does this mean for the future of the Euro? Or, the mainly European banks that hold Greek, Spanish, Italian, and Portuguese debt that likely will not be repaid in full if the Eurozone breaks apart? We think a little caution may be warranted.

In conclusion, we believe the market is anticipating changes that have not yet occurred. The real economy has not changed much since the election. To quote Warren Buffett, the ñUnited States is a large ship with a small rudder,ò meaning that policies take a while to change. As a result, we plan to continue to buy securities 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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# Economic Changes We Are Watching for 2017

## Positive Changes

| CHANGE | LIKELY OUTCOME |
|---|---|
| Lower Corporate Tax Rate | All firms benefit. Companies with mainly USA exposure benefit the most because they cannot hide earnings overseas. Budget deficit likely to increase in short term. |
| Tax Holiday on Overseas Cash of US Corporations | Big financial companies will benefit from increased deposits. Share buy backs, higher dividends, and increased capital expenditures likely from companies brining cash back. |
| Increased Infrastructure Spending | Helps construction companies, but could expand the deficit, especially if taxes are cut as well. Puts pressure on interest rates to increase. |
| Less Regulation | Highly regulated firms like financial, mining, coal and energy companies all benefit. Key Stone Pipeline likely to be built. |
| **Negative Changes** | |
| Higher Interest Rates | Financial companies- mainly banks benefit from higher margins. If rates rise too much the market will sell off as investors lock in no risk returns. Consumers & businesses hurt by higher interest cost, especially autos and homes. |
| More Expensive Dollar | Hurts multinational companies because overseas earnings worth less. Hurts exports, increases competition for domestic companies- particularly manufacturing companies. Retailers that import goods from overseas, and whose products cannot be purchased on Amazon should do well. Service companies that focus on domestic market are not affected. |
| Market Rally since the Election | The S&P 500 is now trading at 21 times trailing earnings, which is high historically. How much of a boost from positive regulation reform and lower taxes are priced into the market? If these things do not happen, market sell off likely. |
| **Neutral Change** | |
| Possible Tariffs on Imported Goods | This is neutral because a trade war is unlikely to happen. American runs huge trade deficits with almost every country we trade with, those countries do not want to lose access to the USA. Industrial companies benefit from tariffs. Oil and Gas firms benefit- Wilbur Ross, the new commerce secretary, goal is to increase energy exports to balance trade deficit and use tariffs as last resort. Tech firms that manufacture mostly overseas could be hurt, not only from tariffs but possible retaliation from other countries. |