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CAPITAL MANAGEMENT

Economic and Market Perspectives

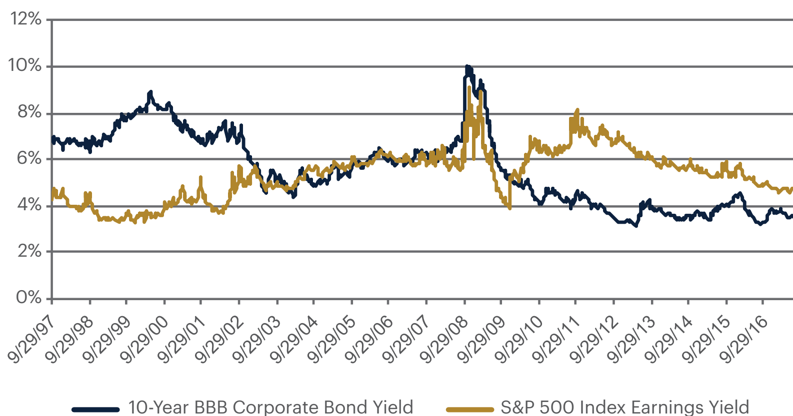
4Q 2017

Introduction

Storms, both natural and man-made, were not enough to slow down global equity markets during the third quarter. Solid corporate earnings and encouraging economic data helped investors shrug off worries about the impact of major hurricane damage and escalating tensions between the U.S. and North Korea. Continued strength in a now globally synchronized growth cycle has reinforced equity markets' resilience to adverse events that might otherwise pose a threat to seemingly solid economic momentum.

The domestic economy, though not growing as fast as during prior cycles, also shows little signs of slowing down. Accommodative financial conditions continue to perpetuate steady economic growth amidst a backdrop of low inflation and unemployment, creating an environment supportive of equity-risk taking. A lack of competitive returns offered by bonds and cash further fueled a 'buy the dip' mentality that persisted in the stock market despite some absolute valuation measures indicating richness.

As shown in the chart below, one relative valuation metric that seems to ease equity investors' concerns over elevated absolute valuations is the comparison of corporate earnings yields to yields on corporate bonds. Despite rising equity prices since the end of the bear market in 2009, earnings yields continue to enjoy a healthy spread over corporate bond yields.



Source: Bloomberg.

Investor optimism has also been renewed by the robust earnings growth U.S. companies have achieved this year. According to Reuters, S&P 500 earnings rose by over 12% in the second quarter, easily surpassing Wall Street estimates of 6.4% going into the reporting season. After five quarters of negative earnings growth ending in the fourth quarter last year, the S&P 500 Index posted positive total returns during the past eleven consecutive months through September.

The bond market has struggled to find such a definitive direction this year. Long-term bond yields fell for most of the quarter until an abrupt pivot in early September when investors were surprised by healthier than expected headline inflation. The Federal Reserve's (Fed) decision to officially implement its well-telegraphed plan to shrink its balance sheet, along with some hawkish comments from Chairwoman Yellen, have also added upward pressure to rates late in the quarter.

As of the end of the quarter, the yield-to-maturity on the 10-year U.S. Treasury Note (2.33%) settled just 11 basis points lower than where it started the year, but up 30 basis points from levels traded in early September. On the shorter end of the yield curve, interest rates found more upward direction with the yield on the 2-year Treasury Note (1.47%) breaking out to new cycle highs at the close of the quarter.

As discussed in last quarter's Perspectives, the Fed finds itself in a pickle. On the one hand, the monetary policy-making body is eager to wean its influence on financial markets and the economy, while on the other, it must remain concerned about the impact of withdrawing monetary stimulus amid stubbornly low inflation. A less noisy measure of inflation that the Fed claims to focus most on, the core personal consumption expenditures (PCE) index, increased by just 1.3% in August—a level not seen since October 2015 and well below the Fed's stated 2% target.

Economic Highlights

U.S. Growth: The domestic economy grew at a robust 3.1% rate in the second quarter. Accelerating corporate profits and business spending helped drive growth to its fastest pace in two years. We expect third quarter growth to slow, in part due to the impact from hurricanes Irma and Maria.[1]

Inflation: After showing signs of softening in June, the Consumer Price Index (CPI) reaccelerated in August to 1.9%. Hurricane damage should bring temporary upward pressure on prices in the coming months. However, excluding food and energy, price growth has remained weak.[2]

Employment: Hurricanes Irma and Harvey put a halt to seven years of job growth in September. An estimated 33,000 U.S. jobs were lost during the month, most notably from the restaurant industry. September's Employment Situation report was an expected temporary outlier, as July (+138,000) and August (+169,000) job growth remained largely consistent with longer term trends. Despite the setback in job growth, wage growth ticked up to an annualized rate of 2.9% in September.[2]

Foreign Exchange: The U.S. dollar continued its decline during the quarter from its cyclical peak at the end of last year. Year-to-date through the end of September, the U.S. Dollar Index has fallen by 8.4%. A weaker dollar should act as a tailwind for corporate profits and exports.[3]

Corporate Earnings: Second quarter earnings for S&P 500 companies increased 12.3% with a robust 5% top line revenue growth. Further, 73% of companies beat consensus analyst estimates. A significant rebound in Energy sector earnings helped drive the overall market higher.[4]

Energy: Oil prices rallied during the quarter after hitting a bottom in late June. West Texas Intermediate Crude closed the quarter at $51.58 per barrel after beginning the quarter at $46.04.[3] Gasoline prices rose even more dramatically after refining capacity was taken offline due to storm damage. AAA National Average Gasoline price closed the third quarter at $2.56 per gallon, up from $2.23 to start the quarter, a 15% increase.

Market performance

	% Total Return					
As of 9/30/2017	Q3 2017	YTD 2017	1-Year	3-Year	5-Year	10-Year
S&P 500	4.5	14.2	18.6	10.8	14.2	7.4
MSCI EAFE	5.4	20.0	19.1	5.0	8.4	1.3
MSCI Emerging Markets	7.9	27.8	22.5	4.9	4.0	1.3
Bloomberg Barclays US Aggregate Bond	0.9	3.1	0.1	2.7	2.1	4.3
BofA ML US Treasury Bills	0.3	0.6	0.6	0.3	0.2	0.5
Bloomberg Commodity	2.5	-2.9	-0.3	-10.4	-10.5	-6.8

Source: Morningstar Direct
Periods greater than one year are annualized

[1] U.S. Department of Commerce
[2] U.S. Bureau of Labor Statistics
[3] Bloomberg
[4] Reuters

New focus for the GOP congress

In late September, President Trump and his Republican colleagues in Congress shifted attention from repealing the Affordable Care Act (ACA) to reforming the nation's tax code for corporations and individuals. Below is a summary of the Unified Framework for Fixing Our Broken Tax Code:

Highlights of the Unified Framework for Fixing Our Broken Tax Code			
Corporate		Individual	
Corporate Tax Rate	20%	**Tax Rates**	New rates of 12%, 25%, 35% and potentially a 4th bracket
Business Pass-Through Rate	25%	**Standard Deduction**	$24,000 per couple and $12,000 for single-filers; nearly doubles current deduction
Repatriation	Two rates for repatriated assets: one for hard assets, one for cash. Both to be paid over several years	**AMT and Estate Tax**	Repealed
Territorial System	Shift to territorial regime	**Itemized Deductions**	Deductions for mortgage interest and charities retained; many others eliminated
Business Expenses	5 years or more to expense equipment	**Child Credit**	Increased but extent not specified
Deduction for Business Interest	Deduction limited—details to be worked out	**Tax Credit for Dependents**	Adds a $500 credit for non-child dependents
Business Tax Credits	R&D and low-income housing credit remains; many others eliminated		

Source: Cornerstone Macro

Despite being generally consistent with promises made on the campaign trail, U.S. corporations and equity investors, eagerly awaiting a formal proposal, were heartened by the key tenets. Shares of companies that are likely to benefit the most from the revised framework (primarily those in U.S.-based cyclical sectors such as consumer goods and services, materials, financial firms, and real estate companies) got a boost after the plan was released. Conversely, the revival of the "reflation trade" was less supportive for defensive, yield-oriented companies and growth stocks lagged.

Companies with high tax rates and large cash balances held overseas also saw share prices rise as investors looked forward to the prospect of repatriated cash being used to increase capital expenditures, share buybacks and dividends.

The business pass-through rate of 25% is a significant change for the sole proprietorships, partnerships, and S-corps that currently pay taxes at the owner's individual tax rate. Since the current top individual rate is 39.6%, the proposed tax reform is expected to be a significant boost for the finances of small business owners, which, according to supply-side economic theory, would be reinvested back in the businesses and enhance overall economic activity.

The long and winding road to a new tax regime

Corporations have generally been enthusiastic about the net impact of the tax proposal, though it is early days yet. Most expect that the scope of the cuts will be pared back in the coming weeks and months. The first critical step will come next month when Congress begins negotiations on the budget.

This task requires determining the size of the overall tax cut even before the various committees get to work crafting the final details that will be sent to Congress for a vote. Setting the size of the tax cut up front, during budget negotiations, does not allow Republicans to increase the size and impact of the proposal later.

Given the many (often competing) groups involved in tax reform, it is more likely that the size of the current tax reform package will decrease rather than remain the same. And while the reform proposal is generally "pro-business", the elimination of several business tax credits in the current system, including those in support of on-shore production, would benefit some industries while negatively impacting others. Lobbying for revisions to mitigate the disparity between industry winners versus losers has already begun.

Deficit hawks, a significant voting block within the Republican party, are likely to take exception to the potential addition to the nation's deficit. This group, commonly known as the GOP's Freedom Caucus, and others may be skeptical of the Administration's claims that boosted economic growth will offset the reduced tax rates—by some estimates tax receipts could decline by trillions in coming years. Democrats in the House and Senate are certainly expected to cry foul over the expected reductions in tax liability for the wealthiest Americans. The proposal includes repealing the estate tax—a tax which contributes modest tax revenue, yet significantly impacts only a limited number of the nation's wealthiest families.

It did not take long before the horse-trading began: two days after outlines of the tax plan were issued by the White House, officials were beginning the negotiating process with President Trump's senior economic adviser Gary Cohn, stating that the President was open to negotiating the plan's proposed elimination of the deduction individual taxpayers can now claim for state and local taxes. As the deduction for state and local taxes primarily benefits higher-income individuals, often in states that traditionally favor the Democratic party, the outreach may be a sign that Republicans will seek Democratic support for the final bill.

If one thing is certain, it is that any bill that passes will likely see major modifications to the current outline. The 25% business pass-through rate may only cover some business income, with the remaining income viewed as wage income and subject to the top personal tax rate. There may also be a maximum amount of pass-through income eligible for the fixed 25% rate—as little as $1 million to $2 million by one estimate. One of the myriad of details awaiting Congressional committees is figuring out how to prevent wealthy individuals from claiming pass-through business status to pay lower taxes on some or all of their income.

Given the heavy-lifting required to convert President Trump's nine-page outline into the most significant pro-growth and pro-investment tax reform bill since the Reagan administration's reform more than 30 years ago, it is unlikely that the package will clear Congress this year. Furthermore, any approved legislation will likely be phased in over several years—making the impact of tax reform on corporate balance sheets gradual rather than immediate.

The coming months will feature plenty of the gamesmanship, arm-twisting, and negotiations required to make the aggressive tax plan law. If there is any legislation that is as cantankerous as health care regulation, it would be the tax code. With the mid-term elections fast approaching and no progress on an ACA repeal, the stakes could not be higher for Republicans. Such necessity should improve the odds of success in some form, but it far from guarantees it.

Crypto craze

By now you have probably at least heard of Bitcoin, even if you do not know exactly what it is or how it works. Bitcoin is a digital or "crypto" currency, which is not controlled by a centralized entity like a government. This decentralized feature has important implications because it does not allow supply to be manipulated[5] like government-issued currency. In an age when "quantitative easing" has become a global household term, a currency with a finite supply has a certain appeal to many.

The details behind cryptocurrency are technical, which likely has steered some away from paying close attention to the phenomenon. In the simplest terms, all digital currencies, including Bitcoin, are based on a distributed ledger (or database) technology known as blockchain. Blockchain relies on a peer-to-peer network to validate and process transactions. So-called Bitcoin "miners" help process transactions in exchange for new units. Units are stored in digital wallets accessible exclusively by the owner's unique key.

[5] Bitcoin will be limited to 21 million units

During a parabolic rise in value over the past twelve months, Bitcoin and its copycats have shown up on the radar screen of many investors. So far in 2017, Bitcoin's value in U.S. dollars has more than quadrupled. In true capitalist form, Bitcoin's popularity has spurred plenty of competition. Today, there are over 1,000 known cryptocurrencies with an estimated market value of $140 billion[6]—roughly half of which is Bitcoin.

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One emerging source of demand for digital currency has come from China. Looking for creative ways to avoid their government's recently imposed capital controls, Chinese citizens have found Bitcoin and other cryptocurrencies to be a convenient way to avoid a depreciating Yuan, while also earning a very healthy return. Worried about the popularity of cryptocurrencies, Chinese regulators outlawed digital currency exchanges and initial coin offerings, known as "ICOs," in September. This crackdown led to a near instantaneous 20% drop in Bitcoin's value.

Exchanging traditional currency for cryptocurrency can only be done on specialized exchanges. Currently, no securitized product exists in the U.S. to "invest" in Bitcoin, although (stock) exchange traded funds (ETFs) may be on the horizon. Seizing on the phenomenon, several hedge funds have launched with the intent of investing in digital currencies and the ecosystem of the blockchain technology.

Opinions on digital currency seem to be about as binary as the potential outcomes of the concept itself. Bitcoin has been championed by some pundits as the next big thing. Other high-profile investors and financial services executives have called it a baseless fraud.

At such an early stage of a technology's development, it can be difficult to predict an outcome with any degree of certainty. Currency, by definition, is a store of value, which one expects to be relatively stable over time. So far, digital currency has been anything but stable. Ironically, the extreme volatility that has led to its early success may ultimately limit cryptocurrency's broader acceptance.

Up, Up And Away

Source: Bloomberg

[6] https://coinmarketcap.com/all/views/all

Even if digital currency succeeds as a widely used form of payment, which "brand" ultimately becomes ubiquitous is anyone's guess at this stage. While Bitcoin has first-mover advantage and dominant market share, that is no guarantee of success in the tech world. Think of MySpace, Netscape, etc. For this reason, one should consider buying cryptocurrency a gamble rather than an investment, at least for now.

Many have prognosticated that blockchain will become a revolutionary technology with wide-reaching disruptive applications for secure transaction processing and data storage, well beyond the currency realm. Much like the early days of the internet, however, it is hard to have clarity on the individual winners and losers. If one thing is clear, we should not dismiss this budding technology.

(EU)reka!

Since the Global Financial Crisis, the European Union (EU), plagued by political strife and structural inefficiency, has largely been perceived as a home for dead money. U.S. equity markets, buoyed by stronger corporate earnings growth and better overall economic conditions (i.e., no sovereign debt crisis to deal with) rallied during this period. European equity markets struggled in the years following the crisis, with the MSCI Europe Index returns lagging significantly behind those of the S&P 500 Index between 2009 and 2016.

However, the tide in Europe appears to be turning. Factors including a stabilizing political environment, improving economic indicators, and attractive relative valuations for European equity markets have all contributed to the region's resurgence. As a result, we remain optimistic about European equity markets.

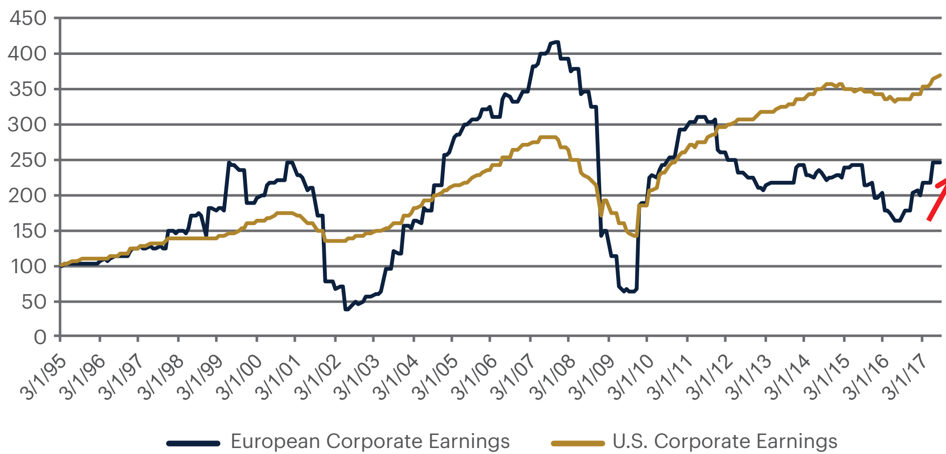
For months, the world awaited election outcomes in Austria, the Netherlands, France and Germany, wondering whether populist parties would succeed. Following the initial shock of the "Brexit" vote last June, the possibility of other European countries succumbing to far-right populism did not seem that far off. However, with each election subsequent to Brexit, populist candidates were rejected at the polls in favor of more mainstream, establishment party candidates. In Europe's largest economies, France and Germany, Macron and Merkel won, mostly quieting the question of European unity—at least for now.

Europe's competitive currency and a cyclical upswing in global demand have sparked rejuvenation in economic activity in the region. The IHS Markit's Flash Eurozone Composite Purchasing Managers' Index (PMI) moved up again in August, from 55.7 to 55.8, which is the highest level that the index has reached in over six years (anything above 50 is considered expansionary). The European labor market has also tightened significantly, with the unemployment rate at its lowest level in almost a decade.

Europe's improving economy provides a catalyst for corporate earnings growth, which has been anemic since the continent's sovereign debt crisis. Early recognition of this trend appears to be in progress. Capital flows have led the MSCI Europe Index in U.S. dollars to outperform the S&P 500 Index by over 8.5% year-to-date through the end of September.

Attractive valuations relative to the U.S. stock market, along with improving earnings growth expectations, should contribute to continued positive momentum in the European equity markets. European corporate earnings have lagged behind those of U.S. companies recently, but have demonstrated a pattern of convergence over longer time periods. As shown in the chart on the next page, that gap is shrinking as European companies are experiencing their first full year of earnings expansion in six years.

While Europe has not yet shed all its baggage, the region offers compelling value nonetheless. Populist movements are still worthy of concern, but have been overly discounted in our view. The European integration project is a work in progress—however, on the balance, political risks are on the decline just as the economy is gaining traction.



Source: Bloomberg

Conclusion

By most measures, the global economy today is at its strongest point since the beginning of the financial crisis. In concert with low real and nominal interest rates orchestrated by central banks, such economic tranquility is music to investors' ears and is reflected by healthy asset price appreciation over the past 12 to 18 months. However, an environment of low interest rates, narrow credit spreads and elevated equity market valuations lowers future upside return potential from stocks and bonds. As a result, past historical returns for major asset classes are unlikely to be matched or exceeded going forward.

With major central banks seeking to pull back monetary policy accommodation as the global economy firms up, investors must not become complacent. Although recent market behavior has heavily discounted the likelihood of such an outcome, hitting an air pocket in the economy is never out of the question. When indications of a slowdown eventually emerge, seemingly insatiable appetites for equity market risk may change at a moment's notice. Therefore, it is especially important that we remind ourselves during periods of general calm that staying focused on long-term goals and strategic asset allocation policy is the key to riding out any storm that could eventually rattle markets.

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