Financial Markets Perspective

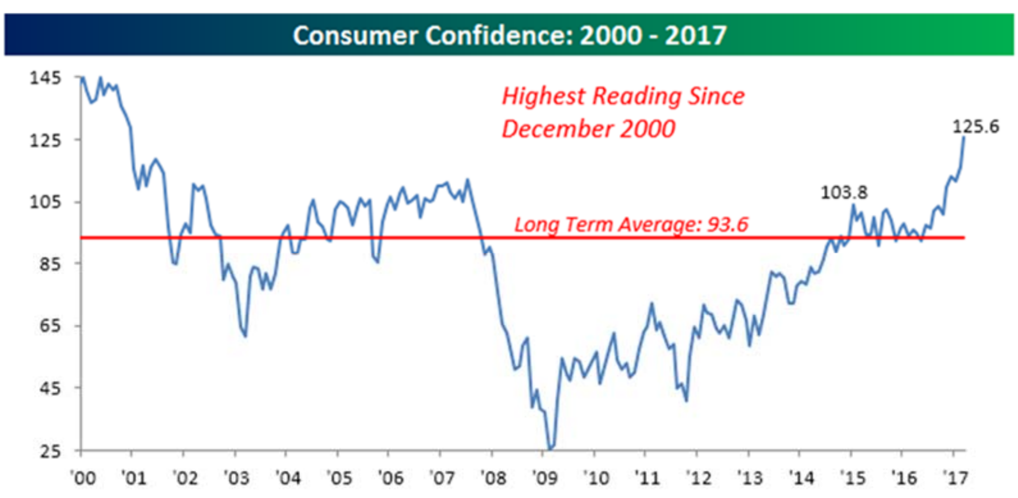
April 2017

Rationale for Optimism

Equity markets had a good start to the year in the first quarter as the so called "Trump Rally" continued to encourage investors that a growth agenda will be in place by the end of the year. The S&P 500 index -- one of three most followed benchmarks for U.S. stock market performance rose by 6.07% while the NASDAQ Composite index that is more heavily weighted towards information technology companies rose 10.13% in the first quarter. Although initial attempts at repealing Obamacare failed, a commitment among Republicans to cooperate on a viable replacement plan appeared to mitigate an initial failure. More importantly, the centerpiece of President Trump's agenda appears to be a broad-based tax reform program to lower both corporate and personal income tax rates to encourage an acceleration in economic growth. As the second quarter of the year began, the Senate approved the president's nominee for Supreme Court justice, Neil Gorsuch, over the contentious objections to his nomination by the minority party.

Financial markets are driven by optimism and pessimism. Recent statistics measuring the optimism of consumers are very favorable as the following Exhibit #1 confirms. As pointed out, consumer confidence hit a record high since the peak over 17 years ago. The fall in the unemployment rate to 4.5% in March coupled with a rise in hourly income appeared to be two important factors in driving optimism higher.

Exhibit #1



Courtesy of Bespoke Investments

The growing optimism of consumers is also reflected in the ongoing low level of inflation and the near-record lows in interest rates even though the economy has been growing (albeit slowly) since 2009. The Federal Reserve has been taking a wait-and-see attitude about changing policy to throttle either too much growth or too much inflation. So far in this economic expansion there have been only two announced rate increases of 25-50 basis points taking the Fed funds rate up to the 75-100 basis point level. We are a long way from the Fed funds rate in the 5-6% range that existed in 2008.

Another important indicator of growing optimism is emanating from the corporate sector. The latest report from the business community—The CEO Economic Outlook Survey for the first quarter of 2017 reflects broad growth in business confidence. The Business Roundtable index made its largest increase since the fourth quarter of 2009. The index jumped from 74.2 to 93.3 in the first quarter, an increase of 19.1 points.

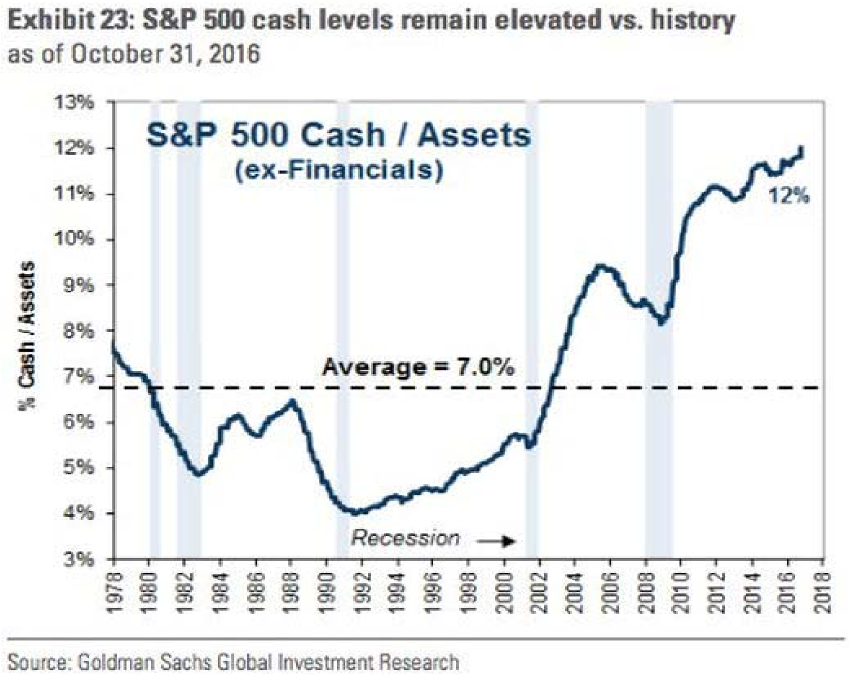
This optimism is backed up by a continued rise in corporate profits. After a period of weakness from January 2015 through January 2016 due to the collapse in oil prices, a recovery in those same oil prices coupled with continued growth in non-energy profits produced a strong recovery in corporate profits with expectations for further gains through 2017 as seen in Exhibit #).

The turnaround in the price of oil will likely positively contribute to the profits of the U.S. energy sector. The number of drilling rigs in the U.S. has also been growing as the price of oil rises. The construction of the Keystone pipeline plus tributaries will improve the efficiency of oil delivery in the continental U.S. and liquified natural gas (LNG) is being exported to Europe—events that will contribute to growing profits in the energy sector.

Exhibit #2

Corporate profits are only part of the optimism equation. The balance sheet of corporate America is truly overflowing. Exhibit #3 depicts the buildup in cash reserves in non-financial corporate America. Current levels of 12% are well ahead of the long-term average of 7%. A lot of that cash is held offshore but could be repatriated if or when the Trump administration formulates a tax policy that favors a decision to bring that money back home. Low interest rates and the deductibility of interest payments on corporate debt encourage borrowing to finance acquisitions or to pay dividends especially when the combination of interest costs after-tax and inflation reduces the real interest cost to near zero.

Exhibit #3



Since the current expansion started, U.S. real GDP has expanded at just a 2.1% annualized rate. At the same time government spending, tax rates and regulation have increased. These government burdens reduce entrepreneurial activity, jobs, income growth and push companies out of the U.S. The good news is that for first time since mid-2014 as seen in Exhibit #4, we have experienced a pickup in total government spending that should contribute to overall economic growth.

Exhibit #4

The biggest battle on the Hill will be over major tax reform. Tax cuts of the magnitude implemented during the Kennedy/Johnson era and the Reagan era may be difficult to get through the Congress because of the concept of revenue neutrality. In other words, if the president wants a substantial cut in personal taxes and the bean counters determine that such a tax cut would increase the deficit then that tax cut would not be approved.

Since the election, equity markets have been in an uptrend proving that it's not just a Trump Bump that is driving stocks higher, nor is it unwarranted or unsubstantiated optimism. Rising equity prices are most likely a response to an improvement in global economic fundamentals that is now becoming clear. Global industrial production has been rising for the past 6-8 months, and the volume of global trade has picked up—most notably towards the end of last year. This rise could be related to improving optimism at both the consumer and business levels. Changes in fiscal policy that appear to be on the horizon—tax rate reductions, reduced regulation, and revamped healthcare—could be triggering rising optimism about the future growth in the U.S. economy.

Two problems that have exasperated market observers have stabilized: the price of oil and the value of the dollar. This calming should lead to improved global trade and a stronger global economy. Corporate profits continue to work their way higher with no stress in sight. Inflation remains low and interest rates are not rising appreciably from the low levels of last year. While some individual stocks may be overpriced the overall market appears reasonably priced given low inflation and low interest rates.

The big question mark is the shape of tax reform as promised by president Trump. If the tax rate cuts parallel the changes made by president Reagan, we could experience a surge in economic activity and rising standards of living. With Secretary Mnuchin promising a tax bill by the August recess, attention will be focused on the structure of that tax cut. Shifts within market sectors could also be volatile as the final tax bill is constructed. The next four months will be critical for the long-term outlook for the economy and the stock market.

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April 10, 2017