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Pence Perspectives, Q1 2018

Bottom Line Up Front:

On December 31st 2017, the stock markets wrapped up their best year since 2013, with the S&P 500 Index ending up over 20%. Last year's steady and largely smooth rise was a result of strong corporate profits, synchronized global economic growth, and the promise of a new US tax law, which cuts corporate rates from 35% to 21%.

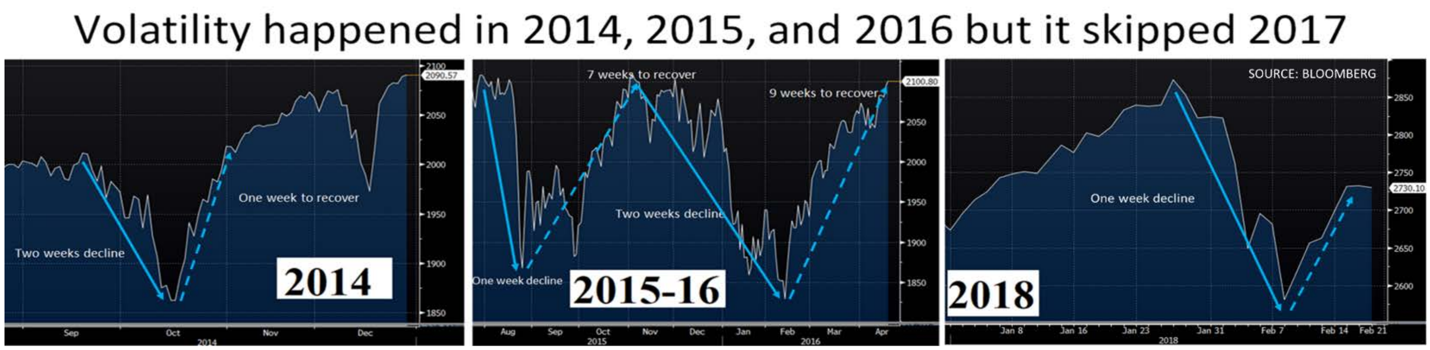
However, after a year of relative tranquility, we saw volatility return to the stock market.[1] As of January 26th, the S&P 500 Index was up 7.5%, in what is the strongest start to a year since 1987. Then, in afternoon trading on Monday, February 5th, the Dow Jones industrial average plunged almost 1,600 points, closing down 4.6% - the biggest one-day point decline in history and largest percentage drop (4.6%) since August 2011, during the European debt crisis.[2]

What happened on Friday, February 5 was essentially good news that became bad news. The selloff was sparked by the latest job market report showing that the economy created 200,000 jobs in January and wages for U.S. workers rose at their fastest pace since 2009. Rising wages are good for wage earners, but the market viewed it as a sign of possible inflation and feared the Federal Reserve (Fed) might quicken the pace of its interest rate hikes.

In 2014, 2015, and 2016 we had movements like we just had in February— where the S&P 500 Index dropped more than 10% within a one week to two week period (see chart below). In all those incidences, the index fully recovered in subsequent short measure. One thing we all must remember is that market volatility, although never pleasant, is part of investing and should be expected. 2017 was atypical as we had the lowest level of market volatility in history. During periods of market volatility, it is important that we remain calm and focus on the underlying fundamentals supporting the economy and markets while maintaining a long-term view. We believe that corporate earnings and the economic backdrop remain supportive for equities for the rest of the year, likely resulting in another positive year for US stocks. On a technical note, of the 12 other years since 1950 that started with a January return greater than 5%, the S&P 500 index finished the year with positive return 11 out of 12 times, with the median 11-month return being 17%.[3] Moreover, of 16 drawdowns of 10%

[1] As of January 29th, it has been a record 399-trading-day since the last 5% drawdown. Data goes back to 1930.
[2] The Dow's 777-point plunge in September 2008 was equivalent to 7%, far bigger than Monday February 5th decline.
[3] Goldman Sachs -- US Weekly Start, Feb 2, 2018

decline since 1976, 11 occurred during a non-recession and a typical correction took 70 trading days to trough and 88 days to recover.[4]



With respect to the new US tax law, once again, policy determines winners and losers. We believe sectors with historically high effective tax rates and companies with large amounts of cash held overseas will benefit relatively more than others. Bloomberg consensus estimates suggest overall earnings growth of 28% for the companies in the S&P 500 in 2018, which would be the highest in 8 years. We believe at least 10% of this increase will come from the tax stimulus.

2018 may very well be the first year since the Great Recession that the US economy grows at a 3% rate, primarily due to benefits from the new tax law spreading across the economy. Higher earnings can pass through to shareholders, employees, and consumers in the form of dividends, stock buy-backs, business spending, higher wages, and lower prices – all of which are beneficial to economic growth and company share prices. We are already seeing examples of companies such as Comcast, AT&T, and Walmart raising their minimum wages and giving bonuses, as well as boosting their business investments.

Lastly, as we stated in our **2017 Q4 Newsletter**, the biggest risk to the stock market is future political gridlock. The United States has a midterm election in November 2018 where the Democratic Party will seek to regain congressional majorities and may make future legislation challenging to pass. The second notable risk is the Fed tightening too fast and creating a resulting spike in bond yields. In the absence of these two risks, we do not expect a permanent market correction in the form of an economic downturn. We believe, with strong investor and business confidence, any market volatility in the absence of a structural issue should be short-lived as investors will most likely view it as a buying opportunity.

The Growth Effect of US Tax Reform

Considering 2/3 of US gross domestic product (GDP) consists of consumer spending, we believe that the tax bill will be immensely additive to the economy and the earnings of participating companies.

On December 22nd the most significant transformation of the U.S. tax code in 30 years was signed into law. **The Tax Cuts and Jobs Act** offers sweeping changes for both individual filers as well as corporations with wide reaching implications for economic growth and further fiscal stimulus.

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[4] Goldman Sachs -- US Weekly Start, Feb 9, 2018

For **individuals**, the number of total tax brackets is kept at seven – as opposed to the House bill's four – with lowered rates and higher thresholds as well as a doubled standard deduction at $12,000 for single filers and $24,000 for joint filers. On the **corporate side**, the largest change is the reduction of the corporate tax rate from 35% to 21% and the institution of a one-time levee of 15.5% on cash held overseas (8% for illiquid assets).

The reaction to the passing of the bill has been overwhelmingly positive with companies increasing their hourly minimum wages and numerous others paying one-time bonuses to their workforce in addition to committing to significant capital expenditures over the next few years. All in all, over 150 companies employing up to 3.5 million workers in the US have thus far announced intentions to increase employee compensation or investment.[5]

The Council of Economic Advisers projects that annual income for American households will increase by an average of $4,000 due to the new tax legislation. Considering there are over 125 million households in the US, it implies total income growth of $500 billion, which corresponds to about 7% of total private sector employee compensation ($7.14 trillion in December 2017). This will be spent on more goods and services, paying down debt, and increasing savings, all of which are good for the economy.

Figures from the **Tax Policy Center** predict that the new tax regime will boost GDP by an additional 0.8 percent in 2018 and 0.7 percent in 2019. Considering the average GDP growth of the US has been 2.2% since 2010, this tax cut is expected to put the US economy near the **3% growth rate** threshold in the next two years, all else being equal. According to a **Council on Foreign Relations** study looking at the historical relationship between corporate earnings and GDP from 1990-2015, tax reform will boost GDP growth by 0.20-0.30 percentage points over the first 10 years.

Elsewhere, 2017 was the broadest synchronized global growth upsurge since 2010 with expansion in 120 economies that together account for nearly 75% of global GDP. All evidence points to stronger, sounder global GDP growth and increased corporate earnings.

Effect of Tax Reform on Earnings

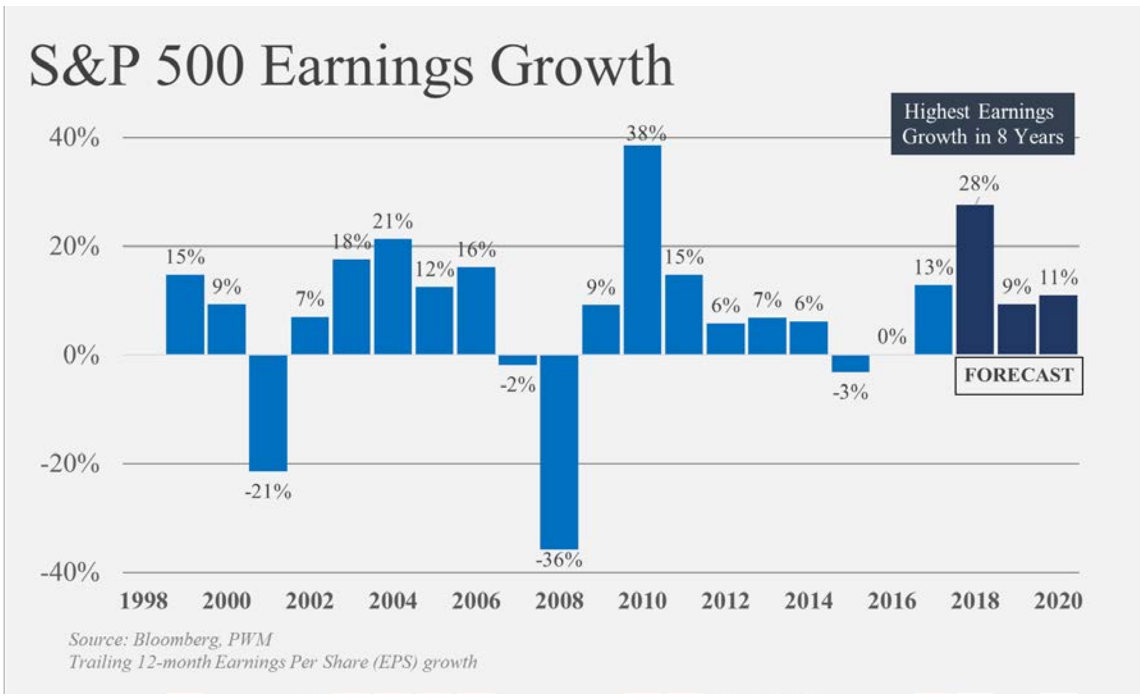
At a US corporate rate of 35%, the average effective tax rate after calculating domestic and foreign sources of income for all companies comprised in the S&P 500 index was 27.9%. After adjusting for a flat 21% corporate tax rate and accounting for state and local tax, we estimate the new average effective tax rate will be around 22.7% (see table below), which was consistent with what we said in our **2017 Q4 Newsletter**. We also estimate that corporations will have tax savings between $90 billion and $100 billion of their operating incomes. This corresponds to an additional 11% growth making for as high as a 30% total increase in 2018 net earnings, the best in 8 years.

[5] https://www.atr.org/

Sectors	Previous Tax Rate	2018 Estimated Tax Rate	Tax Benefit on Net Income
Consumer Discretionary	31%	25%	10%
Consumer Staples	29%	28%	3%
Energy	38%	31%	31%
Financials	29%	22%	12%
Health Care	26%	20%	15%
Industrials	29%	23%	12%
Information Technology	22%	19%	6%
Materials	28%	24%	7%
Telecommunication Services	34%	25%	10%
Utilities	32%	24%	21%
SP 500	**27.9%**	**22.7%**	**11.2%**

Tax Rate = Effective Tax Rate
Data: S&P 500 cap-weighted
Source: Bloomberg, PWM

In our opinion, the strong fundamental growth exemplified worldwide and the added fiscal stimulus of the tax reform supports equity valuations throughout 2018, while rising earnings continue to drive the market.



Legislation and Policy

There are a few factors that need acknowledgment before proceeding forward; one is the Fed and its new chairman and the other is the likelihood of the United States legislative picture changing. Janet Yellen has announced her resignation and was officially replaced by **Jerome Powell**. Powell has been a Fed Governor since 2012, but he's also a lawyer who has worked in private equity and the Treasury Department. We believe that Fed policy will remain mostly accommodative – measured with well-telegraphed rate increases and a continued, if not slightly expanded, balance sheet reduction program. After the Fed's latest rate hike in December, we are forecasting **three rate hikes** over this year with the first of which being in March.

Early indications in the legislative world are that presidential approval ratings and a record number of retiring Republican House Members may leave the door somewhat open for a resulting Democratic-majority House. The Senate, on the other hand, has a lower risk profile with significantly more contested Democratic seats and notably tougher races – we expect the Republicans to maintain or add to their majority in the Senate. However, we also believe that it is far too early to make a determination given the number of factors that will come into play over the next 9 months. Of the 36 retiring or resigning Republicans, only 7 jump out as overly competitive given electorate histories and the fact that year-over-year unemployment levels in those districts are improving – and we still must make our way through the primaries to weigh the final candidates.

In an emotional market, as February shows, it is likely that variations in the political picture combined with the dissection and extrapolation by the media will lead to some volatility as we make our way to November. All in all, our view is that the foundation is still stable regardless of electorate outcome.

Fiscal Stimulus

On February 9, the government signed a two-year budget deal, boosting federal spending for both the military and domestic programs by almost $300 billion over two years. The deal increases defense spending by $80 billion this fiscal year and $85 billion in fiscal year 2019 while boosting domestic, nondefense spending by $63 billion this fiscal year and $68 billion the following year. Some of those domestic funds are targeted for specific needs such as $20 billion over two years for infrastructure improvements including rural broadband, roads and highways, and drinking water. The deal also suspends the debt ceiling through March 1, 2019, limiting the near-term risk of further shutdowns.[6]

On February 12, the White House also proposed a $4.4 trillion fiscal 2019 budget, which highlighted **$200 billion in federal infrastructure spending** over 10 years, mostly in the form of new, competitive grants designed to encourage states and cities to raise their own money for improving rails, airports, highways, digital networks, and water systems. The proposal also would expand federal loan programs for such projects and would streamline the permitting process for infrastructure projects. All in all, the White House estimates the proposal would lead to approximately $1.5 trillion in total, new investment. It appears that the plan counts on states to do the heavy lifting. On any individual project, the federal money will be granted only if local governments promise to spend far more from funds they generate through taxes, user fees, bonds or public-private partnerships.

According to the Wall Street Journal, the proposed new approach would represent a reversal of the way many local and federal partnerships work now. In spending from the Federal Highway Trust Fund, senior administration officials said, the federal government provides 80% of the funding for a new highway project, and the states match that with 20% of the funding. The goal of the new initiative is to essentially reverse those ratios, the officials said.

[6] https://www.wsj.com/articles/house-passes-two-year-budget-deal-1518172770

We expect major defense contractors as well as construction design and material companies to benefit from the proposed fiscal spending.

Conclusion

Going forward, although we will see the return of volatility as the stock market goes in a tug-of-war between stronger corporate earnings, which warrant higher equity prices, and higher bond yields, which lower the present value of those earnings, we expect markets to finish the year meaningfully in positive territory. Fiscal stimulus from the tax cuts and increased federal spending will most likely push the economic growth to at (or above) 3% GDP growth rate which has not been achieved since the Great Recession.

We appreciate your trust and the opportunity to be of service.

All the best, ❖

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