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OUTLOOKS

November 2017

ECONOMIC OUTLOOK

Summary

How will the recently released House Tax Reform Bill impact businesses, consumers and the U.S. economy? It's too early to tell for now as the bill has not become law and will need to be reconciled with the Senate. However, we can make some general assumptions regarding the direction, substance and likelihood for passage of the bill. Republicans dearly need some form of legislative victory, so passing a tax reform or tax cut bill seems likely. In addition, the nature of the bill only requires 50 votes in the Senate, so it may only garner Republican votes in order to win passage. Finally, there are many "pay-fors" that eliminate or cap popular business and consumer tax deductions that will have to be negotiated and could imperil passage of the legislation.

There will clearly be winners and losers in the most consequential tax reform put forth in over 30 years. The U.S. does have close to the highest statutory rates on corporate income in the world (35%) but many loopholes and preference items bring the effective rate closer to 25%-26% overall. Small and midsized companies stand to benefit the most from this legislation as they generally pay a higher effective tax rate compared to their larger brethren. On the consumer side, capping mortgage interest deductions and eliminating state tax deductions will get taxpayer attention and will be a very contentious issue for lawmakers. There are many other details that will impact all types of tax returns for corporations and individuals.

So, what we have is the legislative sausage making taking place in front of our eyes as these proposals see the light of day. K Street lobbyists will be fighting tooth and nail for their constituencies and the opposing party will surely disparage the legislation. We know the final bill will not look the same as the initial version, but how it changes is anyone's guess. As the horse trading intensifies between lawmakers and lobbyists, a more watered down bill becomes likely. But, the Republicans have their backs up against the wall and will feel immense pressure to pass something, potentially at the expense of the budget deficit. Assuming some form of a tax bill does get passed, it should provide a tailwind for the economy boosting investment, jobs and hopefully, wages. This might come at the expense of fiscal discipline, boosting the deficit as a percentage of GDP, but also revving up the economy in time for the 2018 mid-term elections.

Positives

Unemployment rate at 4.1% is the lowest in 16 years

Institute of Supply Management (ISM) Non-Manufacturing Index is the highest in 12 years

Auto and truck sales reach over 18 million units (annualized) last month

Negatives

Housing starts and building permits drop 4.7% and 4.5% last month

Personal consumption dropped to 2.4% from 3.3% last quarter

Labor force participation rate fell to 62.7% from 63.1% last month

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EQUITY OUTLOOK

Summary

The good times just kept on rolling for U.S. equity markets in October. The Standard & Poor's 500 has now closed higher in each month this year and for seven consecutive weeks. What's more, the markets have maintained the current rally without any meaningful market retracement. It has now been nearly 500 days since the S&P suffered a 5% pullback and over 360 days since we've even experienced a 3% decline. The S&P 500 finished the month up another 2.33% bringing the year to date total return to 16.92%.

Growth stocks resumed the leadership position over value for the year after taking a pause in September. The Russell 1000 Growth Index rose 3.9% in October while the Russell 1000 Value was up just 0.7%. Information Technology stocks carried the flag for growth rallying 7.8%, the top performing sector for the month. FAANG stocks (think Facebook, Apple, Amazon, Netflix, and Google) stalled out in the summer, but performed well as soon as earnings season began. Year to date, an equal weighted index of those five securities is up over 48%. Telecommunications (-7.6%) and consumer staples (-1.4%) were the worst two performing sectors last month.

As of this writing, the vast majority of third quarter earnings season is now in the books. To date, 63.7% of companies have exceeded consensus analyst earnings per share (EPS) estimates and 61.0% have surpassed revenue projections. Each of those beat rates are on par with market norms for the last couple of decades. More notable is the relative performance between companies that exceeded expectations versus those that disappointed. Stocks that beat have returned 1.90% on earnings reaction days and those that have missed have declined 3.57% on average.

Corporate earnings momentum, as a whole, is quite strong and domestic and global economic conditions favor a continuation of the recent uptrend in equity markets. Though it's important to recognize that companies that missed revenue or earnings expectations were penalized by the markets. Those that offered poor forward guidance were punished even more soundly and it appears there is becoming a clearer delineation between winners and losers. We could be at the beginning stages of a period in which active management will become increasingly more valuable in sorting through businesses that will prosper and those that struggle to find their way in an ever-changing global economy. As the holiday season approaches we remain thankful and diligent, yet extremely nimble.

Positives

- Legislation to reduce corporate tax rate gaining traction
- Consumer sentiment/labor markets
- Solid corporate earnings momentum

Negatives

- Geopolitical uncertainty
- Rising consumer & federal debt

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FIXED INCOME OUTLOOK

Summary

After two consecutive quarters of 3% GDP growth, economists and market forecasters are becoming increasingly confident about the sustainability of the current economic momentum. Combining this increasing optimism with an unemployment rate that has reached its lowest level since December 2000, the Fed's Federal Open Market Committee (FOMC) remains committed to their strategy of steadily increasing the overnight lending rate even though inflation has not yet reached their target of 2% on a core basis.

In October, the yield curve moved slightly higher and flatter with the 2-year Treasury note increasing 12 basis points (bps) and the 10-year increasing by only 5 bps. On the short-end, the rise reflects the market's increasing expectation for the third rate hike this year to occur at the mid-December meeting of the FOMC. A few months ago, expectations for a third hike were only about 33%. As of the end of October, they had increased to nearly 90%. The smaller reaction in longer rates illustrates that the market is not overly concerned that inflationary pressures will accelerate and cause the Fed to accelerate its progression to normalize rates. The market is also showing little angst about the Fed's gradual reduction in the reinvestment of its balance.

We still believe that rates should trend higher over the last few months of the year and then gradually higher next year. Our target of around 3% on the 10-year Treasury note still seems attainable in 2018, of course that is barring any significant increase in geopolitical pressures.

Even with the increase in Treasury rates across the curve, narrowing credit spreads allowed high-quality corporate bonds to outperform and deliver solidly positive returns last month while Treasury note returns were negative. For the year so far, intermediate investment-grade corporate bonds have delivered more that 2% in additional return than comparable maturity Treasury notes. This trend cannot continue forever, but given the favorable economic backdrop, we see little on the horizon to cause spreads to increase significantly.

Positives

- Markets already anticipate a December rate hike and reductions in security purchases
- Record high equity markets could cause bond purchases as investors rebalance to targets
- Aging baby boomers will likely increase allocation to bonds if rates rise
- U.S. interest rates are the highest in the world for high-quality nations

Negatives

- Economy could expand more rapidly with tax reform, infrastructure spending and disaster rebuilding
- Government deficit and borrowing needs could be higher with tax reform or cuts
- Fed could accelerate pace of tightening and purchase reductions
- Heavy corporate issuance will compete for investor funds

Unknowns

- Escalation of geopolitical tensions with North Korea and/or Russia

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