

## Investment Commentary—January 2017

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Twelve months ago the stock market was in the midst of a sharp decline. By last February's bottom the S&P 500 Index had fallen over 11% on the year and 14% from its November 2015 high. That episode reminds us of several points that would be well to keep in mind at the current juncture. One lesson is that markets have a tendency to overreact. Another is that market corrections (a decline of more than 10%) are not unusual.

Perhaps the most important lesson from last January is how difficult it is to predict markets and the events that drive them. The market plunge was triggered by a collapse in the price of oil, deteriorating economic data in the U.S., and bungled management of the Chinese economy. None of those issues proved to be especially problematic as 2016 unfolded. Meanwhile, the most consequential events--Brexit and Donald Trump's victory over Hillary Clinton in the U.S. Presidential election--were almost completely unanticipated.

All of this is to say that the next twelve months may unfold in unexpected ways that make recent stock market enthusiasm seem unwarranted. To be sure, significant elements in the President-elect's agenda warrant optimism. Corporate tax reform illustrates the potential for beneficial policy as well as the challenges in getting there. The U.S. has the highest statutory corporate tax rate in the developed world. Despite the highest tax rate, actual taxes collected (as a share of the overall economy) are significantly below average for developed economies. This is primarily the result of large multi-national corporations exploiting loopholes to shift taxable income out of the U.S. into lower-tax jurisdictions. Thoughtful corporate tax reform could dramatically lower the tax rate without sacrificing any revenue. While this would be bad news for corporate tax strategists, it would make capital allocation more efficient and benefit the economy.

The problem is that corporate tax reform is a very complicated endeavor. And, as with all major legislation, there will be winners and losers. The lobbying arms of companies whose bottom line would suffer are surely ready for battle. This complex undertaking will make its way through Congress at the same time as several other items on Trump's agenda: repealing and replacing Obamacare (every bit as complicated as corporate tax reform), launching a trillion dollar infrastructure plan, reducing personal tax rates, and unwinding Obama-era regulations in banking, energy and other sectors.

While one can debate the theoretical short-term and long-term impact of all of this on the economy and corporate earnings, the overriding point is that it is almost impossible to predict which legislative packages will make it through Congress, when and in what form. And, setting Congress aside, how will Trump administration executive actions impact the economy and markets, for good or ill? Trade continues to be the biggest wild card. The tone from the transition team has been relatively encouraging, but Trump's trade-related appointees are hard-liners<sup>1</sup> and the possibility of a trade war can't be dismissed. If the lesson of 2016 is the inherent unpredictability of events that shape markets, investors ought to be especially cautious in making bold assumptions about 2017 given the tremendous policy uncertainty inherent in a new administration that campaigned on dramatic change without putting forward detailed policy proposals.

The good news is that heading into this period of pronounced policy uncertainty, the global economy looks more solid than it has in a couple of years. U.S. economic growth, for example, decelerated for over a year due to weakness in energy-related industries and pressure on exporters from a strong dollar. The impact of oil and the dollar seems to have run its course, however, and growth is gradually picking up<sup>2</sup>. Across the Atlantic one index of European economic output<sup>3</sup> hit a 67-month high in December.

In addition to economic data looking better, measures of U.S. consumer and business confidence are rising. The NFIB Small Business Optimism Index—likely anticipating an era of looser business regulation—just reached a 12-year high. Capital expenditures have been notably weak for the last couple of years. Increased business optimism, or “animal spirits” as market pundits sometimes call it, could turn that around. Higher capex would give the economy a meaningful boost.

Acceleration in the U.S. and European economies is showing up in corporate profits which, for the companies in the S&P 500 Index, grew in the third quarter for the first time in over a year. Wall Street analysts, ever optimistic, expect earnings to grow by a robust 11% for 2017. Those numbers tend to come down as the year progresses, but visions of a double-digit rise are providing fuel for bullish investors.

While the improving global economy and stirring animal spirits are comforting, there are some reasons for concern beyond the policy uncertainty described above. Among the potential worries are rising interest rates. The bond market and the Federal Reserve are finally in sync, with both

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<sup>1</sup> It should be noted that a thoughtful reexamination of the impact of unrestrained trade is probably overdue. In spite of significant headwinds dating back to the 1970s, manufacturing employment in the U.S. was relatively steady until China's entry into the World Trade Organization in 2001. Over the next eight years, we lost over five million manufacturing jobs. How clear is it that the benefits to consumers of cheaper goods compensated for the dramatic dislocations in communities around the country that depended on those jobs? President-elect Trump deserves credit for bringing attention to the down side of free trade.

<sup>2</sup> Note, however, that with the Fed expected to raise rates three times this year, we could be in for another surge in the dollar, which could put exporters under pressure again.

<sup>3</sup> Markit's Eurozone PMI Composite Output Index.

anticipating three Fed rate increases in 2017. That much is priced into bond yields and mortgage rates. Those rates remain low enough to encourage home buying, but if a further spike occurs as the year progresses that might not be the case. Rising rates also make the dollar more attractive. Post-election, the dollar has appreciated four percent relative to a basket of other currencies. Another big leg up would hurt export industries.

Outside the U.S., tensions in Europe continue to fuel the rise of nationalist political parties eager for the breakup of the European Union. And a massive accumulation of debt in China continues without any sign that Chinese leadership knows how to control it. Collapsing debt bubbles can wreak havoc, as we learned very painfully eight years ago. Investors should take some comfort from the fact that China is a command economy and may therefore be less vulnerable to the wrenching aftereffects of a debt bubble gone bad. More importantly, while China is tightly woven into the global economy, it is less integrated in the global financial system; for example, it seems unlikely that a disorderly Chinese credit crisis would have disastrous consequences for large global banks.

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The pervasive optimism in the U.S. stock market following the election may be tested over the next several months as the GOP agenda encounters the messy reality of the legislative process. The ups and downs of the process could lead to significant volatility and provide opportunities for nimble stock selection. Speaking of nimble stock selection, the last several years have witnessed huge flows of money into "passive investing," i.e. mutual funds or exchange-traded funds (ETFs) that adhere strictly to indexes such as the S&P 500. Passive investors make no assessment of the component stocks of the indices they mirror. With fewer investors paying attention to fundamentals, the gap between share prices and value can widen. This too may provide opportunities for those of us rigorously evaluating the prospects of the companies whose shares we purchase.

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While it's almost impossible to predict the short term gyrations of the stock market, longer term performance, perhaps counterintuitively, is more predictable. The key, and slightly depressing, fact is that returns over periods of ten years or more are largely a function of valuation. When share prices are undervalued, there is a powerful tendency to correct over the next ten years, which means returns are likely to exceed historical averages. When share prices are overvalued, the reverse tends to be the case. Unfortunately, by almost all measures U.S. stocks are overvalued. Not nearly to the degree witnessed during the tech bubble, but enough to warrant some adjustment in expectations.

*January 13, 2017*  
*Boston, MA*