ECONOMIC OUTLOOK

bounty management
unique investment insight

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The Tax Cuts and Jobs Act of 2017
Another Sugar Fix for Markets

The last major attempt at tax reform under Reagan in 1986 took over two years to move from blueprint to legislation and came at a time when Democrats controlled the House and Republicans the Senate. At the time, the jobless rate was over 7% and a divided Congress forced both sides of the aisle to buy in on major points. The 2017 Tax Cut and Jobs Act moved from blueprint to the President's desk in a matter of months on party-line votes, and early signs are that accountants and lawyers will find plenty to occupy their time in coming years. Unintended consequences and creative workarounds are a bug (and feature) of complex and hastily-drawn legislation. For example, states hardest hit by the $10,000 cap on state and local taxes are already working on ways to sidestep the federal changes to protect residents and revenue streams. One way may be to allow residents to make charitable gifts to public funds in lieu of taxes, or shift from income taxes to payroll taxes, both still deductible.

On the plus side, a cut in the statutory corporate tax rate from 35% to 21% is positive assuming other countries don't lower their tax rates in response. Another positive includes expensing of equipment that should on the margin boost growth, productivity, and wages. Economists have generally agreed that the mortgage interest and state and local tax deductions are on weaker theoretical footing, as with most subsidies. Sophisticated drinkers can rejoice, as legislation includes a lower excise tax for craft beer producers. The negatives include the timing in the business cycle – adding more stimulus creates a sugar high in a tight job market at the expense of worsening deficits and debt down the road, the sun-setting of many provisions on the individual side in 2025, and lower rates on export income that likely violate World Trade Organization agreements. The use of corporations as tax shelters, and the potential for the well-to-do and well-advised to switch from being taxed as individuals at 37% to 29.6% as pass-throughs or even 21% as corporations will be substantial and costly to the Treasury.

Risks lie toward widening social divides if the bill doesn't pay for itself. Current estimates add another $1.5 trillion to the nation's debt and this likely underestimates the bill's costs. Cuts in social spending, by far the biggest and so far untouchable portions of the budget, are being discussed. Sticker shock has occurred in the past, and under far lower debt levels. Under Reagan, the top marginal tax rate fell from 50% in 1986 to 28% in 1988. By 1993, it had returned to 39.6%. Under W. Bush, the top tax rate was reduced to 35% in 2003 only to be returned to 39.6% in 2013. In both cases, the government could not afford the loss of revenue. Over the near-term, stimulus is stimulus, and markets have gone with the tide, finding solace in the belief that somehow, somewhere, there is a central bank printing money or a government spending it.

U.S. Economy

GDP grew 3.2% in the third quarter and estimates suggest a third consecutive 3% plus increase in the fourth quarter, the first time that has occurred since 2004-2005. Weak consumer price inflation in 2017 is attributable to a combination of transitory factors including cell phone plan prices, autos, and some topping in rents, but the second half of 2017 saw a return to a 2% annualized trend. A key question for 2018 will be whether official statistics show further acceleration or whether globalization and technology - the Amazon effect - continues to hold down prices, and by extension interest rates. Higher oil prices at year-end 2017, over $60/barrel, plus weak year-ago results could easily push CPI inflation into the 2.5% to 3% range by mid-year. A December hike by the Federal Reserve, the third of the year, lifted the funds rate to a range of 1.25%-1.50%. The median policymaker expects three more hikes in 2018, then two-to-three in 2019, to meet the "neutral" rate of 3%. The Fed raised their 2018 projection for growth from 2.1% in September to 2.5% in December in part due to the tax cuts, but left the long-term growth projection unchanged at 1.8%.

Employment and Wages

The U.S. economy added over 2 million jobs in 2017. December posted a gain of 148,000 new jobs, a bit below expectations, but still 187 straight months of gains and the longest streak on record. The only soft spot was a lack of upward pressure on wages which were stable around 2.5% y/y according to the Department of Labor. For a job market that is supposed to be moving toward trend employment growth below 100,000, results continue to suggest employers are finding workers, despite an apparent shortage of highly-skilled prospects. A "quits" rate at 2.2% in November matches the mid-2000s expansion peak and is a sign that workers see better opportunities or higher wages elsewhere. Moderately rising wage growth is a plus for corporate profits, and unit labor costs have actually fallen in y/y terms in three of the last four quarters.

Real Estate

The NAHB housing market index was exceedingly strong in December, rising to a fresh post-recession high, while existing single-family home sales breached five million annualized in November, the highest since 2007. Tight supply continues to be a feature of the market, at 3.5 months of inventory in November, the lowest on record, aiding accelerating price gains in 2017 (6.4% y/y in October on the Case-Shiller index). Homeowners will be able to deduct interest payments on $750,000 of debt on new primary residences, down from $1 million previously. The impact of that change on the market may be a bit overstated, but add in state and local taxes, depending on the locale, and higher-end buyers will need to run the numbers a second time.

Consumer and Manufacturing

Consumer sentiment compares well to prior expansions, but diverges by party lines. The Bloomberg Consumer Comfort index shows Republicans seeing blue skies while confidence among Democrats is now the lowest since 2014. Independents' confidence is tracking the steadier improvement in the jobless rate. What people say and what they do can be different, and there has been some moderation in spending excluding food and energy in 2017, to 4.1% y/y in November after near 5% in 2016, and above 5% in 2015. Pockets of distress appear contained to subprime auto and some credit card debt, with student loans still a significant overhang. Student loan debt rose 6.3% y/y to $1.49 trillion, doubling since 2009. The December ISM Manufacturing Survey ended the year on a strong note, rising 1.5 points to 59.7, led by new orders. The Non-Manufacturing Survey in December showed business is still expanding with a reading of 55.9, but at a slower pace, as is seasonally expected after a strong fall.

World Economy

Europe

GDP growth in the Eurozone exceeded that of the U.S. for a seventh consecutive quarter through Q3, posting 2.6% y/y. German real GDP growth remained solid at 2.8% y/y, Spain 3.1%, France 2.3%, Italy 1.7% and Greece 1.3%. The German rebound was paced by strong exports and capex, adding fuel to the upswing in the region. The variability in growth rates among EU members is the lowest it has ever been – quite a difference from a few years ago. Soft data including the Eurozone composite and services PMIs stood at 80 month highs in December. Eastern Europe is faring even better with Poland and the Czech Republic growing rapidly. Even with good growth, the European Central Bank (ECB) only tiptoed toward an end to bond-buying, reducing the purchase pace by half to €30B for the nine months through September 2018. Stubbornly low inflation persists in the Eurozone even though the unemployment rate has come down a full percentage point in the past year to 8.7% with Germany at 3.6%. Spain's jobless rate is still over 16% and Italy's over 11%. Italy has a debt to GDP ratio of 132% and banks are saddled with nonperforming loans.

Japan

Growth continued to improve in the third quarter, accelerating to 2.1% y/y helped by capital expenditures and net exports. The Bank of Japan remains on autopilot to control the yield curve and pushed back against commentary that continued stimulus may be harming bank lending with low and negative rates. Inflation continues to severely undershoot the 2% target, just 0.3% y/y ex-food-and-energy in November. Geopolitical risks in the region are a lingering reason to remain cautious, but large exporters are feeling as good as they have since 2004 according to the BOJ's Tankan Survey. PM Abe's LDP party swept to a two-thirds majority in the October snap election, consolidating support for a fifth year of Abenomics and bolstering support for a rethink of the nation's pacifist constitution.

China

Chinese authorities are responding to risks and opportunities to their growth model. The central government consolidated power under Xi Jinping as the Communist Party declared him the leader indefinitely and lifted him to a revered status alongside Mao Zedong and Deng Xiaoping. Maintaining healthy official growth rates is still a priority, but targets are deemphasized in favor of a crackdown on frothier elements of leverage across local governments and the property sector. Efforts to rein in more visible pollution sources and eradicating poverty are also goals. While trade friction with U.S. is a concern, the upside for China is that trade-wary U.S. policy only speeds up China's "One Belt, One Road" infrastructure initiative across Eurasia. The International Monetary Fund (IMF) nudged up its forecast for world growth this year to 3.5%, the fastest rate in five years.

Gold/Oil

Gold gained 13% in 2017, the best return since 2010. Considering the strong equity markets during the year, these gains are impressive. Gold's value remains a testament to the intrinsic value of the safe haven asset. The dollar fell over 9% in 2017, a result of accelerating growth overseas. Dollar weakness provided support for gold as will more deficit spending and geopolitical instability. The oil markets took time to rebalance and remained oversupplied through the first half of 2017, but prices eventually clawed their way back as oil production in the U.S., OPEC, and Russia ebbed while geopolitical risks intensified and supply disruptions rose. With economies around the world firing on all cylinders and growing simultaneously, oil demand came in ahead of expectations. Brent, the global oil benchmark, closed above $67, up 17% for the year, and U.S. WTI closed at $60, rising over 12% for the year.

Investment Perspective

After some difficult years, particularly overseas, the global economy is strengthening in sync for the first time in over a decade. U.S. economic growth picked up last year and should continue into 2018 with the additional stimulus of tax cuts providing a boost to investment and consumer spending. Low unemployment, high profit margins, robust manufacturing and construction data, and strong new orders are indications of a growing economy. In such an environment, job growth will remain solid and the unemployment rate will likely reach rates last seen in the 1960s. Consumer confidence data was strong last year with the highest monthly average since 2000 with only the long expansions of the 1960's and 1990's significantly higher.

As usual, there is a long list of risks including geopolitical issues (e.g., NAFTA, N Korea, Mideast, etc.), increasing federal and state deficits, aging demographics, low productivity, increasing wages, and inflation. Wage growth so far has been relatively subdued at about 2.5%. If we start to see wage pressures and inflation, the Fed will likely step up the pace of rate hikes in 2018. This affects both the bond market (higher rates, lower bond prices) and the equity market as profit margins are squeezed with higher costs. For fixed income, yields on longer-term Treasury bonds have remained stubbornly low with the ten year Treasury fluctuating between 2.2% and 2.5% in the past year. Lower yields drive investors toward riskier assets and bring down the cost of borrowing, but also indicate modest economic growth in the future.

For equities, we are beginning to sense that some investors have a “fear of missing out” as stock prices set records. We hear and read stories of investor “euphoria” as valuations for equities continue to rise above historical ranges. On the other hand, there is concern of over-valuation, higher interest rates, an aging bull market and geopolitical turmoil. In the background is an expanding economy that is still supported by various forms of global stimulus. Even though the Fed is beginning to wind down their balance sheet - by a miniscule amount - we have to remind ourselves that tax cuts and perhaps infrastructure spending are also deficit financed stimulus. Central bank support to avoid catastrophe both in the U.S. and globally in 2008 has become institutionalized policy over time. Now it is difficult to raise rates too quickly since this will raise the cost of the Treasury’s debt, but without raising rates the Fed has no ammunition to help in the next downturn.

With healthy consumer and higher corporate spending, fourth quarter estimates for the S&P 500 project growth of 11% in earnings. In equities, we favor industrials, energy, technology, materials, and financials. Healthcare remains a core long-term trend, but there is considerable uncertainty due to the repeal of the individual mandate as part of the tax cut legislation. Dividends remain an important part of total return. Although we are still positive on the equity markets, investors need to balance their overall investments with shorter-term, high quality fixed income, cash, and precious metals. The tax cuts enacted by Congress will likely boost growth for the next year or two, but are unlikely to effect the long-term growth rate of the economy. We may make adjustments in the overall asset allocation mix over time, but finding value and maintaining a strict discipline are the keys to positive long-term investment results. We will as always remain vigilant.

December 31, 2017
DJIA: 24,719.22
S&P 500: 2,673.61

About Bounty Management
Bounty is an investment firm based in Boston that provides personalized, professional management of investment portfolios. Since 1971, we have successfully managed investment, trust and retirement portfolios for clients including individuals, families, non-profits, and endowments. Our primary goals are to preserve purchasing power and to produce long-term appreciation of capital.

If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at http://www.bountymanagement.com.