April 17, 2017

1st Quarter Market Letter

Dear Clients,

During the first 90 days of 2017 the S&P 500 Index posted a handsome gain of 6.1%; the NASDAQ increased 9.8% and the Dow Jones average 4.6%; these were new records for the market. Bond prices also edged higher: the ten-year Treasury now yields only 2.23%. The markets' continuing rise is largely based on a brightening economic outlook, subdued inflation (about 2%, the Fed's stated goal), an increase of single-family housing starts (+10%), (the third straight year of such gains), increased oil and gas development, and modest government spending growth. But the biggest stimulus for the economy was consumer spending, which accounts for 69% of U.S. gross domestic product. Consumer spending has been a consistent stimulus for growth recently.

And, then there are the promises, perhaps expectations, of Donald Trump's economic stimulus program. Of particular importance is his plan to spend approximately $1 trillion in infrastructure spending. This is certainly needed to bring our bridges, roads and airports to modern and safe conditions. The question is whether Congress is willing to increase the deficit by the enormous expense of effecting the required repairs and replacement.

Employment too picked up in the first quarter: the unemployment rate is now 4.6%. I consider this almost an irreducible minimum, because at all times there are individuals changing jobs, the temporarily unemployed, seasonal workers, and to an increasing extent, individuals whose jobs are being displaced by robots and other types of automated machinery.

The President's proposed tax cuts for individuals and corporations would also stimulate the economy, if enacted. In the case of corporations, reducing their income tax will have the effect of increasing their earnings per share, which would make their stocks less expensive on a price-earnings basis. And individual income tax cuts would allow for additional spending by consumers, still the mainstay of the economy.

Finally, there are some proposals from the President which would have a less significant effect on the economy such as the surtax on imported goods from countries which have a favorable balance of trade with the United States. The building of the wall across the Mexican border, if and when approved, would at least temporarily increase employment in certain skilled trades, which happen already to be in short supply; whether that wall will be built is an open question.

We cannot know at this juncture whether these grandiose proposals will materialize during the next four years, and how substantial an effect they would have on the economy. The recent defeat of the President's and Congress' plan to repeal and supersede the Affordable Care Act raises the question of whether, and to what extent, the foregoing would actually make it into law and be funded by the federal and state governments.

There are also some substantial obstacles that could limit the economy's growth this year, which include the strengthening U.S. dollar. It is already up 3% since the November election and is likely to rise further this year. If so, that would make U.S. exports less competitive and would widen the trade deficit.

Another risk is that of a trade war if President Trump were to make good on his threat to brand China a currency manipulator. If so, this could cause Beijing to retaliate by buying less U.S. goods, and possibly imposing punitive tariffs on goods manufactured in the United States and sold in China, such as computers, automobiles and airplanes. I doubt that this threat will be carried out: it is counter-productive, and since his recent meeting with the President of China, not likely to be invoked.

Another negative factor are the increasing interest rates. The Federal Reserve raised rates from 0.75% to 1% at its March 15th policy meeting. It commented on the continuing improvement in the labor market and the "somewhat firmer" activity in terms of business investment. It also restated its goal of 2% longer-range inflation that has now been achieved. The Committee also signaled that there would probably be two more rate increases during 2017, but the market expects that those would only be .25% each, bringing Fed funds to 1.5% by the end of 2017.

We do not expect inflation to pick up substantially this year or next. In its announcement commenting on the improvement in the U.S. economy, the Fed remained cautious not to over-emphasize this development because most of the increase in prices came from a reversal in cost of energy. However, energy companies are spending more on development, in the hope and anticipation of increasing energy prices, which are needed to justify the current level of investment.

The Markets

The bull market which we have enjoyed now has lasted 8 years, the second longest in U.S. history. During that period the Standard and Poor's 500 Index almost quadrupled. Most of this was justified by increasing earnings, but 30% of the gain was attributable to a significant increase in price-earnings ratios. I do not expect that to continue. Probably stocks are going to appreciate, but most or all of the gain is going to be attributable to increased corporate earnings (or a decrease in the corporate income tax), and not likely by a further increase in price-earnings ratios. So it would not be unusual to see a normal market correction in the months ahead, especially if the Trump economic agenda is slow to develop.

There are substantial headwinds which will tend to moderate the growth in the market. For example, automobile sales and home sales have slowed; the trade deficit is still very high, even though U.S. exports are on the rise; but imports are growing even faster. This will have the effect of lowering gross domestic product by about a half of a percentage point.

Another factor affecting the economy is the aging of the American population. Individuals spend the most between ages 45 – 54 (approximately $70,000 per household); but, by the time they reach age 75 annual spending declines to about $38,000 per household.

Other legislation proposed by President Trump may not be enacted into law in the near future. Specifically, meaningful tax cuts are probably not in the cards, except possibly for corporations. It is true that our businesses are taxed at a higher rate than other modern countries. But the government is operating at an annual deficit already, so cutting both federal corporate and individual income tax rates would add further to the deficit. Democrats are on record as opposing such a program, and the conservative wing of the Republican party (the "deficit hawks") have agreed. So I do not foresee a significant cut in the federal income tax rate for individuals. Perhaps there may be a reduction in personal deductible expenses, such as state income taxes, medical expenses, interest and the like. But each of these deductions has its own set of lobbyists in Washington, devoted to perpetuating those deductions. For example, repealing the deduction for interest on home mortgages would be objected to by the housing industry, banks, financial planners, home builders, mortgage companies and individual investors. Similar trade groups exist for every other deduction in the Code. Imagine trying to eliminate the deduction for charitable contributions: the number of tax-exempt organizations objecting thereto: hospitals, colleges, churches and synagogues, the SPCA, Red Cross, community foundations, etc. so I think these provisions are here to stay for the long run.

President Trump's stated proposal to repeal the estate tax and gift tax is likely to face substantial opposition. Since the exemption for a married couple from estate and gift taxes is now $10.5 million, more than 99% of the people in the United States would not be benefited by the elimination of this tax; all of the benefit would go to less than 1% of the wealthiest Americans. The repeal of the tax would make it possible for millionaires to pass on all of their wealth without diminution to their decedents, while leaving to charity only those amounts which are "true gifts", since there would be no tax advantage to such gifts.

The one aspect of the Trump agenda which I believe will be *enacted* is a modification of the numerous regulations relating to business practices which were promulgated by the preceding Administrations. For example, the Republican Congress is likely to unwind the Dodd-Frank Financial Reform Law, such as granting banks relief from annual stress tests that determine whether they can survive financial meltdowns along the lines of the banking crisis of 2008-2009. There might also be a repeal of the provision in the Federal Deposit Insurance Corp. legislation which gave the FDIC the power to review banks' so-called living wills, which outline steps they must take if they collapse. The Consumer Financial Protection Agency will probably be more limited in its enforcement powers. For example, Congress could remove its recent ban on financial products that are deemed abusive. Perhaps the most valuable part of Dodd-Frank is the provision that legitimizes corporate bail-outs when they are "too big to fail". President Trump has made it clear that he opposes *any* government bail-out of any sort.

With respect to a fixed income investments, see my comments above about the actions of the Federal Reserve Board. Fixed income investments will continue to decline somewhat as interest rates go up. But I do not expect that increase in interest rates to be dramatic, or the price decline to be alarming. Our income-dependent clients will still be receiving the same amount of income as they have from the time these securities were purchased, even though the principal may decline somewhat. In effect, they are "being paid" generously in the meantime, which more than offsets any minor decline in the price of the security. So we still like higher-yielding preferred stocks, especially whose dividends are "qualified", i.e., partially tax-free.