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Market Review & Update

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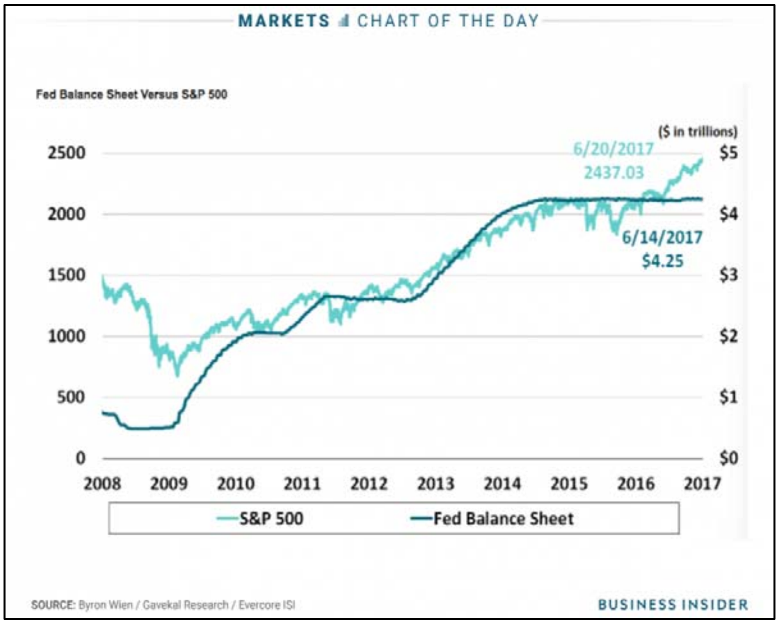
As we may have previously noted, in 2017 the markets have gone about their business by largely ignoring the business of Washington. And while we may now be on the threshold of change, let's first look at what's been occurring. All major indices are trading at record highs and foreign markets have exhibited stronger relative growth, albeit from a much lower trough. What've been the primary drivers? Earnings have been the key manifestation of several trends. In Q1 we saw an approximate 15% jump in earnings. Q2 resulted in a 10% gain. It is widely anticipated that we will see 7-8% in Q3 and 2018 will likely trend toward a mid single-digit increase. Multinationals got an extra boost from the rise in profits in the Eurozone. Stronger commodity prices helped many regions as China reinvigorated a desire to add infrastructure and re-inflate.

The underlying forces that have aided this growth remain a very supportive central banking system, led by our Fed, that has kept interest rates low and the environment where they see little inflation to combat, allowing for that accommodative policy to continue . The Fed's overt passivity has allowed the dollar to recede relative to other major currencies, which gives further translation boost to the profits that multinationals book overseas. One notable change in the Fed's stance is to begin a reduction in its $4 trillion-plus balance sheet. Composed of bonds, the initial step would be to simply let maturities reduce holdings. That should ease market concerns over what large scale sales of their portfolio might do to the yield curve.



Heightened fundamentals have allowed for heightened markets. This has given rise to the coincidental opinions that the markets are overvalued. But is this true? Let's look. Let's use the oft cited long term average for the market's P/E of about 15 times. We now trade at approximately 17 times the anticipated earnings for the next 12 months, so yes, a bit above average. Is that expensive? Let's abandon myopia for a moment and consider the other factors that give rise to a market's valuation. The long term P/E of the market is 15. The long term average for the 10 year Treasury is closer to 6% and the long term inflation number is around 3%. Today, the 10 year Treasury trades closer to 2% and inflation has yet to bang its head on the 2% ceiling. Are these latter two numbers significant? Yes. Given a level of inflation, you discount future growth by that number simply because money, and hence earnings, which are valued by that money, will be worth less. The lower the rate of inflation, the lower that discount. Lower inflation should mean that a future earnings stream is worth more in that future. That 10 year Treasury rate that is trading at about 1/3 its long term average is also significant. Among many factors, it is also the borrowing cost yardstick for producing that stream of future earnings. The lower that borrowing cost, the more earnings that can be produced per dollar. So, looking at P/E ratios should not be done in a bubble, but in the anticipated environment. An oft cited valuation tool, the rule of 20 helps to adjust for these factors. On a forward looking basis, the P/E ratio seems to conclude that equities remain attractive, which should not be a surprise given the still present level of skepticism about where we are headed. That skepticism should make us remember what the investing legend Sir John Templeton once said "Bull markets are born on pessimism, mature on optimism and die on euphoria." If you note that higher levels of optimism result in an investor's willingness to pay more for a future dollar's worth of earnings, this makes perfect sense. And we only need to look back to the year 2000 to recall where euphoria takes a market's P/E. In that year we breached 40 times earnings in an environment of about 3% inflation and a 6.6% Treasury yield.

And speaking of pessimism, let's bring Washington back into the conversation… While the markets have done their best to ignore it, some initiatives may change that. The dark horse is a somewhat clandestine effort to push another version of healthcare through, we'll see where that goes. More significantly, the work on a new tax bill continues with vigor. It will likely contain a corporate tax rate of around 20%. It will also include a streamlining of historical bells and whistles and an effort to stimulate repatriation of foreign earnings. The tax proposals carry more bi-partisan agreement and could be viewed as more likely to happen. A big surprise in all of this has been Treasury Secretary Mnuchin's recent comments that he would support a retroactive effective date of 1/1/2017. That would be a positive element not factored into estimates and would likely be an additional element adding to the anticipated increase in aggregate demand that any significant improvement in the tax structure would provide. We will see.

Business tax changes (proposed):

- A 20% corporate tax rate.
- A 25% rate for pass-through business services.
- Elimination of some business deductions, industry-specific incentives, and more.
- A one-time repatriation tax.

One last item. We have talked about the concerns that tech giants have about the various levels of impact that artificial intelligence will have on our future, which includes the end of it. On a practical note, one of the more foreseeable functions is clearly autonomous driving. In the US there are currently just shy of 4 million people now employed as some version of commercial driver.

Enjoy a beautiful Fall!

We'll talk to you soon…