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Market Review & Update

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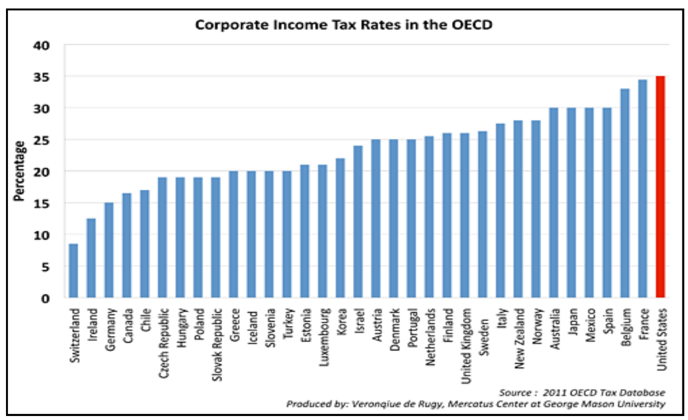
"And now for something completely different"…

And no, we will probably not be discussing what you may think John Cleese's Monty Python quote is pointing toward. Instead, we will take a closer look at the following. We have spent about 8 years heading inexorably down a series of singular, unyielding paths. And this has manifested in nearly 8 years of legislative gridlock, with the major achievement being the Affordable Care Act and unilateral layers of complex regulation. We have likewise experienced nearly 8 years of monetary stimulus, while the Fed awaited assistance of the fiscal variety. And, when you couple slower economic growth with increased benefit expenditures the results can be constricting to say the least. Let's take a closer peek at these and see what 2017 and beyond may bring us. What is completely different is that a single party is now in control of the House, Senate and the White House. In theory, that should end gridlock for the most part. Here's what we may see.

LEGISLATIVE-the beginning of the end of gridlock

As we mentioned, and voters seemed to react to, legislative gridlock has worn out its welcome in the US. It has resulted in the highest corporate tax rate as well as the world's only tax on profits earned overseas, which have both resulted in the trend toward corporate inversions and the huge piles of corporate cash abroad, now estimated at more than $3 trillion dollars. Additionally, as we noted, gridlock left the Fed alone to fight slowing economic growth. In a real world, the Fed brings in monetary stimulus quickly to provide interim economic stimulus while the legislative branch forms its fiscal stimulus. The latter never materialized as the branches of government couldn't agree upon whether corporations were our friends or our enemies. The Economist wrote a lengthy piece earlier in '16 pointing out that central bankers around the world have proved that all their monetary might could sustain a GDP growth rate in the 2% range, but if you want more, a combination of fiscal stimulus in the forms of lower corporate taxes and limited punishment on foreign repatriated profits were required. http://www.economist.com/news/leaders/21693204-central-bankers-are-running-down-their-arsenal-other-options-exist-stimulate



Cisco provided us with the Reader's Digest version of the problem and the solution: "We have $4 billion in our checking account in India. If you tax us at 30-40% to bring the money home, we will build the factory in India. If we can bring the money home with little or no tax, we will raise our dividend, buy back stock, consider several acquisitions and probably do some hiring." This all sounds so simply obvious, it is a shame it never occurred, till now…

We will most likely see something very similar to the version of a tax plan that Paul Ryan had constructed in a bi-partisan effort over the past few years. A lowering of corporate taxes to some number near 20%, and a small repatriation tax that would help support a focus on infrastructure build that we heard much of over the past year. The latter has significant bi-partisan support. But, single party control probably means that much can happen without it. Perhaps more immediately, we will see a roll-back of the massive amount of regulations that have acted like a weight on businesses small and large. Like athletes, these companies are in a global race, often against companies that have much lower tax rates and little to no regulatory burdens. Corporate boards have a fiduciary obligation to make the most productive decisions for their shareholders. These efforts will help them elect to do more at home. This is fiscal stimulus.

THE FED-The long overdue handoff from monetary to fiscal stimulus

The Fed has announced that it will begin to withdraw its monetary stimulus throughout 2017 and the year or two thereafter, "data dependent"… This means that for the foreseeable future we should not expect renewed quantitative easing efforts and that interest rates will be slowly raised, perhaps as many as three times during this calendar year. Two main reasons have brought this about. First, data has been mixed, but improving just enough to end what has been a period of emergency relief in the US that has been even more sustained abroad. And, second, the Republican sweep has increased the Fed's confidence that more forms of fiscal stimulus will be forthcoming. As we have said before, periods when the Fed begins its rate increases have been broadly positive for the equity markets, if for no other reason than that they are normally coincident with improving economic fundamentals. The Fed's overseas counterpart in the Euro Zone is also beginning to see signs of improvement there. Deep into a QE program supporting a negative interest rate policy we have discussed prior, Mario Draghi has hinted that he will begin to wind down the massive monthly buying of Euro debt. It will take them longer to heal, but they do seem on a similar, though slower, path. Obviously, this will have its primary impact on currency relationships which do have a direct impact on foreign profitability, so we, and no doubt the Fed, will keep an eye on exchange rates to gauge their forward impact.

THE CONSUMER-more cash, better attitude

Ok, so we know the basic benefits companies will receive under the kind of tax plans floated by the now controlling party over the past few years. But what changes will manifest for households and consumers? Estimates show that an approximate 8% positive change in cash-flow will be available to the average human in the US. As we have often stated, consumer behavior isn't simply dictated by available cash or credit. Confidence, or the lack thereof, plays the pivotal role in spending decisions that can ultimately translate into greater velocity of money which then manifests into improved GDP. Since '09 we have witnessed a recovery that had a below average level of consumer confidence, but since the election that has begun to shift to the positive. It should not be unreasonable to extrapolate that an environment with more visible monetary stimulus, infrastructure buildout, rising equity markets and tangible improvements in after tax income will result in improving levels of cash to spend and a more enthused consumer willing to spend it.

THE MARKETS

Bonds are the simple part. The Fed and stronger economic activity take rates higher. Bonds do not like rising rates. Risk assets, like stocks and commodities don't mind this at all. Lower corporate taxes will make more revenues translate into higher earnings. Those companies with the ability to repatriate cash from abroad will bring money home. Stock buybacks, increasing M&A activity, increased dividends, as well as the potential for increased hiring are anticipated. This is much of what the last few months of market increases have been the result, thereof… Currencies will continue to matter, and strength in the US will support a strong relative dollar. That could likely keep advances sober, yet advances nonetheless. The Dow has been flirting with 20,000, a near 14,000 point trek, built on a foundation of monetary stimuli and corporate earnings growth. The recent beginnings of more pro-growth fiscal stimulus efforts are catching the market's attention for good reasons. We look forward to watching the progress into '17 & '18. Our best wishes for a healthy and happy new year!

We'll talk to you soon…