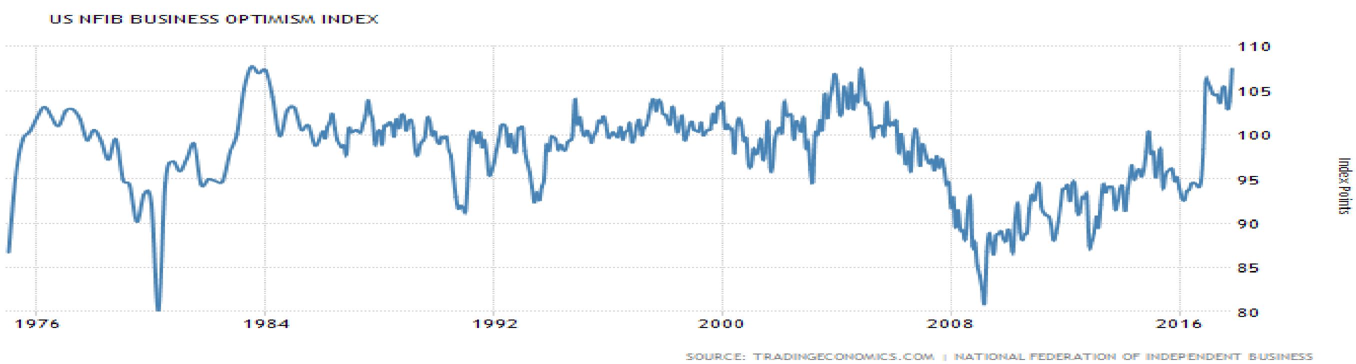
THE *LONG RUN*

Reynders, McVeigh Capital Management, January 2018

Happy days are here again!
The skies above are clear again,
Let us sing a song of cheer again,
Happy days are here again!
--Milton Alger

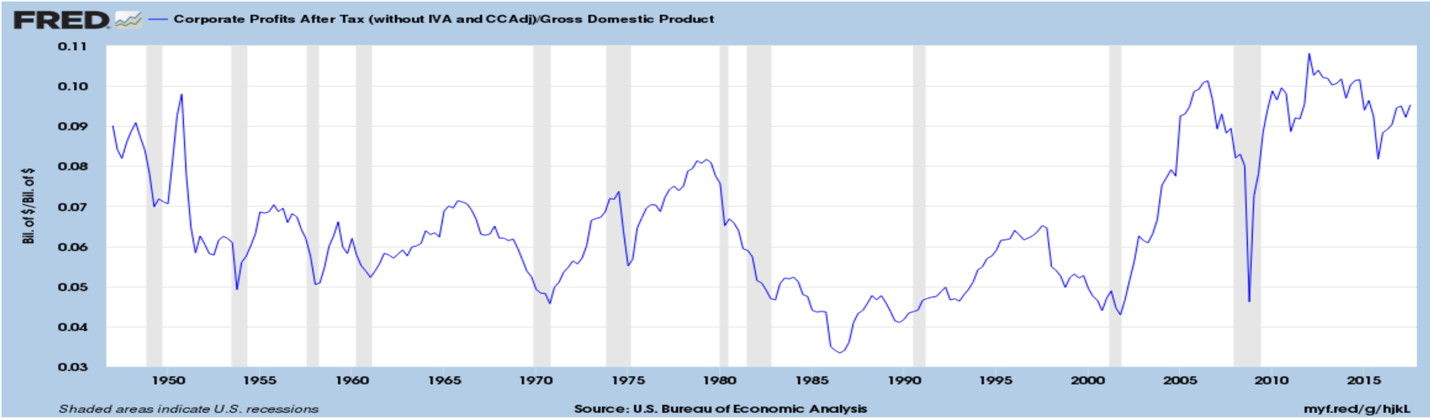
Spurred by a slowly accelerating economy and pro-business policies that have pushed deregulation and a major corporate tax break, blue skies led to very green stock prices in 2017. Potential clouds of rising interest rates, nuclear weapons in North Korea, and higher oil prices were blown away by investors shifting their outlook from one of denial to acceptance. The S&P 500 index advanced by 19% and provided positive returns during every month of the year. This was the first time this has happened since 1970.

How clear is the outlook now? A recent survey from the University of Michigan found that consumers saw a nearly 65% chance that the stock market would be higher in the next twelve months. This was the highest level on record. Additionally, the Small Business Optimism Index hit its highest point in 34 years (and its second highest level in the 44 years since it was started.) About two-thirds of investment newsletter writers are bullish on stocks, nearly a three-decade high. TD Ameritrade reports that its index measuring investors' exposure to the stock market just had its biggest single-month jump ever and sits at a record level.



While the economy continues to look like it will grow faster next year than it did in 2017—a definite plus for stock prices—we do note that rising optimism is characteristic of the later stages of a bull market. Indeed, *Happy Days Are Here Again* was written just months prior to the stock market crash of 1929.

Though we aren't predicting a stock market crash, we are worried that stocks are anticipating an awful lot of good news around the impact of the U.S. corporate tax cut. It is fairly clear that cutting corporate taxes is a bullish event for stock prices. Estimates are that it will lead to an immediate 10% increase in corporate profits. Profit margins, which are already well above historical averages, should move to record levels. In addition, lower taxes on repatriated cash will likely lead to stock buybacks and a higher level of acquisitions, two positive forces for equity prices. It is our belief, though, that much of the market's advance this year was in anticipation of this event and that it is likely already reflected in stock prices.



The real question is whether or not corporate tax cuts will lead to some greater second-order effect on the economy beyond just a one-time, initial impact of higher profit margins and stock buybacks. Will companies share the wealth through higher pay for employees and by reinvesting in their business in order to grow faster? While Southwest Airlines, for example, has announced it will buy 40 new planes and pay all workers $1,000 bonuses due to the tax cut, so far we have seen relatively few others make any announcements that would support an acceleration in economic growth. Without such a growth surge, the country will be left with declining tax revenues and a mounting deficit. Most economists remain highly skeptical that the tax cut will lead to positive results.

While we share much of this skepticism, we also like that it exists. If everyone were convinced that the current tax reform effort would lead to higher growth, the skies would be a little too clear and optimism much too high. A one-time lowering of taxes on overseas cash should logically lead to one-time reactions such as buying back stock. This was certainly the case when it was last tried in 2004. But in theory, a long-term lowering of tax rates from 35% to 21% could lead to more capital investments and faster economic growth. Given the current levels of building optimism, we would need to see this second-order economic impact of the tax cuts beginning to occur early in the year for markets to move higher in 2018.

Can the unexpected happen? It has been a year of many surprises. Saudi Arabia took a sudden turn towards modernization. North Korea has started talking to South Korea. Philip Morris International has set a goal to stop selling cigarettes in the U.K. Danish Oil and Natural Gas (previously known as Dong Energy and now called Orsted Energy) divested all its fossil fuels and became a wind company. Carbon emissions from energy sources fell in the U.S.; in the U.K., they fell to their lowest level since 1894. The U.S. economy is set to grow at a 3% rate for three consecutive quarters for the first time since 2005.

Though we are edging towards more conservatism by rebalancing equity allocations to stay in line with each client's long-term targets and by trimming expensive stocks and adding to more reasonably priced growth opportunities, we are keeping our eyes focused on evidence that the economy could in fact surprise with higher growth. Despite an unemployment rate that has fallen to 4.1%, there is still tremendous slack in the economy and a need for higher and more shared growth. According to the Federal Reserve, 49% of part-time workers would prefer to work more hours and 47% of respondents said they don't have $400 to pay for an emergency. This is the good and the bad news. If expected growth comes, we have a ready work force to support it and the potential to empower a broader consumer base to reinforce it. If, however, the tax cuts do not lead to the kind of investments that drive longer term economic growth, too many U.S. consumers are too close to the edge to help drive the kind of economic awakening that the equity markets are expecting.

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