—New Albany—
Investment Management

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**Markets Remain Resilient;**
**Earnings & Tax Reform Provide Tailwind**
**(by Barbara Huff)**

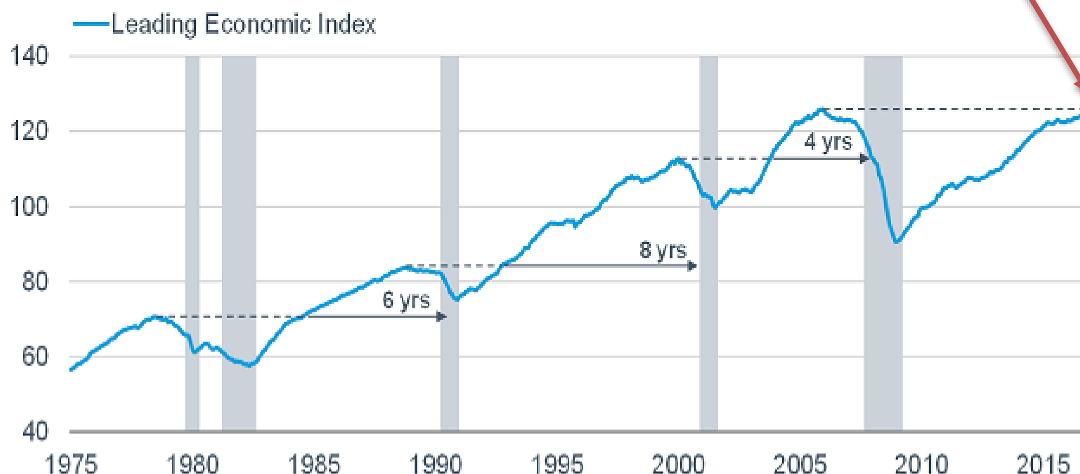
**Summary:**

- Markets are resilient in face of geopolitical tensions
- French election results take Europe's political risk off the table
- 1st Qtr. economic data weak, but leading indicators strong
- Corporate earnings and fundamentals remain quite healthy
- Potential Tax Reform is a big tailwind for equity markets

Since early March the market has traded sideways as it grappled with unsettled geopolitical tensions and weak US economic data. On several occasions, the bears tried to take a stand, but could only push the market down a mere 3% from its all –time highs. Now with the French election results confirming the status quo, fears over a breakup of the EU have dissolved and the market is turning its focus back to economic growth, earnings, and tax reform. The summary below takes a look at these the key market drivers.

**1st Qtr Data Weak, but not a surprise:**

- 1st Qtr GDP is estimated to be 0.7% which is anemic and appears to fly in the face of the Fed raising rates. The Bond market was also expecting stronger growth and had pushed 10yr Treasury rates up to 50bpts to 2.6% before quickly retreating. Though growth looks weak, it is not particularly surprising. According to Liz Sonders at Charles Schwab, 'weak first quarters have become a consistent pattern. Over the past 10 years, <u>the average for all first quarters has been exactly zero real growth; while the average for the other three quarters has been 1.8%.'</u> It is important to remember the market is always forward looking, and so prospects of future growth are what matter.
- **Healthy growth ahead**: The good news is that the Leading Economic Index (LEI) which is a composite measure of 10 leading economic indicators, is rising and just exceeded its 2006 high. This is a good indication that growth is likely to accelerate.

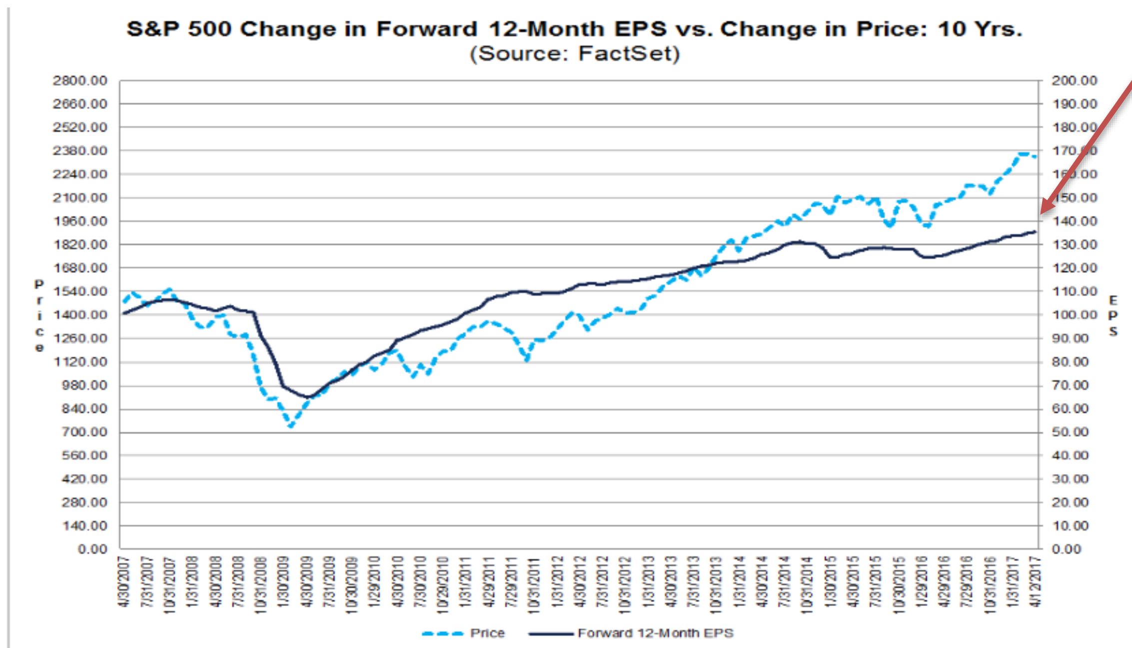



Source: Charles Schwab

**Corporate Earnings/Valuation:**

- 1st Qtr Earnings looking good; Broadening Global Growth: Though still early, blended earnings of the S&P 500 are expected to rise 9.2% and would mark the highest year-over-year earnings growth since 2011. One of the main drivers of improvement is coming from companies with more global exposure to economies in Europe and China where growth is improving. This is a big deal because now the global growth base is broadening, not so dependent on the US, and is a sign of health and stability.
- Valuation is stretched: Forward 12-month P/E ratio now stands at 17 which is above the 5yr & 10yr average of 15 & 14 respectively. But as long as both economic and earnings growth continues, investors will likely support higher prices.

The chart below shows the change in forward EPS (black line) verse the change in price of the S&P 500. Notice how recently EPS has broken above its 2014 highs, and has provided justification for higher prices.




(Source: Fact Set)

**Proposed Tax Reform: "The biggest tax cut in US history "**

The proposed tax reform could potentially have a huge impact across the economy, both on individual and corporate spending and savings patterns. According to the press release, Treasury Secretary Steven Mnuchin said 'the bill would be paid for through economic growth. This uses a formula called dynamic scoring, which uses assumptions that gross domestic product will grow because of increased spending to make up revenue that is cut in the tax bill.' The Treasury secretary said he expected sustained annual GDP growth of 3%. To put this in perspective, under President Bush, GDP average 2.1% from 2001-2008; under President Obama's 8yr term, GDP was only 1.5%. Critics are skeptical because the Trump plan contains broad outlines rather than firm legislative text. Never the less, the proposal has the market expectant of better things to come.

In particular, two items that could significantly impact earnings are the reduction in the corporate tax rate and the tax on repatriated foreign earnings. The latter is a huge deal, as there is estimated $2.6 trillion dollars of earnings held outside the US (that has already been taxed in by Foreign countries) and would be taxed again under the current law, if brought back to the US. The US is the only country in the world that double taxes corporate earnings. Thus, many companies opt to keep their earnings off shore, and invest the money in foreign markets.

Here are the key points of the plan: (Green denotes positive impact to earnings)

- **Corporate tax rate of 15%:** Such a rate would deliver on Trump's campaign promise; the current federal statutory rate is 35%.
- **Allows pass-through rate for business owners:** Instead of self-owned businesses being taxed at the personal income rate, business owners would have incomes from operations taxed at the 15% rate. So if you own your own business, income from that business would be taxed at the corporate rate. According to The Times, that could apply to the Trump Organization.
- **No border-adjustment tax:** The tax on imports was favored by House GOP leaders such as Speaker Paul Ryan and Kevin Brady, the chair of the Ways and Means Committee. Mnuchin said the White House talked to Ryan and Brady but thought the tax did not "work in its current form."
- **A slight adjustment to individual tax rates:** White House officials said there will be three tax brackets with rates of 35%, 25%, and 10%, down from the current 7 brackets and the code would be "simplified." Cohn told reporters that he did not have the exact incomes associated with the brackets.
- **Double the standard individual tax deduction:** This would allow individual filers to deduct their first $12,700 in income from their taxes and $25,400 for joint filers, as opposed to the current $6,350 for individuals and $12,700 for joint filers.
- **A one-time repatriation tax:** This would allow companies to bring back money from overseas to the US with a slightly lower, one-time tax. The White House did not clarify the rate at which this money would be taxed. President George Bush enacted a repatriation tax at a 5.25% rate in 2004, but studies show the money brought back mostly went to stock buybacks and dividends rather than hiring workers.
- **Eliminate the estate tax:** This would eliminate a tax on assets being transferred via a will after someone dies.
- **A change in tax exemptions for the middle class:** According to The Times, the plan will propose an increase in the standard deduction for individuals.
- **Eliminate itemized tax deductions other than charitable donations and mortgage payments:** Mnuchin said this provision would close "loopholes" and offset the decrease in base tax rate for high income Americans.
- **Repeal 3.8% tax on net investment income:** The tax was levied on "individuals, estates and trusts" with higher than a certain threshold in investment income. For instance, the threshold for an individual was $200,000 in investment income last year.
- **Repeal the alternative minimum tax:** This requires some people that have large amounts of deductions to calculate their income tax under the normal tax rate and the alternative and pay the higher amount. According to the Tax Policy Center, this was originally designed to eliminate large deductions by wealthier individuals, but not applies to roughly 5 million people.
- **No infrastructure spending:** Reports on Tuesday said Trump was considering including infrastructure spending in the plan to try to win over Democrats. Mnuchin denied the report in the speech, saying the proposal would be "just a tax plan."

Of course the devil is in the details and Congress on both sides of the aisle will have much to debate. But even if only some of this proposal is enacted, the implications could be significant and thus is a big tailwind for the markets.

**Market Outlook: Positive for Now.** Barring a surprise on the geopolitical scene (which must not be ignored), improving earnings, broadening global growth, and the prospect of radical tax reform will support the equity markets. However, it will likely be a choppy and frustrating period, as investors will have to wade through all the political drama, dealing with delays and disappointments. But the path for prices should eventually move higher.

**Investment Strategy:**

Stocks: Equity exposure is broadly diversified and on the upper end of each client's individual risk band. With US fiscal policy now firmly in the driver seat, changes in the law will have varying effect on different segments of the market. Thus it is more of stock picking market where individual sectors and stocks will move independently from broad market. One example is tax reform which will not have the same effect across all equities. The Repatriation Tax impacts multi-nationals (Large cap), whereas the Business Pass Through Tax would impact small cap firms. At the same time, the market will continue to experience rapid leadership rotation from Value to Growth, or Small to Large, as investors' confidence about the future and their tolerance for risk waxes and wanes. Outside the US, European, Far East, and some Emerging economies are seeing improvement, and with valuations attractive, more exposure is warranted.

Bonds: Interest Rates will likely continue to creep higher over the year, thus duration is short with exposure to investment grade and high yield corporates, and floating rate bank loans.

These are my thoughts on the current market environment and investment strategy. As always, please contact me with any questions or concerns.

Kind Regards,

*Barbara*

Barbara HS Huff
CEO & President
New Albany Investment Management
614-216-6139 www.newalbanyinvestment.com