Market Commentary

After eight consecutive years of positive stock market returns, the S&P 500 recorded another stunningly strong advance to extend the streak to nine consecutive years in 2017. Happy New Year! The year was a fabulous one for wealth building with stocks.

In nearly every intervening year since 1965, when Tom Lehrer wrote and performed "That Was the Year That Was," one might use his humorous title as an appropriate reference to that year. Yet it rings true again for the event-filled year of 2017. The signature event, emerging from the ashes of repeated legislative failures, was the passage of the "Tax Cut and Jobs Act," which passed both houses and was signed by the President just before Christmas. Given that the Bill is the most significant piece of tax legislation since the cuts during the Reagan Administration, a meaningful discussion of its impacts is warranted in this market overview. We are preparing a more in-depth client newsletter for issuance in January, 2018, entitled, "Will the Rising Tide of Tax Reform Lift All Boats in the Economy?" Our thoughts expressed in this commentary will be focused on a few select features of the bill and what it might mean for the path of the economy and financial markets.

We have stated for many months that a tax bill that cut the corporate tax rate, shifted our tax system to a "territorial" system (in which we tax only economic profits earned in a company's U.S. operations) and permitted the repatriation of foreign retained earnings at a low tax rate would be unambiguously positive for U.S. economic growth. Furthermore, even if the resulting tax changes are entirely tax revenue neutral (which they aren't using the static analysis of the CBO), we believe making our tax system more competitive with other countries should be hugely beneficial because of the positive incentive effects to investing, working and saving in the U.S. The incentive to pursue corporate tax inversions, for example, should come to a complete halt as a result of the changed incentive structure of the tax cuts. The U.S. economy is quite likely to grow much more rapidly over the next several years (ceteris paribus— meaning the U.S. does not pursue destructive trade policies) than the 2% growth rate it has been stuck in for eight years prior to 2017.

There will always be winners and losers with tax law changes of this magnitude, but we believe the Act will still reward and incent economic activity, business formation, capital investment and hiring. After nine years of stock market advance, however, the big question remains: who will be the greater beneficiary of the changes, "Main Street" or "Wall Street?" As Republicans began to cobble together intra-party coalitions in the second half of the year, the stock market rally intensified in anticipation of many of these benefits. While both should benefit, it appears to us that "Main Street" will be the bigger beneficiary from here as stock market valuations are not depressed today compared to when major tax cuts were implemented in 1964 by the Kennedy Administration, in 1983 by the Reagan Administration and in 2003 by the Bush Administration. This doesn't mean we are headed for a major stock market correction, but one has to recognize that much of today's optimism may already be reflected in today's valuations.

We have positioned most client portfolios to maintain exposure to economically sensitive companies and sectors. This was both to take advantage of depressed valuations among many such stocks and also to benefit from improving economic growth expectations (from events such as the tax bill). With the exception of the "FAANMG" stocks (Facebook, Apple, Amazon, Netflix, Microsoft and Google-Alphabet)—which had a combined index weight of around 11% at the beginning of the year and as a group contributed approximately 25% of the S&P's 2017 total return—the market's total return was quite broad. The year as a whole is best described as a "market of stocks" with stock selection providing potential for significant relative return advantages compared to sector selection or passive index investment. The one exception to this was in the health care sector, which significantly underperformed the overall market in 2016 in anticipation of a bipartisan move toward heavier regulation and price controls. This weakness created the opportunity to capture significant return potential by over-weighting this sector.

Most puzzling during the year was the divergence in the yield curve shifts between short and long-term bonds. The yield curve twisted with the one-year T-Bill yield rising over 90 basis points while the 30-year T-Bond yield fell nearly 30 basis points—flattening the curve. The upward movement in short-term yields is not hard to understand given the Federal Reserve Board's decision to boost Treasury yields back to more "normal" levels. The three increases in the Fed Funds rate in 2017 reflected the Fed's determination to do this. Yet, investors in the 30-year T-Bonds do not yet appear to believe stronger economic growth will trigger higher price inflation or rising real interest rates. Most likely, long T-Bond yields attracted foreign investment given the negative interest rates that exist in other international markets (i.e. Europe) or U.S. investors who view Treasuries as a good counterbalance to the risk posed by stock investments. Both impacts appear to us to have run their course, along with the U.S. dollar's weakness relative to the Euro (which degrades the U.S. yield advantage), and the yield curve is likely to rise in a parallel fashion or steepen again in 2018.

While we do not believe cutting tax rates will automatically trigger higher inflation rates, we do believe rising real interest rates will be the primary source of yield increase at the short and long-ends of the yield curve. This should not be negative for the stock market or the economy until interest rates reach a substantially higher level. Yet given the overvaluation of many traditional defensive sectors that are "interest sensitive," we have generally chosen to underweight such sectors.

The more significant risks to the economy and to stocks in 2018 may come from negative trade actions. The reduction in tax rates and regulations already on the books in 2017 are positives for economic growth in 2018, yet the Trump Administration's mercantile-like view of trade policies (believing a surplus trade balance is the only important goal) has not yet been fully fleshed out or acted upon. The U.S. is being left behind as the world seeks to open up markets to trade with fewer and lower tariff and non-tariff barriers. Poor policies or trade conflict could become a headwind to the world economic growth, but we just cannot tell at this time whether this is negotiating bluster or a real risk. We will watch these developments closely.

It wasn't just smooth sailing in 2017 financial markets as the initial optimism the market expressed after the election (the "Trump Bump") proved too optimistic in the light of reality regarding the difficulty of getting Republicans to work together, much less to build a bipartisan consensus. Hence, the initial rally turned into the "Trump Slump" for part of the first half of the year. After 2016 when "value" benchmark returns surpassed those of "growth" styles, 2017 saw the reverse of this relative performance. In our view, the tax cuts and the reinvigoration of economic growth is more favorable to "value" oriented stocks than "growth." So even while optimism reigns, healthy caution about future market trends should make SKBA's below market historical volatility characteristics a desirable attribute.