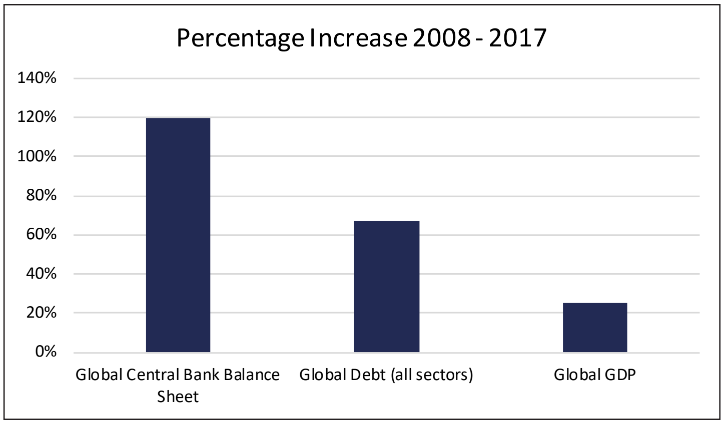
# Tax Cut Nirvana

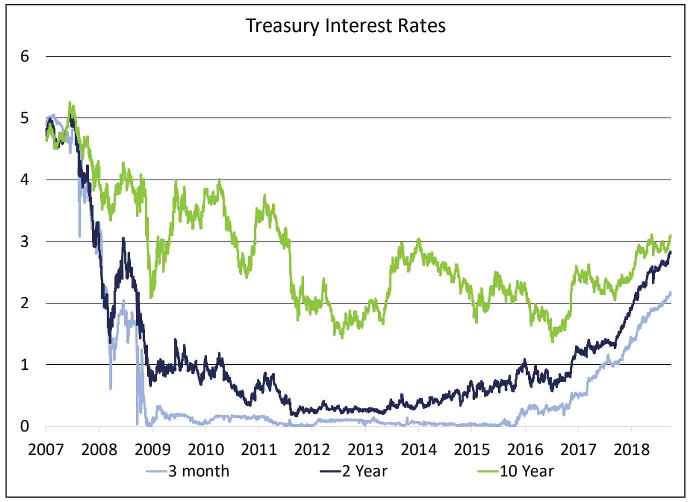
Corporate per share earnings are on pace to post the highest gain in nine years. 2010 had marked the initial recovery from the recession with a gain of 47.3% (reversing the 40% decline in 2008). If S&P 500 companies meet current expectations, 2018 earnings will result in a 26% gain this year. It is estimated that approximately one half of the projected 26% gain is the result of corporate tax cuts. Assuming that tax rates are unchanged in the future, 2018 earnings gains represent a permanent increase in corporate earnings as measured in gross dollars. The percentage growth in the future will of course be lower. Projections for 2019 earnings growth stand at a less dramatic rate of 12%.

Linear thinking would suggest that stock prices should have moved 13% higher as soon as the tax cuts were passed last December. However, stock prices suffered a swift 10% correction in January and were unchanged for the year as recently as June 30th. As the year has progressed, investors are more confident that full year earnings projections will be met and perhaps also becoming more comfortable with the permanency of the tax cuts. Given today's stock prices and projected earnings, valuations will move to below average within 6 months. This is in stark contrast to the over-valued levels in stock valuations just 10 months ago.

What can possibly de-rail the road to nirvana? There is always the chance of a surprise military or terrorist action, or a political crisis somewhere in the world, yet such events are impossible to anticipate. Tariff actions could spiral out of control and result in slower growth and higher inflation. However, the most obvious known issue in today's economic world is the total level of debt. Consider the following: Central Banks had grown their balance sheets by 120% and lowered interest rates to near zero or negative levels. Total global debt has grown by 67% to $237 Trillion. Global GDP growth was 25% over the same period. With the outsize growth in debt, global debt now stands at 270% of global GDP – an unusually large ratio.




The most vulnerable debtors remain emerging markets that have borrowed money in foreign currencies (we have already seen developing crises in Turkey, Argentina and Brazil). Next most vulnerable may be corporations that have binged on low cost debt. The central banks of the world are in the process of reversing course by raising interest rates and reducing their balance sheets. The high debt level environment carries two risks. The first appears as debt service costs rise. Corporations, individuals and governments with maturing debts find higher interest costs. The second risk is solvency, or the inability to repay or re-finance principal payments at maturity. This can become more problematic for the most leveraged entities.




The stage is set for debt defaults to rise. No single debt issue will cause a loss of confidence in the global financial system. However, a series of marginal problems or a single high-profile situation can snowball into a loss of confidence and affect global markets in general. Even though the Federal Reserve has been tightening for only a couple of years, key interest rates have generally recovered 50% of the decline they experienced during the financial crisis. The process has been deliberate.

**The Economy**

Growth in real Personal Consumption Expenditures rebounded in the second quarter of the year, which helped real GDP growth rebound to 4.2%. Most current estimates for third quarter GDP growth range between +3% and +4%. Although we have seen a modest uptick in inflation, consumer sentiment remains at multi-decade highs. Corporate earnings growth has been strong, and leading economic indicators are broadly positive. Despite the negative political rhetoric that dominates our news cycle, the economy seems to be on stable ground and poised for continued growth in the near term. Inflation has now reached 2.7% versus a rate of 1.1% two years ago. There are many indications that inflation could persist at this level or higher. If so, interest rates across all maturities still fail to compensate for inflation, suggesting there should be more weakness in bond prices (higher yields) over the intermediate term.

**The Markets**

The stock market advanced during the quarter as expected earnings growth has been realized. Full year corporate earnings are bolstered by the reduction in corporate taxes and are expected to advance by 26%. Projections for 2019 are for a more normal 12% increase. Rising interest rates and global trade tensions continue to provide headline risk and have the potential to precipitate periods of market volatility. Our equity portfolio holdings target over-weightings in the technology and health care sectors. These sectors offer attractive risk-adjusted valuations and earnings growth potential. Our bond exposure remains defensive in short-term, high-quality securities and our asset allocation is neutral. This leaves room to re-allocate between stocks and bonds as relative valuations change over time and present appropriate risk/reward opportunities.

Thank you for your confidence in our firm as we continue to apply our disciplines to the markets, looking for opportunities to add value.

**Your AAMA Team**