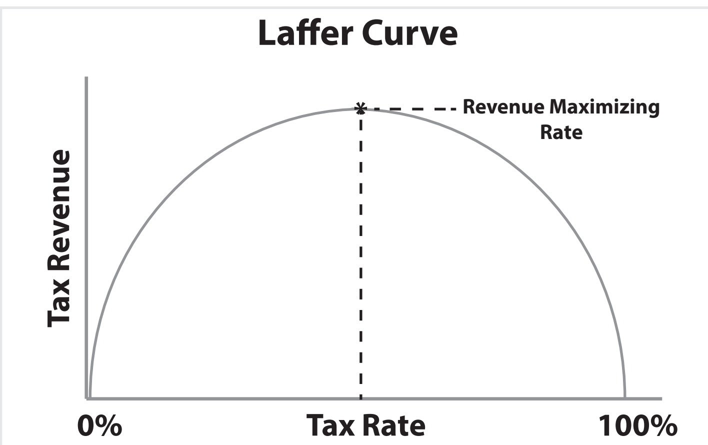
The Big Bet

The new tax legislation is a big bet on several fronts. First, and most significant, is the change in the headline corporate tax rate. The new rate of 21% vs. the old 35% rate should level the playing field for corporate locations around the world. Companies who wish to locate offices and facilities in the United States will no longer be deterred by a tax rate that was one of the highest in the developed world. This bet will likely bolster the growth prospects of U.S. based corporations. The estimated impact on reported aggregate corporate profits is for an increase of approximately 5% which suggests that the average corporate tax rate has been running about 25% due to special benefits in the old tax code. Of course, some companies will realize higher tax savings than others and the aggregate affects will not be known for a while. The markets have undoubtedly priced in lower corporate rates.



The second 'bet' is that lower tax rates will stimulate spending and growth (which we will discuss further), and that *lower* marginal rates will actually result in *higher* tax collections. This theory is based largely on a well-known economic principle called the Laffer curve, made famous by Reagan era economist Arthur Laffer. The Laffer curve examines the relationship between government tax receipts and marginal tax rates. At its simplest, the theory states that there is an optimal rate of taxation that will produce the highest possible total revenue. To wit; If the tax rate were 0%, then tax collections would be zero no matter how much work is done. Conversely, if the effective tax rate were 100%, tax collections would also be near zero. Most people would choose to simply not work rather than work and pay 100% of their income in taxes.

The theory that tax collections will go up, therefore, assumes that A) The shape of the curve is substantially similar to the one illustrated here, and B) We have previously been operating somewhere to the right of the equilibrium point, whereby people have been discouraged from extra work by unreasonably high marginal tax rates. Unfortunately, we have our doubts about both assumptions, and ultimately we do not expect an increase in labor production or the accompanying increase in tax revenues.

Another benefit from an income tax reduction involves consumption, rather than production. A tax decrease means more disposable income, which theoretically means more consumption. In a developed economy like the United States, where nearly 70% of GDP is derived from personal consumption, a marginal tax decrease could have a significant impact on the economy. One of the basic tenets of economics, however, states that in order for a tax decrease to effectively change consumption habits, it must be fairly significant, and people must believe it to be a long-term policy. If people believe that the decrease is not significant or only short-term in nature, they are far more likely to save the proceeds rather than alter their consumption. A recent survey showed that 47% of people polled either "disapprove" or "strongly disapprove" of the new tax plan.

In our estimation, the reason for this trepidation has nothing to do with the potential ramifications for the federal deficit, but rather the partisan nature of our current political environment. Frankly, with nearly every taxpayer getting some relief, we believe it is highly likely that many just do not understand the plan and are simply believing what they're being fed by the talking heads. Regardless of the reasoning behind the "disapproval", it is clear that many Americans have not yet "bought in" to the new tax plan. We are therefore somewhat lukewarm in our expectations for significant increases in personal consumption and GDP growth, at least in the short-term. Perhaps that will change as more of the new tax code is implemented and people are able to digest the actual impact it has on them individually.

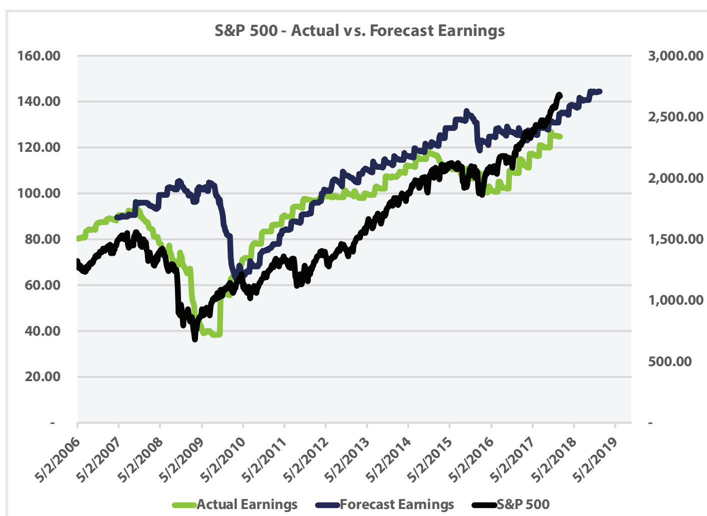
Citing similar concerns, most current economic estimates are for $1- $1.5 Trillion lower tax revenues over the next 10 years, which will add to the already stubborn federal budget deficit. Aging demographics, high debt levels, and rising interest rates tend to dampen growth. Increasing productivity, lower regulatory burdens and lower taxes tend to bolster growth. On the margin, lower tax rates could help to spur economic growth, but the effect could get lost in the sea of other economic factors as we progress through the next several years.

Interest rates

The Federal Reserve increased its target for short term interest rates in December - the fifth increase in the last 24 months. The Fed also started reducing its holdings of bonds in October, however; the impact on longer term bond yields can not yet be correlated with the Fed's selling. Since the Fed started its monetary tightening in December 2015, short term rates are higher by 1.25% while 10 year Treasury yields are higher by only 0.16%. Sporting a 2.41% yield on the 10 year, the long term bond market is still not convinced that the economy is accelerating and the Fed has successfully engineered consistent 2%+ inflation. We still consider a 4% yield to be indicative of a successful Fed experiment. We continue to position fixed income holdings in high quality, short term bonds due to the risk to principal values should interest rates move materially higher.

Corporate profits

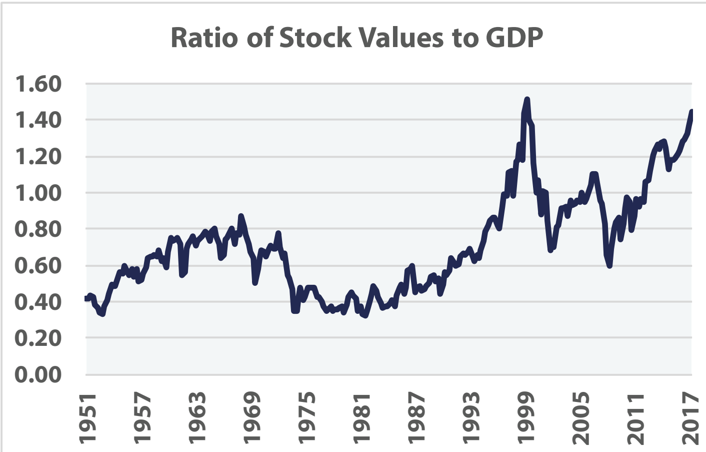
As noted above, tax law changes should provide a one-time 5% boost to aggregate corporate profits. This will accrue in 2018 after two years of earnings recovery from the 2015 earnings recession. As of December 2017, corporate earnings will have grown at an annualized rate of 3.4% over the last three years. The five- and ten-year growth rates are 5.2% and 4.2% respectively. Quarterly earnings reports often generate sensational breaking news stories, but the last ten years have failed to match our long term corporate profit growth of 6%. Recent earnings growth has not matched long-term averages, and has sometimes fallen short of expectations, but the rebound from2009 lows has led the stock market to all-time highs.



Stock market

2017 was a good year for stock investors, especially in the 5 companies that contributed 25% of the market gains…or the twenty that contributed 50% of the gains. The stock market tends to discount forward earnings and the 26.5 median forward P/E of the fab five indicates continued fast growth for these companies (expected to be 29% next year). Historically, these same companies have not posted such impressive numbers with growth over the last 5 and 10 years of 10% and 6%, respectively. Priced for perfection and continued high growth, there is more room for disappointment in these companies than other segments of the market, especially if the outlook were to be tempered and more in line with longer-term history.

We have previously reviewed the components of return that have contributed to the bull market over the last 9 years. Stock prices have simply grown faster than underlying values:



- Stock prices have grown faster than earnings per share – an expansion of P/E ratios.
- Earnings per share have grown faster than total dollars of earnings – due to shrinking of outstanding shares.
- Total dollars of earnings have grown faster than revenues – an increase in productivity.
- Revenues have grown along with real GDP growth, at a relatively modest pace.

The first two factors have been the most significant contributors. And all factors have compounded to produce a ratio of stock prices to GDP that exceeds all readings in the last 66 years (with the exception of the first quarter, 2000).

Looking forward into 2018

The stock market seems to be priced for perfection going into 2018, and perfection in the economy is tough to come by. Even though the equity market is overvalued by many historical measures, corporate operating earnings have posted six consecutive quarters of increases. Corporate profits are at new all-time highs and appear to be going higher, given the potential for lower taxes at the corporate level. Excessively high stock valuations do not necessarily spell a tumble in stock prices. However, it is an environment that is more vulnerable to disappointments and geopolitical news events. We appreciate your continued confidence in our firm and look forward to assisting you in meeting your long term investment goals and objectives.

Our best wishes for a healthy and prosperous 2018.

Your AAMA Team