Taxes, Tariffs and Trouble?

Assuming you have a smartphone, do you ever use the GPS or maps application? If you're like us the answer is probably "yes." In fact, it's amazing to consider how we ever got anywhere prior to the advent of mobile navigation networks that now fit in our pockets. In using GPS, have you ever found the data on the screen conflicting with your actual location? The dot says you're one place when you know for a fact you're somewhere else? If you're like us the answer is probably another "yes." As "smart" as data networks might be, they can become decoupled from reality and sometimes simply looking out the windshield can provide all the information you need as to your location.

Not unlike GPS that can be incredibly precise and also at times disconnected from the real world, the capital markets today demonstrate similar characteristics. Many signals on the "smart" data networks would signal a robust recovery will continue but a look out the windshield provides conflicting views as to our actual location. In this edition of Capstone Comments, we'll take a look at the following:

1. Tax Reform Legislation Impacts and Considerations
2. Trump Administration Trade Policy
3. Trouble for the Economy and Market Valuations

Tax Reform

There is a myriad of changes far too many for us to recount here but we will touch briefly on the aspects **Personal**, **Corporate** and **Estate** taxes that are most notable and their potential economic impact.

With respect to changes in the **personal tax rates**, the most notable is the doubling of the standard deduction from $12.7K to $24K for married folks filing jointly. In doing so, itemized deductions are largely eliminated as is the attractiveness, for some taxpayers, of the mortgage interest deduction. This could also increase taxes for some folks who have previously relied on personal exemptions which are no longer offered.

Overall, rates at the lower end have been reduced by a few percentage points and the top rate for income tax caps-out at 37% which is a reduction of 2.6%. From a personal tax standpoint, the new code will be helpful to some and less than helpful to others. Most everyone should be paying somewhat less in federal income tax in 2018 than they would have otherwise. The extent to which this is a long-term economic catalyst is yet to be seen.

Shifting to the **corporate tax rates**, the legislation cuts the rate on corporate income taxes from 35% to 21% which is the lowest level since 1939. To be clear, most corporations in America have never paid the top rate. The average, effective corporate income tax rate is 18%.

The legislation also allows for profits earned overseas to be brought back to the US and not face a tax. This is presumably to help spur investment in the US as opposed to companies offshoring overseas profits to avoid taxation. This will likely have the greatest benefit on the pharmaceutical and tech sectors as their massive overseas piles of cash can be brought to the US for further investment. Again, the extent to which that will occur remains to be seen.

Finally, there's the **estate tax** which previously kicked-in at $5.5mm. Now, an American citizen can die with up to $11mm in assets without paying any federal estate tax. For tax year 2017, the Tax Policy Center estimates that only

11,300 estate tax returns will be filed and of those only 5,500 will be taxable. The federal estate tax already impacted a relatively small portion of the population. Now it will impact even fewer.

What hasn't changed is the Washington state estate tax which begins being assessed for estates worth $2.1mm. This is obviously a much lower threshold than the federal tax and one that hasn't been altered. It's also worth noting that the federal estate tax, which is 101 years old by the way, has been all over the map. There are years in which there was no estate tax and years in which the exemption amount was $0 and the tax was 80%. The point is that, to the extent anyone is interested in preserving assets for multi-generational use, proactive planning that minimizes and even avoids estate taxes is far better than reacting to the whims of Congress (1).

Overall, the reform does seem to have had some positive effect as a number of employers have offered bonuses, increased dividends and stock buybacks. It is unclear however the extent to which those will be recurring sources of strength. What is clear is that the US Treasury will likely be taking in less taxes which is certainly not a bad thing but, to the extent such tax policy will continue, must be met with a commensurate lowering of federal expenses or the already expanding federal deficit will grow at an even faster pace.

Tariffs

The writer of this piece had attempted to gather a cogent analysis of the impact of a potential trade war and has since given up for two reasons. First, the specifics of exactly how and to what extent tariffs will apply keep changing. The administration has settled on steel and aluminum for now, citing its role in our national defense which allowed for unilateral executive action. That has begun to shift somewhat as certain nations are excluded/may be excluded. It seems that the approach to China on this issue is as much of an attempt to get China to the negotiating table as it is a long-term policy initiative. Given our view that such tariffs are imposed primarily as a negotiating tactic and not as a course of an extended policy initiative, we'll not spend much time trying to analyze the "what-ifs" of such action.

Second, is that, with extensive analysis or not, it is well known and well understood that tariffs don't work. This is not to say that China hasn't been a bad actor with respect to its own trade policy and particularly with respect to its rampant theft of intellectual property. It's simply to say that going down the road of tariffs solves some problems by creating others and is not a long term viable solution to our trade issues with China or any other nation. Issues that most around the world agree need to be addressed.

What we can say is that, as in any war be it trade or otherwise, the longer it continues the more casualties we'll incur. These casualties will take the form of lost production and increased cost as consumers bear the burden of such policy. It also bodes poorly for the agricultural sector as that is our chief export to China. Given that reality, we hope that longer term solutions that do not require artificially adding cost to a good or service are reached.

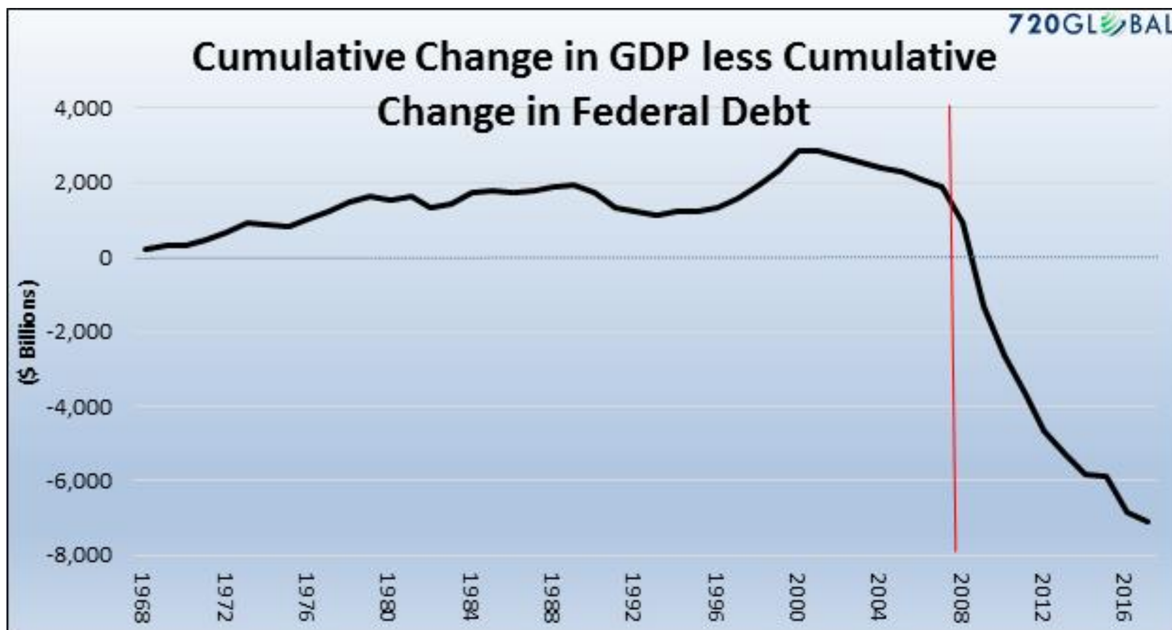
Trouble: Debt & Stock Valuations

Pictures are often indeed worth a thousand words. The one below is technically worth about $7 trillion dollars. All of it debt. It graphically represents a simple bit of arithmetic that can easily get lost in the terminology. The arithmetic is as follows:

GDP Growth – Growth in Federal Deficit = Net Growth. Net Growth is good by the way.

No different than if we were looking at a business whose top line revenue was growing, we'd want to know the extent to which that growth is sustainable and the extent to which that growth has been fueled by taking on more debt.

What this chart tells us is that, since 2008, for every dollar of GDP growth we've experienced there is now $7 worth of Federal Debt. As you might imagine the downward sloping line is the opposite of what you want to see and is indicative of an unsustainable financial position. It is sustainable until it isn't. That point will be when borrowing costs increase and those that lend to the US government require higher and higher rates of return in order to lend to a borrower that is becoming less financially stable (2).



The turning point for that is unknown and likely not in the near future. However, that is the direction we are heading and, unless we can engineer sufficient growth to overwhelm our present level of indebtedness, the reckoning will not be easy.

This brings us to the issue of **Interest Rates**, which as you may have notices, have begun steadily rising. Jerome Powell took over as the Chair of the Federal Reserve in February of this year and has struck a remarkably hawkish tone with respect to interest rates. A tone that contrasts sharply with that of his predecessors, Yellen and Bernanke who oversaw a period of unprecedented liquidity and low rates.

The current Federal Funds Rate, which is a foundational interest rate used to price everything from business loans to home mortgages, currently stands at 1.75%. Powell has indicated that the rate will rise to at least 2% by the end of 2018, 2.5% in 2019 and then hit 3% in 2020. This forecast is of course "data dependent" and could be accelerated or decelerated at any point.

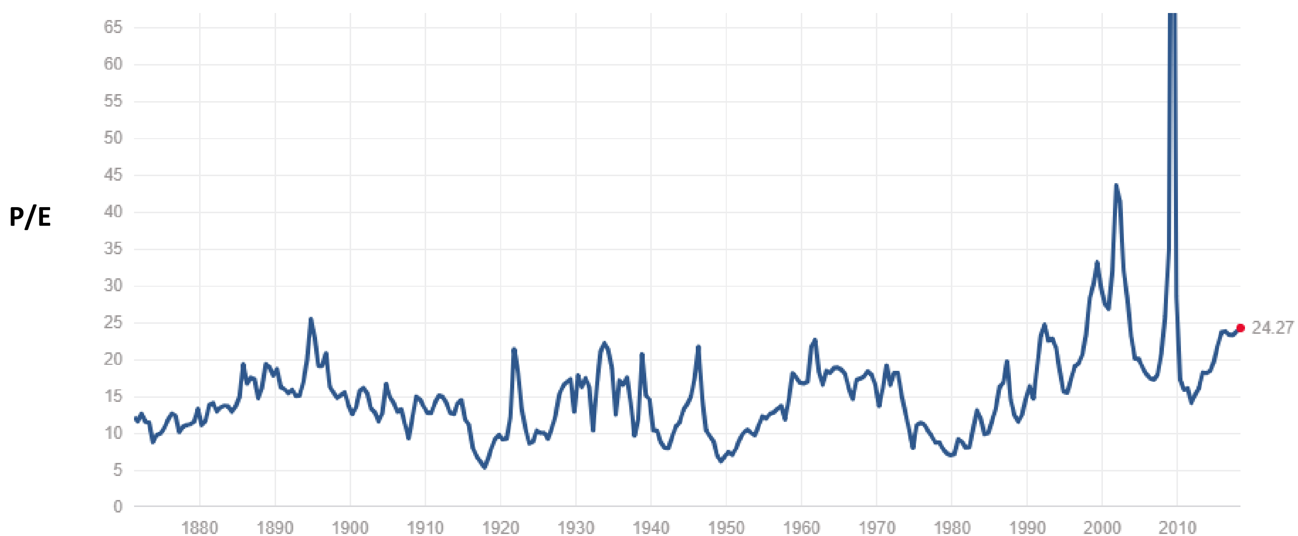
The Fed has indicated clearly that its primary concern is that of controlling inflation which it sees signs of now that the economy has “recovered.” That concern is well founded particularly as low rates have driven money into assets such as stocks and real estate the former of which is certainly sporting frothy valuations which we’ll speak to in a moment. If we can assume that the last number of years of stock performance has been predicated upon very loose liquidity and low rates than we can also assume that an end to that liquidity (the money-printing operation known as “Quantitative Easing” is over) and a rise in rates creates significant questions as to what can propel stocks further. The old saying, which some of you have heard us repeat is “don’t’ fight the Fed.” This simply means that if the Fed is inclined to keep money cheap and liquidity high then risk assets such as stocks will generally rise. If, however they do the opposite then the opposite is more likely to occur.

The takeaway here is one of caution with respect to the stock market in particular as the Fed takes very overt steps to make money tighter and more expensive.

This brings us to the issue of **Stock Valuations**. There are a number of metrics used to gauge how cheap or expensive stocks are at any given time and one of the more common is a ration known as the P/E ratio or Price to Earnings ratio. It simply tells us how much one must pay for $1 dollar of earnings. For instance, a stock that earns $1 per share and sells for $10 per share would have a P/E of 10. The same analysis can be done on segments of the stock market as a whole.

Value investors tend to buy stocks with lower P/Es but lower P/Es don’t necessarily mean it’s a good deal. Just because something is cheap doesn’t mean it’s a good value. Conversely, growth investors aren’t afraid of higher P/E’s if the company/market is growing. Amazon (AMZN) for instance has a P/E ratio of 347. That means each dollar of Amazon earnings costs you $347 to purchase. Apple (APPL) by contrast has a P/E of 20. Which is the better deal? Apple is certainly cheaper but Amazon is growing like crazy. No one can say for sure which of these will be the better investment in ten years’ time but we can say that the higher the price for anything the less the margin of safety (3).

Regarding the S&P 500 as a whole, the chart below offers a historical look at the P/E of that index going back to the end of the Civil War. The average P/E for that period is about 15.5. Right now, the S&P is trading at a little north of 24 or a 58% premium to its long term average. There have only been three times in the last 153 years when the index was more expensive: 1895, The Dotcom Boom of 2000 and late 2007 before the Great Recession. Does this mean that the S&P is guaranteed to fall? No. It simply means that there is little margin for error and that investors should be cautious in this period given the heightened price for the US market. A price which historically has a history of reverting to the average. An average that is much lower than the P/E today (3).



Conclusions

What all of this indicates to us is that we're getting close to the end of this market cycle. It's persisted far longer than we could have imagined but it will end as every market cycle does and a bear market will ensue. This does not mean you should sell your stocks today. It does mean that you must have a plan and a process for how you invest your funds and more importantly why you invest your funds. A what without a why is a house with no foundation. Investing involves risk as we all know. That risk must be managed appropriately and be taken for the right reasons. Reasons that justify the possibility of financial loss.

As financial planners and professional investors, we seek to have a coherent plan and strategy in place for how we will deal with the next bear market. That strategy will differ somewhat from investor to investor but at its heart is the need to know how we'll respond to certain events before those events are staring in the face. Crisis often requires decisions but the heat of the moment is usually a poor time for critical thinking. This means that our decisions as to how we'll respond need to be determined before and not during a time of crisis.

We're not market timers by any stretch but CIG has employed with great success technology that helps us identify when long term trends are shifting and when it's advisable to pursue certain asset classes over others and become more defensive when necessary. As the data continues to develop we don't see significant outflows from US stocks as being likely in the near term, but that asset class is certainly showing signs of weakness. We are seeing strength and taking increasing positions in asset classes such as commodities and emerging markets.

If you have questions or concerns with respect to how you're positioned for the current market and any challenges we may face, let's talk. We strive to educate our clients as to the strategies in place in part to create understanding in part to ensure that the fashion with which the dollars are invested is consistent with the needs and dispositions of our clientele.

As always, we're grateful for the opportunity to serve you and we look forward to seeing you again soon.

Kindly,

CAPSTONE Investment Group, LLC

Sources Cited:

1. Internal Revenue Service
2. 720 Global
3. www.multpl.com

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