INVEST WISELY.

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Observations and Perspectives:

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"Political, economic and social changes are underfoot globally"

Is the Sugar High Wearing Off?

Anticipation of lower taxes and higher infrastructure spending initially pushed investor enthusiasm and stock prices higher for several weeks following the election of Donald Trump as the 45th President of the United States. At the same time, a sea of change from central bank dominated markets to a focus on fiscal policy sparked inflationary fears, a stronger dollar prompted a melt-up in interest rates. As the Dow inches toward the historic level of 20,000, the sharp runs in stocks have begun to consolidate while rates have retreated. The sugar high is wearing off.

Political, economic and social changes are underfoot globally. Brexit and the U.S. election were key pivot points in 2016. These developments will continue to drive volatility in 2017. In particular, we are carefully watching the calendar for the January 20 U.S. Presidential inauguration, March 15 voting in the Netherlands and the April 17 first round Presidential elections in France. Notably, populist gains in core European countries – a real possibility - may present the biggest risk of significant market inflections in 2017.

We can speculate on the outlook, but one thing is clear right now: optimism for the future of U.S businesses and the U.S. economy has increased dramatically across a number of surveys. Modest economic growth in the U.S. over the past several years kept businesses, consumers and investors risk-averse and tentative. That has changed.

The incoming administration's proposals for huge (or "yuge") increases in government spending and decreases in taxes (paid for, probably, with borrowed money) are stoking that optimism. Stimulative policy should turbocharge growth and boost corporate profits, but stocks are ahead of themselves and rates could sit at current levels for longer.

Take taxes. A best case scenario for corporate tax reform is a drop from 30% (the current average effective rate) to 20%, or 10 points. One percentage point reduction in the corporate tax rate equates to about $1.50 in S&P 500 earnings, so $15. Apply a 15 multiple on those earnings and we get 225 points. The rally since the elections is nearly entirely priced in already.

Government infrastructure spending, ignoring the massive deficit spending necessary, requires "shovel-ready" plans – and this takes time. A one-time tax on previously untaxed foreign profits will not be used to buy back shares, but to pay down all-time high corporate debt levels. In other words, the translation into higher profits (and therefore higher stock prices) isn't there (yet).
Listen. We want prosperity, of course. A new era of all things positive would be fine with us. But, we also want to continue to focus on fundamentals and realistic valuations. Near term growth prospects may look to be a little better, but the anticipation of changes in tax and regulatory policy got ahead of the reality right now.

We like the improved optimism in corporations and consumers. We applaud the orderly tightening of credit spreads in the high yield corporate bond market. We are just saying, proceed with caution. The sugar high is wearing off.

The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

The Standard & Poor's 500 Index (S&P 500) is an index of 500 stocks seen as a leading indicator of U.S. equitites and a reflection of the performance of the large cap universe, made up of companies selected by economists.

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