Investing in a Trumpian World

By Peter D. Scholtz

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Since the election, the capital markets have been turned upside down with the change in economic confidence. The instant response to the Trump win was the S&P dropping 6 percent in the overnight overseas markets. Foreigners reacted to what they thought was a U.S. nightmare, Trump getting elected. But U.S. professionals, like Carl Icahn, bought in the middle of the night and by the time the U.S. market opened in the morning, it had all but fully recovered. The positive surprise was that the Republicans had captured the Presidency and Congress. The long awaited corporate tax reform could now be passed by simple Republican majorities. Unfortunately, the road forward has gotten murkier since the election's initial euphoria.

Over the past several months, the jubilation has given way to caution as the reality of the political divisions within the Republican Party prompted the "making of sausage" analogy. Handling the Affordable Care Act's repeal, the Republicans quickly realized the far right would prevent a comprehensive deal and with no Democratic support, it all fell apart. The large budget swings regarding the health care bill help to fine-tune the tax cuts, identifying a view of the budget through reconciliation. Tax reform seems as complicated as the health care bill with the main legislative disagreement on tax reform centering on the Border Adjustment Tax (BAT) as well as deficit sizes. The BAT is a tax on imports at the corporate tax rate and a tax subsidy at the same corporate tax rate on the value of a firm's exports. As our country is a net importer, the BAT's chief attribute is that it raises a lot of revenue. This enables much deeper tax cuts in other areas, including both personal and corporate tax rates. While the net benefits of the BAT are debatable, lower rates would greatly help the U.S. economy, enabling our fast growing, very profitable domestic companies to accelerate. If we had a tax rate no higher than our trading partners, cash overseas could return tax free as opposed to the current system where we have over $2.5 trillion in trapped cash overseas. Lower U.S. corporate rates would also attract overseas capital. Eliminating special deductions and tax credits, and simplifying the tax code would streamline the economy. Lower corporate tax rates are what most economists think is the most positive policy move we currently have available to us.

The administration leaps from topic to topic, indicative of a world of tweeting. Recently though, tax reform seems to be making its way toward the front of the line, but the market realizes that all timelines for tax reform policy are slipping. While Trump's team recently laid out his initial principles for tax reform in what could be viewed as an opening "bid," there is a lot of distance to cover for an approvable plan. Portfolio managers are on edge. We remain hopeful of some form of tax reform eventually getting done, but without it, the market will likely struggle. The Republicans simply can't afford to not get something done.

From a market perspective, the biggest debate is over how much of the market rise is Trump hope for policy reforms and how much is the fundamentals grinding higher. Now that energy companies have recovered somewhat, S&P 500 earnings have been quite strong and earnings ex-energy have improved nicely. Consumer and business optimism has soared, but little has been translated into more economic activity, especially from the consumer. Shorter term, car sales are softening, but housing activity continues to slowly improve. The market over the past year has been very resilient to mixed or bad

107 ELM STREET • FOUR STAMFORD PLAZA, 5TH FLOOR • STAMFORD, CT 06902
TEL: (203) 714-9900 • FAX: (203) 588-9032

news. This is the result of good money flows from buybacks, bond sales and foreign central bank quantitative easing. We continue to monitor this for as time goes on, this market support could wane.

Inflation has picked up a little, but with a tight labor market, there is a risk of an acceleration. For now though, inflation still seems benign. Bond rates have been very stable in the mid-2 percent range for 10-year governments. The Fed is expected to raise short rates twice more this year, leading to a flattening yield curve.

The 10-year government could rise toward 3 percent, but that should be the upward bound. Corporate bonds have some risk of higher rates as spreads are unusually low. This will leave the market solely dependent on GDP and earnings growth.

In periods of low inflation, growth stocks' relative valuation rises. As an example, you have two companies, one with real growth of 15 percent, the other, 2 percent. In a 10 percent inflation world, one grows at 25 percent and one at 12 percent. In a 2% inflation world, one grows at 17 percent, the other at 4 percent. The growth stock grows twice as fast as the other in a 10 percent inflation world, but over four times as fast in a 2 percent inflation world. You want to own top line growers in a low inflation environment. I suspect this cycle will end with overdone enthusiasm in growth stocks, probably the large cap tech area. Names like Amazon, Google and Facebook will continue to attract investor attention.

Energy has been baffling. The world market has been in a deficit for many months, and with strong improving fundamentals. World storage supply has been declining steadily, although it is still high. The Bull/Bear debate is on what price the world oil price would be in equilibrium. We use four oil analysts and all four believe that the price will get to $65 a barrel or higher to maintain supply. The Permian oil companies grow at 40 percent a year and are dirt cheap. We believe they are an excellent opportunity.

The investor is faced with a multitude of potential outcomes for the U.S. and Global economies. Our outlook is neutral for the market, bond rates and the dollar. It appears that slower, but longer continues to be the correct attitude towards the economy. Yet, we are well on our way through this economic cycle. Given the soup of potential political and economic developments, a profile of the "right" stock begins to emerge. Companies with a domestic focus, high tax rates and good growth with little economic sensitivity fit the bill.