REGISTERED INVESTMENT ADVISOR

DENEWILER

Capital Management Inc.
1600 Stout Street
Suite 1690
Denver, CO 80202

303.832.7475 / 888.808.7475
Fax 303.832.7484
greg@growmydollar.com
www.growmydollar.com

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OBSERVATIONS ON THE MARKET

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By Greg Denewiler, CFA

One of the many sayings on Wall Street is: "Buy on the rumor sell on the news." The market has continued to move higher right up to, and now after the new tax law has passed. Corporate earnings will soon receive an immediate bump from the new lower corporate tax rate. The future is always being discounted. What appears to be different this time is that there is no selling on the news, at least not yet. One possible explanation is that along with the lower tax rates, companies are going to also be able to bring back the profits that they have earned in other countries at a much lower tax rate. It is hoped that corporations will invest this money in new projects that help provide growth to the economy longer-term. Will they invest the money, or just pay more dividends and buy back their stock at inflated prices?

It is estimated that earnings may get a bump of up to 10% from the new law. However, if you look back over the last 100 years, earnings have been relatively steady at about a 6% growth rate. Tax cuts do provide an immediate benefit, however, they do not change long-term growth. The S&P 500 advanced 20% last year. It is now up another 4% this year. It has already exceeded the expected benefit of lower taxes. With all these expectations of growth comes the risk of higher inflation, which usually leads to higher interest rates. Can we have one without the other?

Nothing seems to have worked like it should have since the recession of 2008. Nine years of near zero interest rates wasn't even considered possible 10 years ago. Now, we wonder if they will ever get back to normal. The danger is always trying to figure out if it is a new paradigm, or, if there is going to be a reversion to the mean? Fortunes are won and lost contemplating this dilemma. It wouldn't be such a big deal if prices weren't priced for perfection.

Howard Marks, in his latest quarterly memo, quotes a speech from William Dudley, the president of the New York Federal Reserve bank:

While the recently passed Tax Cuts and Jobs Act of 2017 likely will provide additional support to growth over the near term, it will come at a cost. After all, there is no such thing as a free lunch. The legislation will increase the nation's longer-term fiscal burden, which is already facing other pressures, such as higher debt service costs and entitlement spending as the baby-boom generation retires. While this does not seem to be a great concern to the market participants today, the current fiscal path is unsustainable. In the long run, ignoring the budget math risks driving up longer-term interest rates, crowding out private sector investment and diminishing the country's creditworthiness. These dynamics could counteract any favorable direct effects the tax package might have on capital spending and potential output.

So now we have a case where on one hand the Federal Reserve is rising interest rates (a restrictive act), and on the other hand, our government is lowering taxes (a pro-growth act). It would seem like this is not exactly an efficient policy method. Maybe, just maybe, the market shouldn't be so eager to price itself for perfection. Investors see a better economy ahead, stronger growth globally, and a favorable political (debatable) business climate. Admittedly, this is an attractive outlook. However, if you have been around the block a few times, you know these things always end because the economy is cyclical. You just don't know when, and the warning signs are not evident until after the fact. Being cautious doesn't hurt you as bad if you are wrong, as being aggressive does when you are paying higher prices to invest.

The records just keep coming. We are on the verge of experiencing the longest period of economic growth ever. Last year was a record for the lowest volatility in the stock market, we never even saw a 5% correction. We are now experiencing some of the highest valuations historically. The one factor that gives some encouragement is that investors do not seem to be euphoric. Good luck trying to predict how this year will end.