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The Outlook for the Economy

In 2017 the U.S. economy had a weak start at 1.2% real GDP growth in the first quarter but then had growth of 3.1% and 3.2% in the second and third quarters with our expectation of 3.0% or more in the fourth quarter. The Bureau of Economic Analysis will announce fourth quarter and final results for GDP in 2017 on January 26, 2018. Our expectation is that final GDP growth for 2017 will be 2.6%. We believe that with the passage of the Tax Cuts and Jobs Act on December 21 that President Trump will achieve over 3.0% economic growth in 2018. That result will break the weak economic growth trend of 2.1% over the past eight and a half years that has been accepted as the "new normal" by the majority of economists. The reasons for the recent improvement in economic statistics include a significant reduction in regulations brought about by the New Administration, a noteworthy gain in individual and corporate sentiment that resulted in higher consumption and a gain in capital investment. In addition, the improvement in many foreign economies, after a lagged recovery from the Great Recession, also aided the U.S. economy. Looking ahead, we believe that 2018 will bring even faster economic growth because of the new tax legislation, a program of infrastructure spending and continued strong economic growth from abroad. Also, with unemployment at 4.1% wages should increase above their current 2.5% y/y rate. After nine years of relaxed monetary policy by the Federal Reserve, the new fiscal expansion will require tighter monetary policy in terms of higher interest rates and a continued shrinkage of the Central Bank's balance sheet, a program started in October. A failure to do this will lead to higher inflation from current levels of about 2.0%. Historically, the Federal Reserve's actions have tended to lag inflation.

A summary of some of the details of the Tax Cuts and Jobs Act is provided as follows: the corporate tax rate was reduced from 35% to 21% while pass-through businesses (95% of all businesses) will get a 20% deduction. Overall, the tax cut for businesses amounts to $1 trillion over the next decade. With regard to individuals, those who currently pay no federal tax, will rise from 44% to 47.5% of households. For those who do pay taxes, the number of brackets will remain at seven, with the top rate going from 39.6% for married couples making $470,700 or more to 37.0% for those making as much as $600,000 in the future. The child credit will rise from $1,000 to $2,000 for families making up to $400,000. For those families with children and not paying taxes, they will get a refundable credit of $1,400 from the government. The state and local tax deductions along with property taxes will be capped at $10,000. Mortgage interest loan deductions will be allowed for new loans up to $750,000 down from one $1 million. The standard deduction will double to $12,000 for single filers and to $24,000 for married couples. Estates will not be taxed up to $22 million for married couples, up from $11 million currently. These are just a few of the details from a massive tax over-haul, the first in 31 years.

Those individuals in high tax states such as California, Connecticut, New Jersey and New York could possibly pay higher taxes under the bill because of the $10,000 cap on state, local and property taxes. Those individuals who pay the alternative minimum tax (4.5 million taxpayers) and don't currently get these deductions, might fare better because the income level has been raised for the application of the tax. Overall, the new tax plan favors businesses directly, probably more than individuals, but to the extent that the country prospers, individuals will benefit indirectly. Certainly the lower business taxes will make the U.S. more competitive compared to foreign businesses and should lead to more investment in the U.S. Also, the approximately $2 trillion held abroad by corporations will lead to some repatriation of funds because of the lower corporate tax.

In terms of current business conditions they could hardly get better. New home sales increased 17.5% in November to an annual rate of 733,000, the highest level since July, 2007. Existing home sales increased 5.6% y/y in November to a 5.8 million level, the highest in a decade. The boom in housing has led to record low inventory levels and the only restraint is few available workers to build new homes and record high prices that is making renting relatively more affordable. Employment in terms of nonfarm payrolls increased by 228,000 in November with unemployment falling to a new low at 4.1%. Retail sales advanced 0.8% in November and are up 5.8% y/y. Auto sales were up 6.3% y/y, building materials by 10.7% y/y and gasoline sales up by 12.2% y/y. Industrial production rose 0.2% in November and is up 3.4% y/y. The leading indicators at present are up 5.0% and productivity in the third quarter increased by 3.0% (a quarterly annual rate) after being flat in 2016. The main concern currently is over-confidence suggested by the falling consumer savings rate that has been in a steady decline all year from 6.0% to 2.9% in November. The falling savings rate has partially financed consumption this year. It fell to a negative level just before the financial crisis of 2008-9.

Our forecast for 2018 primarily incorporates faster economic growth, higher inflation, and significantly higher corporate profits largely based on the new tax law. We are expecting 3.2% GDP growth, 2.5% CPI inflation, and a corporate profits gain of 15%. In terms of the S&P 500 Stock Index, earnings would increase to $150 per share versus our forecast of $130 per share in 2017. The main caveat would be considerably higher inflation leading to a recession.

The Outlook for the Financial Markets

With the year almost finished, the S&P 500 Stock Index is up 20.2% and the Dow Jones Industrial Average up by 25.5%. Foreign markets also boomed in 2017 with Europe (FTS Eurofirst 300) up 21.2%, Japan (Topix) up 24.2%, Emerging markets (MSCI) up 31.1% and China (SSEA) rising by 10.1%. Since equity markets tend to be forward looking, the higher equity prices are projecting stronger economic growth ahead. Obviously however, there are always elements of speculation encompassed in equity prices and so investors must carefully keep themselves informed of the economic and financial fundamentals while judging the merits of various investments. Currently, the S&P 500 Stock index (2683) sells at a P/E ratio of 20.6 and 17.9 times our 2017 and 2018 estimates of $130 and $150 per share. These P/E ratios would represent earnings yields of 4.5% and 5.6% respectively and would compare to the current yield on 10-year Treasury bonds of 2.49%. Historically, P/E ratios have been about 15 times the current year's earnings or 6.7% in terms of earnings yield. One must keep in mind however, that current interest rates are still exceptionally low despite the Federal Reserve's recent moves to raise interest rates. Investing is all about alternatives, risk levels and therefore asset allocation.

The Federal Reserve's December rate increase of 25 basis points resulted in the federal funds rate of 1.25 -1.50%. They also indicated that three more rate increases could occur in 2018 depending on the rate of inflation and other measures of the economy's health. The prime rate is currently 4.5% versus 3.75% a year ago. The Federal Reserve's preferred measure of inflation, the personal consumer expenditures index, is currently 1.5% twelve months through November. This index, excludes energy and food, and at present is lower than other measures of inflation such as the consumer price index (+2.2% y/y) and the producer price index (+3.1% y/y). We should also mention that oil prices are at two year highs with West Texas Crude at $58 per barrel and Brent Crude at $65 per barrel. As mentioned in past investment letters, energy is a major ingredient of inflation. In summary, we believe that inflation will increase from current levels in 2018 against the background of a very strong economy and that bonds accordingly will be at risk with the 10-year Treasury bond yield rising to 3.0% from 2.49% currently. Since equities are also at historically high levels, a fall in bond prices could have an impact on equities. Since the Great Recession, equity and bond prices have tended to be closely correlated.

While we see no immediate risks in equities or bonds, we believe that because of generally higher valuations against the backdrop of more passive investing practices combined with the greater probability of higher inflation, that a conservative asset allocation should be maintained. As a result, we believe it is prudent to maintain an asset allocation of 52% equities, 20% bonds (corporate and municipal), 5% gold (up from 3%) and 23% cash (down from 25%). The reason for the latter change is our forecast of higher inflation.

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