Market Commentary

During my eighty-seven years I have witnessed a whole succession of technological revolutions. But none of them has done away with the need for character in the individual or the ability to think

– Bernard Baruch

Foreign stocks outperformed the S&P 500 for the first year since 2012 with the MSCI EAFE Index returning 25.6% and the MSCI Emerging Markets Index returning 37.3%, compared to the 21.8% return of the S&P 500. As discussed in previous commentaries, the recent outperformance of non-US stocks stems from a combination of lower valuation and increased economic growth in these markets. Both Europe and the emerging markets experienced recessions during the 2013-2016 period. These economies began to recover in 2016 and demonstrated sustained growth last year, which the market rewarded. We believe non-US stocks can continue to outperform given their lower valuation and continued global economic growth.

With economic growth and the recent tax cut, yields on US Treasury bonds increased last year. The yield on the ten year Treasury bond rose from a post-war low of 1.35% in July of 2016 to its current level of around 2.5%. The market expects inflation in the range of 2%, as evidenced by current yields on Treasury Inflation Protected Securities. While interest rates increased, we remain in the post-2008 Financial Crisis environment of close to zero expected real (net of inflation) returns. From 1900-2016 US government bonds returned 2.0% annualized net of inflation. To achieve this level of return today, the ten year Treasury bond would need to yield 4.5%.

Equity valuations reflect these low real yields. The textbook model of stock valuations begins with what an investor can return without risking loss of principal. Over a ten year period, this would be the return on the ten year Treasury bond. The model then simply adds then an extra 'risk premium' – or the amount of extra return an investor demands for assuming the risk of investing in stocks. Stocks are real assets, meaning that the returns will pass through inflation as companies will raise prices which will be reflected in nominally higher earnings and dividends. Given this, speculating about the future rate of inflation can be safely ignored in valuing stocks. In the same data set, US stocks returned 6.4%, net of inflation over the 1900-2016 period. Using the simple model above, this would decompose to a 4.4% extra return, or risk premium, that investors in stocks received over bonds. With 2.0% expected inflation today and a 2.5% ten year Treasury yield, the expected real return for bonds is now 0.5%. Adding the 4.4% historical average risk premium for stocks to the expected real bond return of 0.5% gives an expected real equity return of 4.9%, a substantial reduction from the 6.2% historical average. Adding back 2.0% inflation, the total, nominal return of US stocks would be 6.9%. To make matters worse, current valuations also imply a lower risk premium, and our analysis gives stocks a 4.2% expected real return over the next ten years.

Congress passed The Tax Cut and Jobs Act, which President Trump signed into law on December 22. Beginning in 2018, the top rate decreases from 39.6% to 37%. The bracket at which the top rate applies increased. For 2017, the top 39.6% rate applies to income above $470,000 for a married couple filing jointly. Income between $400,000 and $600,000 for a married couple filing jointly under the new code is taxed at 35% with the top bracket of 37% applying on income over $600,000. For example, $500,000 of ordinary income for a married couple filing jointly with the standard deduction would be taxed about $138K at 2017 rates, or about 28%.

Under the new code this same $500,000 of income would be taxed approximately $118K or about 25%. Tax rates on qualified dividends and long-term capital gains remain unchanged. The Act doubles the estate tax exemption, increasing it from $5.6 million per person to $11.2 million. In another significant change, 529 plans can now be used for primary and secondary education expenses up to $10,000 per child per year.

Formerly, investors were able to deduct investment management fees to the extent they exceeded 2% of Adjusted Gross Income (AGI). The Act eliminated this deduction, with the lower tax rates partially compensating for the loss of the deduction. Importantly, management fees paid within mutual funds or ETFs are not affected – these internal fees are netted against the income and gains within the fund, and investors continue to be only taxed on the net amount. Additionally, fees paid within IRAs are implicitly deducted and not affected by the change. The 3.8% net investment income tax (i.e. the 'Obamacare tax') on investment income was unchanged by the Act. This tax continues to be due on the lesser of a) investment income, and b) the amount by which total income exceeds $250K (for a married couple), but this calculation still allows the deduction of investment management fees.

The Tax Cut and Jobs Act dramatically reduced corporate tax rates from 35% to 21%. In simple terms, this means a 21.5% increase in after-tax income for a company formerly paying the top 35% rate. While this is a boon for the economy and corporate profitability, some caveats apply. Many industries will not obtain the full benefit due to their global operations and existing, complex tax sheltering arrangements. Additionally, companies with past unrepatriated (and therefore untaxed) offshore earnings will now have to pay back taxes on them at a lower rate of 15.5% spread over the next eight years. Apple, for example, currently has over $250 billion in past untaxed offshore earnings. They will pay approximately $39 billion to the US Treasury over the next eight years under this rule. While companies predominantly operating in the US, such as retailers or banks, will obtain the full benefit of the tax cut, eventually price competition will impact their initial increase in after-tax profitability. Ultimately, consumers, not companies, should benefit the most from the Act through lower prices. Uncertainty over the sustainability of next year's after-tax income gains could contribute to increased volatility in stock prices over the next few years.

With valuations, particularly in the US, becoming stretched and expectations rising, it makes sense to focus on maintaining a high quality portfolio that can withstand potential future volatility. The Tax Cut and Jobs Act likely will provide a modest boost to corporate profitability and economic growth, but does not materially change the investment environment. The past several years have seen considerable rotation between sectors and countries. 2016 was a year for value and dividend stocks, both of which lagged in 2017. MLPs underperformed last year, but are beating the S&P 500 so far in 2018. MLPs – owners and operators of pipelines, storage facilities, natural gas processing and most every other asset that connects the well to the power plant or the refiner – remain both the most frustrating and promising allocation in portfolios. With yields near 7% and sustainable 5-6% distribution growth, they remain one of the few assets whose current valuation supports a double-digit return. Maintaining a disciplined allocation and avoiding the temptation to chase performance remains the best strategy for long-term investment success.

- Stephen C. Browne, CFA
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