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January, 2018

- Presented by Kalos Management

Tax Reform and Deregulation Spur Economy and Markets

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Significant deregulation, improving consumer and business sentiment, and the prospect and eventual passage of tax reform have driven the S&P 500 up over 21% through the end of 2017, and the economy likely enjoyed greater than 3% GDP growth for the year. The U.S. bull market has now reached almost nine years in duration, making it the second longest since World War II. Given various positive developments, it appears likely that economic growth will not only continue but increase in strength pushing the U.S. stock market to new highs in 2018.

The anticipation of tax reform has driven much of the market's rise. The tax bill's corporate tax cut from a rate of 35% to 21% should boost S&P 500 earnings an additional 5% to 8% in 2018, adding to the previously projected 5% increase.

Tax cuts should also help economic growth by adding another 0.25%-0.50% to U.S. GDP in 2018. The drop in U.S. taxes will also impact actions globally and continue to boost U.S. growth longer term. A 21% U.S. federal rate creates strong incentives for European and Asian companies to invest in America rather than in their home markets. A report released by Germany's Center for European Economic Research simply declared "Germany Loses Out in U.S. Tax Reform."

Yet, in spite of the impact and attention given to tax reform, deregulation rather than tax changes is likely the most impactful Trump action of the year. His administration has been rolling back the regulatory state at a pace faster than even Ronald Reagan.

In Obama's last year in office, the Federal Register which lists new and proposed rules and regulations reached a record 95,894 pages according to a Competitive Enterprise Institute report, and Obama presided over six of the seven highest annual page counts ever. The American Action Forum estimates that his administration saddled the economy with an additional 549 million hours of compliance, averaging nearly five hours of paperwork for every full-time employee.

President Trump very publicly declared and has followed through on reducing bureaucratic regulations through executive orders. The Federal Register page count is down 32% this year, and much of the existing page count results from an ongoing implementation of rules put in place before Trump took office. President Trump's executive order directing his departments to scour the books for rules they could rescind or repeal, and also his mandate that agencies identify at least two regulations that could be eliminated for every new rule proposed are making an impact.

In addition to direct cost savings, potentially the larger impact is the reduction in uncertainty generally associated with new regulations and their enforcement. In the Obama era, CEOs and managers struggled to guess when or how a federal agency might create and interpret new rules. Lessening policy uncertainty has resulted in greater risk-taking and investment which is likely to continue in the coming years.

On matters beyond policy, manufacturing continues to look good in the U.S. with the manufacturing index hitting 58.2 in November. While the reading is down a bit for the second straight month, it's still running at a remarkably high level since a reading above 50 signifies growth. The latest data reveal a manufacturing sector growing solidly that has moved past distortions caused by last summer's hurricanes.

Internationally, the world continues to experience a very unusual level of synchronized growth with all 45 of the top global economies expanding. Goldman Sachs and Barclays among others predicted in December that global growth in 2018 will hit 4%. The Eurozone is finally breaking free of its slump after years of recession, high

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unemployment, currency crises, and political uncertainty, creating a future as bright as it has been since the 2008–2009 financial crisis. Of particular note, unemployment reached its pre-crisis level of 5.6% in October, and growth should reach nearly 2% in 2018.

China is expected to continue its modest deceleration in 2018 to around 6-6.5% while the government seeks to transition the country from a capital-intensive exporter to a more consumer-based economy. China should be able to maintain its financial stability throughout the shift and avoid a hard landing in 2018. In other Asian economies, forecasts remain strong with an average growth rate projected at 6.2% for 2018–2022.

Given the strength of the U.S. and global economy, the primary near-term risks to the ongoing expansion likely flow from U.S. monetary policy and an increasingly tight jobs market. Around 80% of major global economies are at full employment, and the U.S. unemployment rate should dip well below 4% in the coming months. The U.S. Federal Reserve is predicted to raise rates around 2% by the end of 2018. Rate increases and expectations for more offer up at least one significant risk in the seemingly otherwise positive environment, and a constrained job market can also cause significant problems.

Still, the many factors driving this equity market should continue into 2018 including low inflation and easy monetary policy, ongoing economic growth, strong corporate earnings, and more recently, deregulation and tax reform. GDP growth in 2018 should easily hit 2.5% and many are already predicting 3% with a few forecasts hitting 4%. A recession, which is the most common terminator of a bull market, seems very unlikely within the next year or two.

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While U.S. stocks are more expensive today in terms of earnings and book value than at any time since the tech bubble of the late 1990s, they still appear inexpensive relative to bonds and should continue to outperform based on various tailwinds. Still, risk is ever-present. Barron’s, a financial magazine primarily read by finance professionals, ran a headline on December 5th saying the market was in the middle of a “melt up” that would not last. The article argues that equity prices are moving too high too quickly, making a near-term reversal likely. On the same note, risk premiums for many asset classes appear slim. Given current equity valuations, most financial experts estimate that the ten-year outlook for global equities has declined to around the 4%–6% range with expectations for the U.S. market even lower. Good news abounds, but it’s largely been factored into prices already. Current market levels highlight the need for investors to remain disciplined and globally diversified while maintaining realistic return expectations.

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