SkyView Investment Advisors:

Economy and Markets - Outlook for 2017

February 2017

The Economy and Markets – Where We Are

These comments cover varied topics including proposed personal tax reform; the economic impact of fiscal policy proposals; and starts with the economic outlook and ends with the U.S. as the default position for political and economic stability—importantly, will that continue?

Looking out to the rest of 2017, the list of unknowns seems to be increasing if not daily, then weekly.

Economic Outlook

In their GDPNow publication, the Atlanta Federal Reserve forecasts 2.3% growth for the first quarter. In addition, the blue chip consensus forecasts of economists included in that publication shows their first quarter GDP forecasts ranging roughly between 1.7% and 2.6% growth.[1]

For investors, the earnings boost in the first quarter should come from the energy industry which will benefit from substantial increases in energy prices since last year. However, the relative strength of the dollar may offset some part of that energy industry improvement as it negatively effects the operating results of global U.S. companies. We are early into the quarter, so that the dollar impact could moderate. Overall, first quarter earnings per share growth should prove a positive for equity markets.

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The Remainder of the Year

Looking out to the rest of 2017, the list of known unknowns seems to be increasing if not daily, then weekly. Two key factors helping to determine the economic outlook for the remainder of the year will be the timing of both the Fed funds rate increases and the details of the proposed new stimulative programs.

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The Fed Funds rate will likely remain relatively low throughout 2017 and should not significantly affect the rate of economic growth.

Most observers expect either two or three Fed funds rate increases this year with the first likely to occur in June. With the Fed funds rate increases, the very accommodative monetary policy in place since the great recession will become less so. At the same time these increases come off a historically low base. Therefore, this key interest rate will still remain relatively low and should not significantly affect the rate of economic growth.

The timing of proposed stimulative fiscal policy changes such as tax reform will not likely pass congress until well into the third quarter. How rapidly these tax reform changes become effective will help determine the balance between these seemingly offsetting economic policies. Gradually reduced accommodative monetary policies could possibly restrain the economic outlook in the second half of this year before more stimulative fiscal policies take hold. If this proves to be the case, then the market outlook for the second half of this year will likely be more muted when compared to the hopes of investors at the beginning of 2017.

How Growing Debt Levels Will Likely Impact Increased Fiscal Spending

With higher interest rates, the interest expense burden on the Federal budget will grow rapidly even without new stimulative programs.

First let's look at the growth of the Federal debt relative to the economy. Since the first quarter of 2008, the relative impact of Federal debt held by the public increased from over 36% of GDP to 76%--or from over \$5 trillion to about \$14 trillion. At the same time, reflecting the decline in interest rates over the same period, Federal interest expense declined from 1.7% of GDP to 1.3% despite the substantial growth in Federal debt.[2] With higher interest rates, the interest expense burden on the Federal budget will grow rapidly even without new stimulative programs adding to Federal borrowings.

So let's take a look at the marginal impact on GDP from increased debt. Hoisington Investment Management Company recently published interesting ratios to provide some clues. In their recent *Quarterly Review and Outlook*, they showed that from 1952 to 1999 it took \$1.70 of domestic nonfinancial debt to increase GDP by \$1.00. More recently, from 2000 until 2015, it took \$3.30 of domestic nonfinancial debt to create a \$1.00 of GDP growth—or nearly twice the relative debt to GDP relationship of the prior 47 years. Over the long-term, 1870-2015, their calculations show it took \$1.90 of domestic non-financial debt to generate \$1.00 of GDP growth.[3]

Data suggests that new debt-financed fiscal programs will not generate the same bang for the buck they did in the past.

These comparisons suggest that the increased debt needed to finance new fiscal programs will not generate the same bang for the buck of debt that they achieved in the past. The first step for investors to make that judgement will begin as the details of new fiscal stimulative programs move through congress.

Higher Inflation May Effect Equity Earnings Multiples

One final economic force that may affect equity valuations will be inflation. Normally, as the business cycle moves into its later expansionary stages, it brings upward pressure to commodity prices. If the Fed continues to move to normalize monetary policy, this should also further signal this expansionary cyclical progression. At this cyclical stage, inflationary pressure will typically raise its ugly head through commodity prices. The possible introduction of destination based taxation will, initially, also add to commodity price inflation.

Commodity pricing pressures may lead a shift in inflation from financial to real assets.

Commodity pricing pressures may lead to a shift in inflation from financial to real assets. That may occur as the Fed further moves to a less accommodative monetary policy in order to restrain inflation. Then the earnings multiple expansion that resulted from distortions created by the Fed's very accommodative monetary policies may erode as the Fed further normalizes its policies to reflect the increasing inflationary pressures. If that proves to be the case, stock prices will more likely depend on earnings per share growth rather than either multiple expansion or share buybacks that benefitted from the Fed's past very accommodative monetary policies.

Personal Tax Reform and Investor Impact

In our last commentary, we reviewed the important proposed corporate tax reforms that the Trump administration and congress will consider. These reforms will create important changes for many businesses and likely change both their short and long term strategies.

This commentary turns to proposed personal tax reforms and the most important changes impacting investors. According to most observers, the proposed personal tax reforms will likely show less of an impact on the economy than the proposed corporate tax reforms.

To begin, both the Trump and House proposals look to reduce the top individual tax rate from 39.6% to 33%. In addition, the two proposals repeal the 3.8% Obamacare tax on investment income and the alternative minimum tax (AMT). Of interest to some, the Trump proposals tax carried interest at ordinary tax rates. And finally for the young inheritors among our readers, the proposals would eliminate the death (estate) tax.

If the House proposal becomes law with a 16.5% tax rate on interest income, tax-free municipal bonds will lose attractiveness.

Affecting investors will be reductions in the current tax rates on capital gains (23.8%), dividends (23.8%), and interest income (39.6%). The House proposal would tax all three at a 16.5% rate. Trump's proposals would tax capital gains and dividends at 20% and interest income at 33%. If the House proposal becomes law with a 16.5% tax rate on interest income, then the attractiveness of tax free municipal bonds will be greatly reduced. In addition, the timing of reduced capital gains rates may cause some investors to delay taking long-term profits until the new tax rates become law.

If higher standard deductions reduce the need to use the mortgage interest deduction, will home ownership rates decrease as a result?

One other major change increases the current standard deduction of $12,600 for joint filers. The House proposal would increase the standard deduction for joint filers to $24,000. The Trump proposal would increase it to $30,000. [4] As a result, the number of taxpayers using the standard deduction could sharply increase. With higher standard deductions, the House Ways and Means Committee estimated that only 5% of taxpayers would itemize their deductions compared to 35% currently.[5] While the mortgage interest deduction would remain, the higher standard deductions would reduce the need to use it. And that brings up the question as to whether the reduced attraction of the mortgage interest deduction would further lower the rate of home ownership contributing to increased demand for rental properties— both apartments and single family houses.

Personal Tax Reform and Investor Impact

Financial Markets

We remain cautiously optimistic for the first half of 2017.

With the potential for substantial changes in monetary, fiscal as well as trade policies, financial markets face much to absorb this year and next. We remain cautiously optimistic for the first half of 2017 based on the positive economic and earnings outlook. The economic outlook for the second half of 2017 and first half of 2018 will importantly reflect more details on some of the issues raised in this commentary. Financial markets will reflect the judgements of investors as these details become somewhat clearer to them.

The U.S. as the Default Market

We now turn to what could affect our cautiously optimistic outlook. Financial markets reflect, in part, the political stability of their countries. The U.S. in recent history, represented the global default position of stability with the inherent premium that brings to our financial markets.

Since the beginning of this century, our political system in Washington increasingly became dysfunctional. For the most part, this standoff stayed in Washington and did not importantly infiltrate the rest of the country.

Hopefully, the U.S. will be able to maintain its premium for political stability among the democratic nations of the world.

We now see a change. The standoff in Washington seems to be spreading to other parts of the United States. Social networks contribute importantly to that outward movement. This result increases the possibility that even the important policy proposals described in this and our prior commentary may not be enacted. Most likely, my concerns will prove to be overstated. If not, the financial markets ultimately will take note that our country's default position of political stability no longer may prove to be the case. Hopefully, the U.S. will continue to earn its default premium for political stability among the democratic nations of the world.

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Sources:

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