CUMBERLAND

INFLECTIONS

It seems as though the Christmas season kicked off with the US Presidential election instead of the traditional U.S. Thanksgiving weekend. Is this market for real or is everyone on a sugar plum high and way ahead of themselves? I won't keep you in suspense; I think we're at an inflection point provided President-elect Trump can deliver. But let's not give him all the credit. There were a lot of positive things going on in the market before he got elected. His victory was simply a shot of adrenalin that amplified their impact.

So, it might be helpful to review the foundation underlying this market before we layer on the Trump effect.

The reality is that the market started to change its complexion last spring. That change was set back by the Brexit vote but reasserted itself in July, resulting in a pretty good third quarter. The November election just amplified those changes.

I refer to them as inflection or changes in direction for some of the major "macro" factors influencing the market.

There were four changes already apparent before the election:

1. Interest Rates – the only issue remaining for the Federal Reserve was deciding when they were going to raise rates.
2. Economy - as I said in my last quarterly, the economy was already showing signs of improvement as the price of oil stabilized.
3. U.S. Fiscal Policy – it was shifting from austerity to stimulus. Regardless of who won the White House, there was talk of more government spending and infrastructure projects.
4. Inflation – it was showing signs of picking up as a tightening labour market was starting to put pressure on wages.

On balance, these shifts were good for economically sensitive stocks and bad for fixed income and bond substitutes. According to Reuters, the S&P 500 companies are expected to report a 6.2% improvement in their fourth quarter bottom line.

The Trump election poured a little gasoline on these embers of change and he added two more.

The 10 year bond yield had already bounced from its July 8th low of 1.37% to 1.88% by election day. By year-end, it had risen another 57 bps to 2.45%. Trump's stimulus package plus tax cuts will likely increase the U.S. budget deficit and more borrowing in theory should push bond yields higher.

On the economic front, tax cuts, repatriated foreign earnings, infrastructure spending, deregulation and adjustments to the trade policy will help stimulate GDP growth.

Fiscal stimulus will also be greater under a Trump administration as the government will run larger budget deficits.

And finally, inflation is likely to be higher under Trump's proposals as trade and immigration regulations could raise the cost of goods and labour.

Besides amplifying these existing trends, Mr. Trump added two addition elements.

First, deregulation. This is a huge inflection from the Obama administration. Although it is very hard to quantify, it will be a significant positive to economic growth.

Second, optimism. Consumer confidence and small business owners' confidence have spiked sharply higher since the election. Having the wherewithal to spend and invest has existed in the U.S. economy for some time. It's been frustrating for the Federal Reserve that they haven't seen that capacity exert itself in the economy. What has been lacking is confidence and willingness. The polls indicate this is about to change.

So, is all of this for real? While there are pros and cons, the stock market's overwhelming vote is that it is positive. So let's take a look at how some of the inflections plus Mr. Trump's agenda are going to help investors. Although we don't know his priority nor the intensity of his support, his stated objectives are:

1. Corporate and personal tax reform, including a tax break on foreign cash holdings;
2. Deregulation;
3. Repeal and replace Obamacare;
4. More infrastructure spending;
5. Renegotiate trade deals and immigration policy.

The biggest impact on earnings will come from the proposed reform to corporate and personal taxes. To appreciate how significant this is, let's set a baseline of pre-election expectations. The current official corporate tax rate is 35%. However, very few companies pay that rate after using deductions and aggregate numbers are influenced by companies reporting losses, as did the energy companies last year. Consequently, the effective tax rate is estimated to be somewhere between 25% and the S&P estimate of 29%.

Trump has proposed a cut to the official rate to 15% while House Speaker Ryan has proposed 20%.

Estimates equate a 1% cut to the effective rate to $1.82 per share increase in S&P 500 earnings. In other words a 5% cut could amount to a $9.10 increase in earnings while a 10% cut equates to over $18, assuming cuts are retroactive to the beginning of the year. S&P 500 consensus earnings expectations for 2017 were $128 preceding the election but have crept up to $132.63 currently, probably due to better than expected third quarter earnings. That would be a 12.2% improvement over 2016, not unrealistic if you consider that the energy sector, which has seemingly stabilized, reduced earnings by 7.3% in the past year. That puts the S&P 500 at 16.88x 2017 earnings which is a bit lower than its recent peak but still expensive and the biggest impediment to any further market advance.

However, analysts have not yet incorporated tax reform into their estimates. If one assumes a 5% effective cut then the 2017 estimate moves to $141.73 and the market multiples of earnings improves to a more reasonable 15.8x and a 10% cut gets us to 14.8x, which would go a long way to alleviating the market's overvaluation. However, tax cuts are a one-time event and thus, they probably deserve a lower price earnings multiple.

Regardless, it is important to appreciate that the benefits from Trump's proposals have yet to be quantified in earnings estimates. Furthermore, no one is certain when these changes will take effect. Consequently, many market strategists have moved on to focus on 2018 earnings which will be the first full year of implementation.

That takes us to the current 2018 estimate for the S&P 500 of $148.16 – before tax adjustments, which could push the earnings per share number to between $157 and $166. Now we're getting positively cheap at 14.2x to 13.5x earnings. No wonder the market was up 4.6% since the election.

The impact from personal income tax reform is hard to quantify but one can assume that it is likely to be a positive as it will increase after tax personal income. Some of that is likely to get spent.

There is also the impact on earnings from a tax reduction on repatriating cash from overseas. It's estimated that there is $2 trillion in offshore retained earnings. If one assumes that $1 trillion is repatriated and 35% goes toward share buybacks, it would represent a 72% increase over the $485 billion in stock repurchases last year. This would equate to 1.8% of the S&P 500 market capitalization, $350 billion in repurchases could add 1 – 2% to earnings per share, another $1.42 to $2.83 per S&P share.

Deregulation will be another unquantifiable positive. As we said earlier, business confidence is up dramatically as seen in his chart

In a survey of CEOs, last year was the 5th in a row when they said that regulation was their greatest cost pressure. Furthermore, nearly one fifth of the respondents to Duke University's business outlook survey said that their increased optimism has led to an increase in hiring and business spending plans for 2017. CFOs now expect capex to increase 1.4% in 2017 which is up from an earlier projection of -0.4%.

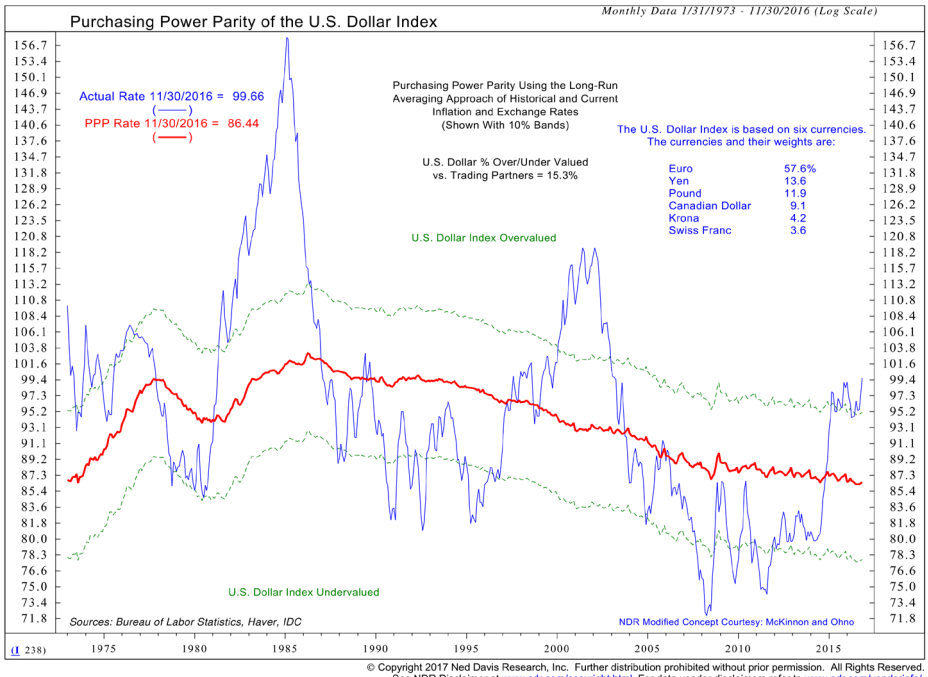
Increased infrastructure spending will also help the economy and certain companies. However there is a negative associated with more government spending in that it will increase the budget deficit and push interest rates higher. Furthermore, the Federal Reserve has gone on record as saying that additional fiscal stimulus at this juncture will probably accelerate their normalization of interest rates. It's an interesting shift for the Fed which has repeatedly asked for help from fiscal policy to pick up for the reduced impact from monetary policy. Obviously, the Federal Reserve must be feeling much better about economic prospects now that they are concerned that additional stimulus could result in labour shortages and more inflation. Although interest rate increases will not immediately be transferred to corporate income statements as most corporate debt has a fixed term, there are estimates that a 100 bps increase in rates will equate to $1.30 hit to 2017 S&P 500 eps.

Higher interest rates could also put further upward pressure on the U.S. dollar. Yardeni Research equates a 2% change in the dollar to a 1% change in S&P earnings as about half of the S&P revenues come from overseas. Deutsche Bank estimates that a 5% increase in the dollar would translate into a 3% impact on earnings and a 50 bps hit to GDP.

The dollar is already up about 5% since the election. Using Yardeni's sensitivity, it suggests a $3.32 hit to the 2017 earnings estimate assuming that tax benefits would not be affected.

The impact from renegotiating trade deals and changing the immigration policies are difficult to quantify. There is also talk of a border tax which would be very difficult to execute. Generally these changes would likely be inflationary as they raise the cost of goods and labour. They will specifically hurt importers and retailers while helping exporters. One also has to assume that higher inflation will equate to higher interest rates and potentially a higher dollar. Both of these would be negative for equity earnings and also valuations as price earnings ratios would likely be pushed lower.

The only mitigating factor is that the dollar is already overvalued by about 14% on a Purchasing Power Parity model, as seen in this chart.



Nonetheless, trade restriction could be one of the bigger potential threats to an otherwise positive outlook.

If we try to quantify the Trump initiatives for the S&P 500 earnings it might look like this.

Trump's S&P500 Score Card		
Quantifiable		
Corporate tax cuts	-	+$9.10 to $18.20
Share buy backs	-	+$1.42 to $2.83
Interest rates 100 bps increase	-	- $1.30
Dollar, 5% appreciation	-	- $3.32
Unquantifiable		
Individual tax cuts	+	
Deregulation	++	
Optimism	+++	
Trade and Immigration	---	

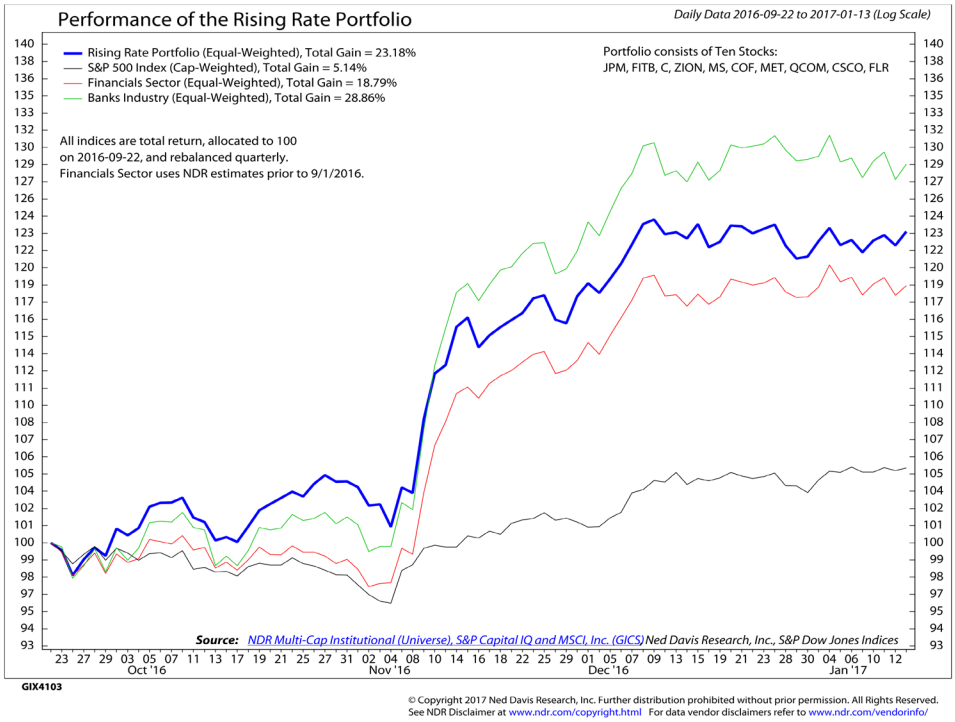
In summary, the conservative estimate will get you to $138.53 or 16.16x 2017 adjusted estimates. Not bad but not cheap. However, if one wants to look out to 2018, the market still has upside.

The apparent observation from this exercise is that the general overview is quite positive but the two risk issues that bear watching are trade policy and the value of the U.S. dollar.

Stock Market

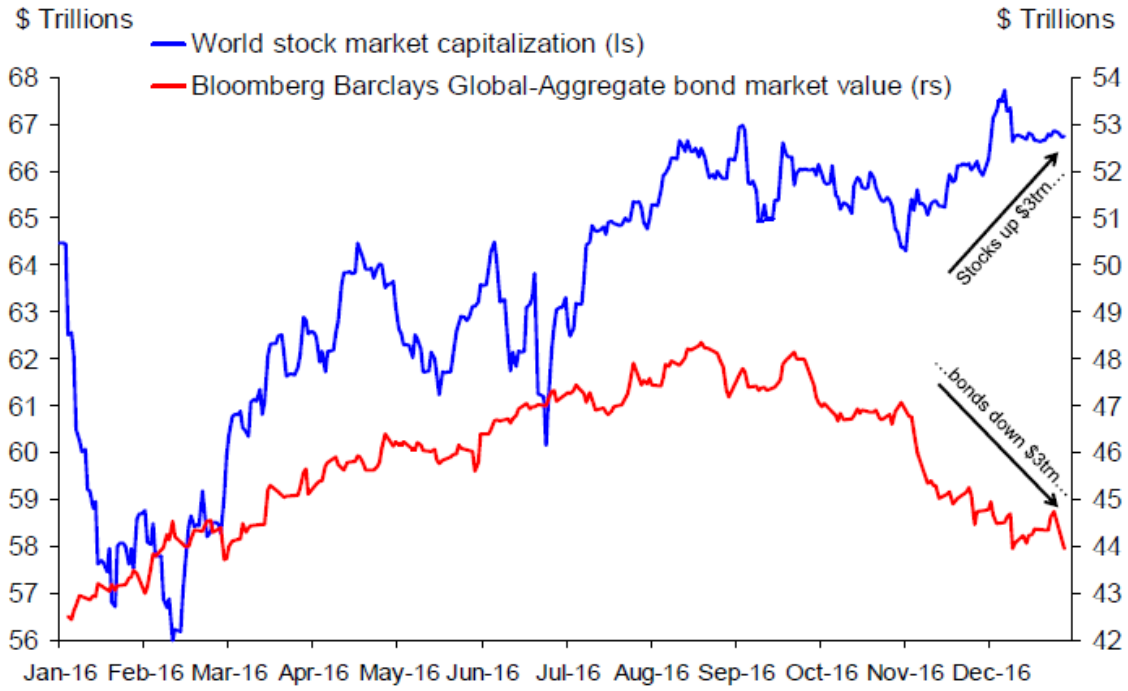
With this back drop, we can identify several inflections for the market that complement our macro ones. As we said in our fall quarterly, we expect the market to experience a significant rotation in sector performance. Our market inflections would include:

1. Interest rate sensitive to earnings sensitive. A shift in focus from straight yield to yield spread. This will benefit banks, consumer finance companies, and capital markets which have all outperformed the S&P by 1000 bps since July 5th. You can see in this chart how a portfolio of companies correlated to higher interest rates has performed relative to the market.

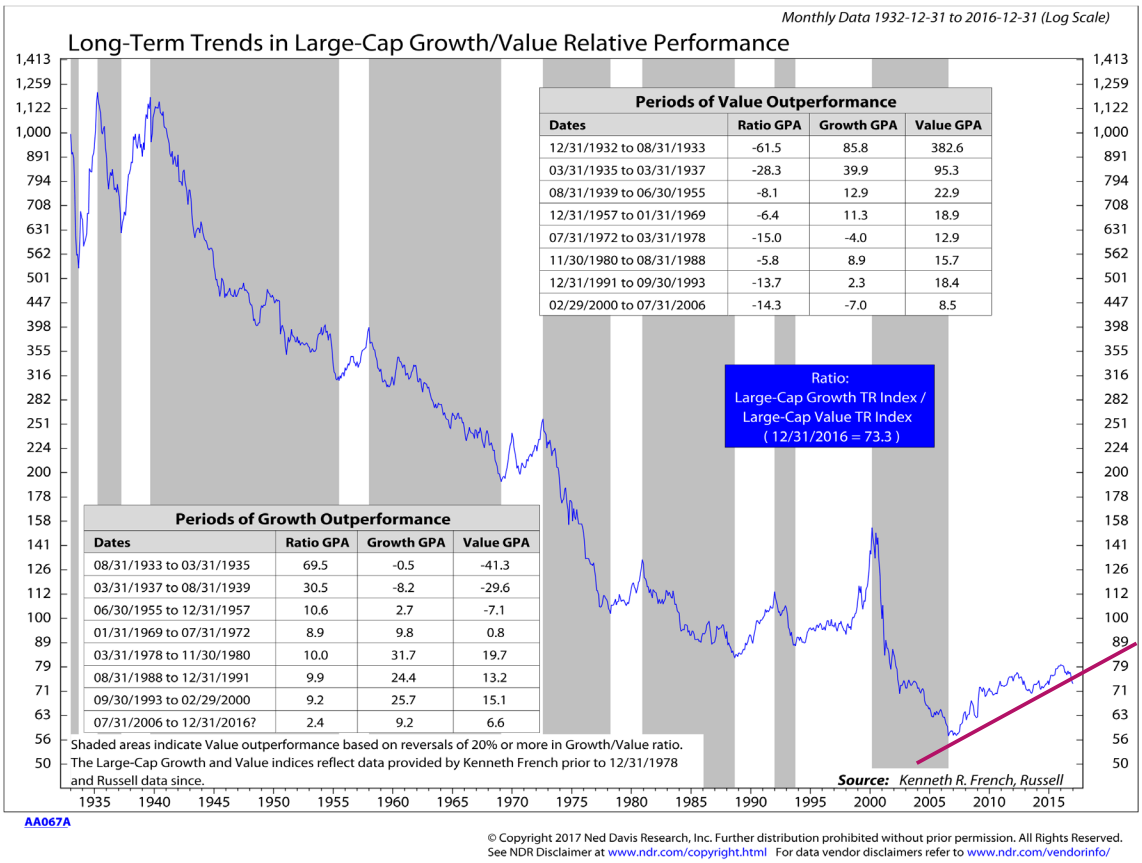


2. Shift from bonds to equities. Investors' transition from a deflation bias to reflation coincident with the bottoming of oil prices. This rotation could have a significant impact on the market as seen below.

Since the US election in Novevmber roughly $3trn have moved from bond markets to stock markets



3. A rotation from growth strategies to value investing. An accelerating economy will benefit the earnings of value stocks. We've also witnessed an extended period of growth strategies outperforming value strategies as seen in this Chart, which has now extended at ten years.



Periods of Value Outperformance

Dates	Ratio GPA	Growth GPA	Value GPA
12/31/1932 to 08/31/1933	-61.5	85.8	382.6
03/31/1935 to 03/31/1937	-28.3	39.9	95.3
08/31/1939 to 06/30/1955	-8.1	12.9	22.9
12/31/1957 to 01/31/1969	-6.4	11.3	18.9
07/31/1972 to 03/31/1978	-15.0	-4.0	12.9
11/30/1980 to 08/31/1988	-5.8	8.9	15.7
12/31/1991 to 09/30/1993	-13.7	2.3	18.4
02/29/2000 to 07/31/2006	-14.3	-7.0	8.5

Periods of Growth Outperformance

Dates	Ratio GPA	Growth GPA	Value GPA
08/31/1933 to 03/31/1935	69.5	-0.5	-41.3
03/31/1937 to 08/31/1939	30.5	-8.2	-29.6
06/30/1955 to 12/31/1957	10.6	2.7	-7.1
01/31/1969 to 07/31/1972	8.9	9.8	0.8
03/31/1978 to 11/30/1980	10.0	31.7	19.7
08/31/1988 to 12/31/1991	9.9	24.4	13.2
09/30/1993 to 02/29/2000	9.2	25.7	15.1
07/31/2006 to 12/31/2016?	2.4	9.2	6.6

4. Prominence of the Federal Reserve and monetary policy will diminish in favour of dominance of fiscal policy.

On balance, we're positive on the market and feel that the "Trump Bump" that we have seen is justified. Where it will go from here depends on the new administration's ability to execute their agenda. Certainly there is some expectation built into this market but as we said earlier, there were some favourable trends already in place before the election. Trump has amplified them but they are not likely to reverse even if he is unsuccessful with his agenda. Right now expectation is pretty high but a 4.3% increase in the S&P 500 since the election is not inconsistent with what we have seen in other presidential elections and certainly doesn't discount the full potential of Mr. Trump's promises.

Nevertheless, we're about to move from the pilot project to the reality show and any disappointment versus expectation will likely be ill-received by the market.

So, let's look at some of the reality checks he's likely to experience.

1. There has been some bold rhetoric around trade, immigration and foreign policy that is worrisome. However, there is quite a contrast between what President-elect Trump says and what his advisors are saying. Are they not on the same page or does Trump set the negotiating stage from a bully pulpit only to let his cabinet members do their job? I'm hopeful Mr. Trump's rhetoric is designed to create "table stakes" for negotiations and his extreme remarks are intended to generate the appearance of a legitimate threat. In other words, adversaries worry that maybe he is crazy enough to do something stupid.

   To date he has been an equal opportunity abuser. Whether you are corporation (Boeing, Ford, GM) or a foreign government (China, Mexico) or involved in a merger (Time Warner and AT&T), Trump has taken them on verbally if he thinks their practices are unfair. And, in most cases, there has been a compromising response from the victim without the need for legislation. It is interesting to note that Mr. Trump has already softened his stance on a number of issues including immigration and has yet to publicly denounce any contradictory comments from his advisors.

   Some of the inconsistencies would include:

   A. A wall at the Mexican border would not be effective, a blanket ban against Muslims is wrong and climate change is a threat.

   B. James Mattis (Defense Secretary) is opposed to torture and would support the Iranian nuclear agreement.

   C. Rex Tillerson (Secretary of State) – considers Vladimir Putin a regional and international threat. Rejected a ban on Muslim immigrants. Is committed to NATO. Favours remaining a party to the global climate accord reached in Paris in 2015.

   D. John F. Kelley (Department of Homeland Security) said that "a physical barrier (wall with Mexico) in and of itself will not do the job".

   E. Jeff Sessions (Attorney General) says that he does not support the idea that Muslims, as a religious group, should be denied admission to the United States.

   Trump's unconventional views may need a reality check not only in Congress but also from his own advisors – the reality of governance.

   Trump's response is that he will keep "an open mind to it". So let's hope that a more rational President prevails over concerns about his extreme policies.

2. There is the uncertainty of legislation being passed. Although Congress is Republican, there is a disparity of views on several issues. Washington has a reputation for being somewhat slow moving and intransigent, and Trump is unlikely to change how the system works.

3. There is also the complexity of the bureaucracy and its rules. As an example, one of the pieces of legislation that does seem to have support is tax reform. To accomplish his proposals he would have to put his changes to a vote of the Senate which would require 60 votes. Unfortunately, the Republicans only have 52.

   Their alternative is to use the "reconciliation method" to pass the legislation which only requires a simple majority. Unfortunately, tax reform must be revenue neutral over ten years and the Trump/Ryan proposal is not.

   Furthermore, it took over four years to implement the last tax reduction plan.

4. He has conflicts in his stated goals. If you go back to basics, you can only have economic growth if you have either improved productivity or more workers. That's the only way you can make more stuff.

   Growing the workforce will probably require more immigration. Improving productivity will probably eliminate jobs. There is a choice to be made here that conflicts with his stated goals.

Conclusion

Last year's market had the worst start in history. Leading up to the election, the S&P 500 had fallen for nine straight days, its longest losing streak in 36 years.

If you had known the UK would vote to leave the European Union and that Donald Trump would win the Presidency, it's doubtful that you would have expected the market to finish higher.

So, even with the clarity of hindsight, it is difficult to explain why markets do what they do.

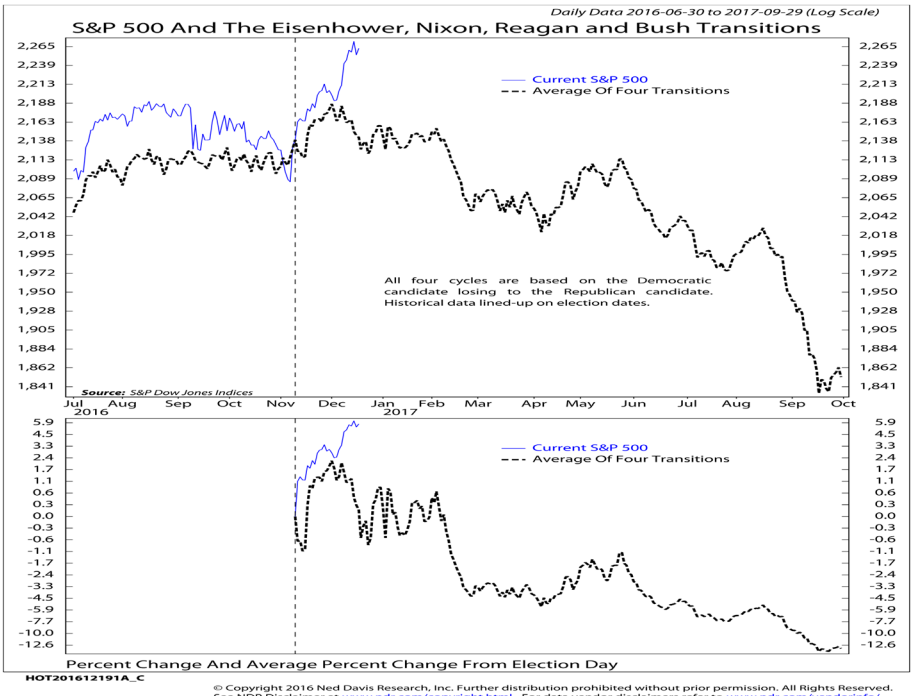
Nonetheless, we'll go on record as an optimist for this year, at least the first half. Given Trump's proposals, especially on tax which has a reasonable probability of passing, earnings and the economy should improve. More importantly there is likely to be some significant differences in performance between sectors. Financials could do very well as they benefit from low taxes, higher interest rates, economic improvement and more active capital markets.

Importers, on the other hand, may not fare so well. I just hope my local Corona distributor makes it.

In the back half of the year, we're likely to see more sorting out between reality and expectation and disappointment will hurt.

For the very short term, the market is a little stretched. Sentiment indicators have gone from 14% bulls on November 4, 2016 to recently as high as 83%. It pays to lean against the crowd.

History is also mixed on the subject.



As you can see in this chart, the market has not been kind to transitions from Democratic to Republican Presidents, with an average loss of 10.4%

However, the combination of a Republican President with a Republican Congress has resulted in gains averaging 7.03%.

Bottom line, we'll give President-elect Trump the benefit of doubt and assume he will deliver on at least some of his proposals. Furthermore the heavy lifting is really dependent on American business. Right now, they are optimistic and will have the regulators off of their backs. This is a much bigger factor than most understand.

Furthermore, there is more substance to this market in the context of the inflections we outlined earlier than just Mr. Trump. Interest rates, economic growth, fiscal policy and inflation were all headed higher before the election. Optimism and deregulation are bonuses that could be quite significant in unleashing America's economic potential.

However, in the longer term, I'm a little more concerned. Market valuation has been our issue for some time but tax cuts should put it back on side. Yet, there are other issues. Consumer and business confidence is quite high, the labour market continues to improve, the Federal Reserve is starting to tighten monetary policy and payroll costs are accelerating. These factors are more consistent with market tops than bottoms. But, for now, let's consider them late cycle indicators and enjoy some of the optimism that this market is experiencing.

Nonetheless, as I said to a colleague, *I feel so good, I know I should be worried*.

GRC/amh
January 12, 2017

Credits:

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