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2017 Third Quarter Review
"Tax Reform"

The equity markets have defied the sceptics and continued to march higher during the third quarter. It was a pretty impressive showing since even the specter of nuclear war couldn't put a dent in the averages. Oftentimes the months of September and October produce a scary ride or at least a few good jolts to investors. This year produced the calmest autumn in decades with a noted absence of swoons even with a good dose of what might be considered pretty bad news.

By the end of September the S&P 500 was up 12 ½ % while smaller stocks represented by the Russell 2000 Index had climbed 9.85%. Technology stocks continued their strength while smaller company stocks lagged those of their bigger brethren. Even though the Federal Reserve Board is committed to raising interest rates, bonds have not suffered as might have been expected. It appears that the rate increases may be more gradual and will therefore provide less of a jolt to fixed income prices. Long and medium term US Treasuries rallied through August and dipped in September, but are generally positive in price for the year.

Somewhat paradoxically, the economic damage caused by the recent flurry of hurricanes has provided an economic boost as vehicle, equipment, and building supply sales have ramped in the aftermath of the storms. Although the weather was a disaster on a local level for many, it has been another stimulus to the economy and to the equity markets.

One of the reasons for the recent rise in the stock market appears to be the possibility of corporate tax rates being reduced from 35% to something around 20%. Lower tax rates would imply greater value to stocks in general. On the face of it, this would be a reasonable catalyst for higher stock prices as more revenues would fall to the bottom line in profits. However, the lower rates will come with the elimination of many deductions. Once again, 'the devil is in the details." Without knowing the specifics of the plan (which no one knows) it is difficult to pick the corporate winners and losers. Once the details are announced, that will only be the beginning of the haggling. As one analyst described it, "This will be the Super Bowl for lobbyists." Corporate special interests will mobilize and try to influence the drafts to their favor, as is always the case. The market will likely react once the plan is announced, but even then final outcome will be far from certain. Consequently, some investors opt to "play" the reaction to reduced taxes by buying the indexes on the near term as the benefits will be spread among the many.

Some investors are also excited about the possibility for tax incentives to encourage companies to "repatriate" (bring back to the U.S.) the corporate cash balances that have been accumulated by American companies abroad and are still being held by their foreign subsidiaries. The thinking is that this cash will then be used by those companies to invest more heavily within the United States. Repatriation of the foreign profits of US companies may not create the anticipated effect on the domestic economy since much of the money may already be held in the U.S. by domestic banks, only registered in the name of

foreign subsidiaries. We will soon learn more about the details of proposed tax changes and will react accordingly.

Last quarter's letter outlined the many risks to the market in some detail. There's no doubt that, by most historical metrics of value, the stock market is expensive. The well-known "value investors" at Grantham Mayo in Boston are quite blunt about it, writing in their recent report:

"The average US stock has never been more expensive than it is currently. We have never seen such broad-based overvaluation of US equities. We are facing an exceptionally expensive stock market." "The cruel reality of today's investment opportunity set is that we believe there are no good choices from an absolute viewpoint – that is, everything is expensive. You are reduced to trying to pick the least potent poison."

As we've noted before, it stands to reason the level of overvaluation is usually rectified by either an increase in corporate profits or a decrease in stock prices. We have to be mindful of the fact that it may be the profits that will rise to justify current prices. That is what the bullish investor would say. Profits for the companies in the S&P 500 Index increased by 10% for the second quarter. This built on similar growth in the first quarter. Unemployment has remained steady and inflation (as measured by the Fed) has remained low. We may be seeing the beginnings of a world-wide resumption of robust economic growth. Value investors would say that we'd better be seeing that, or else stocks will likely come down to compensate.

For those of us who are in it every day, lately it is as if the stock market will not and cannot go down. We know that is not true, but it begins to feel that way after such a steady and relentless advance. I am reminded of the old saw that the stock market "goes up like an escalator, but comes down like an elevator." It is in times like these that we may need to remind ourselves not to become complacent and expect a new era of placid investing.

It should go without saying that most people who are in or near retirement should not be 100% invested in stocks and, therefore, should not expect to capture 100% of any market rise. However, if you would like to increase or decrease your exposure to equity markets, please call me and we can make adjustments accordingly.

Please review the enclosed statements at your convenience and contact me with any questions or suggestions you might have.

Sincerely,

Claude Carmichael CFA