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Surprise, Surprise…

By Anish Ramachandran, CFA

None of the so-called statistical pundits saw it coming, but the United States' unexpected election of Donald Trump as president has been a game changer for both stocks and bonds, thus far. Stocks have rallied since November 9, fueled by investor enthusiasm for Trump's pro-growth agenda, whereas bond yields have climbed approximately 0.7 percentage points due, in part, to fears of higher interest rates and inflation. I must admit, given that I gave Trump a slim chance in the election, I did not pay much attention to his economic agenda. However, since his election, after having gone over some of his ideas, I am somewhat surprised. In this article, I will explain some of his proposals that we may see being implemented and assess the kind of impact they may have on the economy and the financial markets.

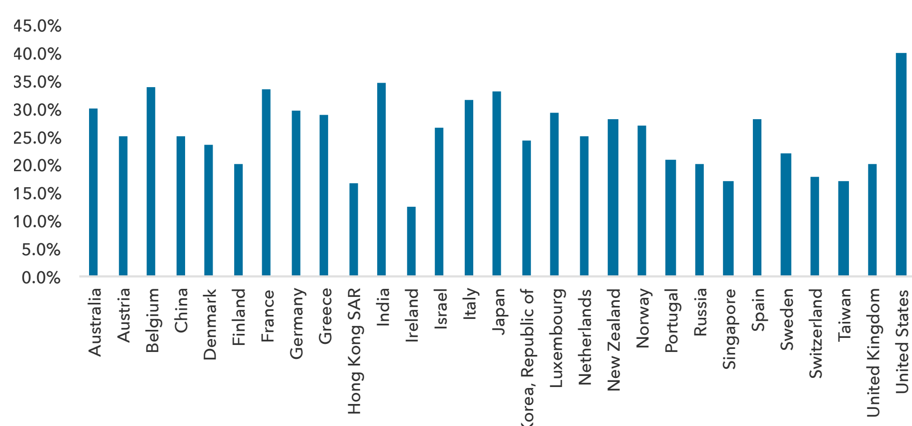
Corporate Tax Reform

Both Donald Trump and U.S. Congress are on the same page with regard to reducing the marginal tax rate for corporations. Trump has proposed a reduction from 39% to 15% while Congress suggested a decrease to 20%. Both think that lowering this tax rate will prevent firms from moving their operations outside the U.S. Compared to most nations, the U.S. has a higher marginal tax rate as the chart below shows, but, we all know that firms really don't pay 39% in taxes. The effective tax rate for firms in the U.S. is just below 20 percent, and, just like everything, varies according to the source.

My opinion aside, assuming that Congress finds other ways to generate some tax revenue to not balloon the deficit, a reduction in the corporate tax rate will benefit domestic companies. In the aggregate, lower taxes will translate to higher earnings, and should, in the short term, be beneficial for stocks. In addition to the tax rate reduction, both Trump and Congress have proposed repatriation for untaxed foreign profits at close to a 10 % tax rate.

The argument is that if corporations are allowed to bring their foreign cash over, they can invest it domestically back into their business and help the overall economy. This type of repatriation was done under the 2004 American Jobs Creation act, where over 800 companies brought back close to 300 billion in foreign earnings. About 80 billion of it was used to reward shareholders and I would imagine something similar could happen this time around. Some of this money could be used to pay down debt which also helps in cost reduction as the interest burden gets reduced. I am under no illusion that repatriation will help create a ton of jobs, especially at these low levels of unemployment. I do think lowering taxes and bringing cash back will help the company earnings, which is good for stocks in the near term.

MARGINAL CORPORATE TAX RATES (2015)



Source: www.damodaran.com

Deregulation

The incoming administration has proposed reducing the regulatory burden, especially for firms that are in the energy and financial sectors. As far as energy is concerned, the new administration has talked about energy independence that could potentially result in expanded drilling, easier deployment of pipelines and easing of environmental regulations on coal production. Making pipeline installations easier will benefit some energy companies, and eliminating certain restrictions on coal production may slow its decline, but these are unlikely to replace the use of natural gas and renewables as they get cheaper and more environmentally friendly.

The financial sector, which rightfully carried much of the blame for the Great Recession, was at the receiving end of some of the most stringent regulations that were instituted in the last eight years. Trump has already talked about repealing Dodd-Frank, which would be difficult, but it will almost certainly be amended. Softening Dodd-Frank will allow financial companies (mostly banks) to reduce expenses related to compliance, and lower capital requirements will allow them to take on more projects that will add to both revenue and earnings. What may be good for banks may not necessarily be good for the consumer, but the bottom line for financial companies should improve in the coming years. The market is already anticipating higher profitability, which has made financials the best performing sector post-election.

Infrastructure

Infrastructure spending is a topic that has received intense attention since the election. Trump has proposed a $1 trillion infrastructure plan leveraging private and public partnership to lessen the impact on the deficit with the main goal of increasing GDP growth. One can make the argument that stimulus would have been more beneficial to the economy when it was operating at 7 or 8 percent unemployment rather than the current 4.6 percent because it would have employed more idle resources at the time. With unemployment at 4.6 percent, it may be that resources will be taken away from another place to make this happen. The supporters of this plan cite the 9.3 percent unemployment rate that includes all individuals that can be employed but are not working. They think that a stimulus of this magnitude has the potential to bring some of these people back in the labor force, which will add to the economic growth in the coming years. I would have preferred a stimulus five years ago but I'll take it now as I think it will likely be positive for the economy, although, of course, it may carry with it the unintended result of higher inflation.

International Trade

Trump has been very vocal about bringing jobs back to the U.S. from abroad, especially in manufacturing. To achieve this, Trump has talked about withdrawing from or re-negotiating certain trade deals and imposing tariffs on some trading partners. These are actions that I would view as being disruptive to the economy and could overshadow the other growth initiatives in his policy. The last thing the U.S. needs is a trade war that leads to higher uncertainty and disrupts the domestic economy since many firms rely on international inputs for their business. Although this was a key campaign talking point, I expect some re-negotiation to happen; but on the tariff front, I expect all noise, and no action, as Congress wants to avoid any negative shock that can take the country into a recession.

Stocks, Bonds and the Dollar

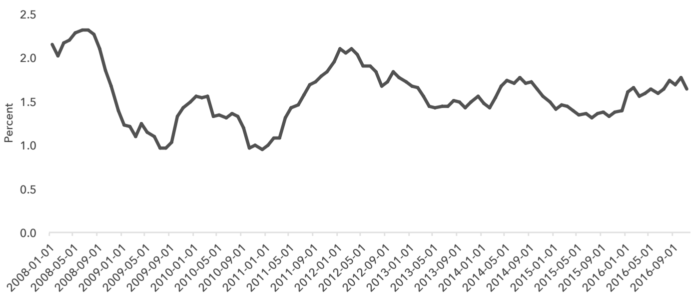
One can see that most of the major proposals presented by the incoming administration are pro-growth, which is typically better for stocks than it is for bonds. Since the election, the S&P 500 is up approximately 6% and the Barclay's Aggregate bond index is down approximately 2.7%. The next chart perfectly illustrates the current market sentiment.

SINCE THE U.S. ELECTION IN NOVEMBER, ROUGHLY $3 TRILLION HAVE MOVED FROM BOND MARKETS TO STOCK MARKETS

Source: Bloomberg Finance, LP, DB Global Markets Research

If we can look past the confusing axes, what we see is money that came out of bonds went into stocks because the growth policies are expected to help the economy and companies earn more. But what about these growth policies caused the outflow from bonds? The answer is expected inflation, as it is one of the key determinants of bond yields. Since the Great Recession, the inflation rate, as measured by Personal Consumption Expenditures excluding Food and Energy in the U.S., has been well below the Federal Reserve's target of 2%.

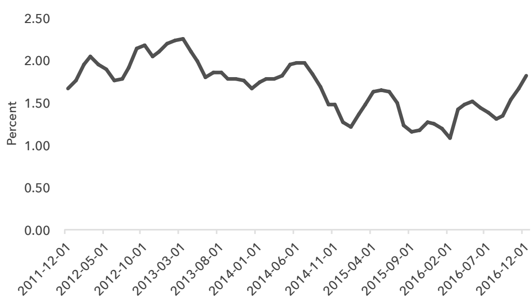
PERSONAL CONSUMPTION EXPENDITURE EXCLUDING FOOD AND ENERGY



Source: U.S. Bureau of Economic Analysis | fred.stlouisfed.org

Future inflation expectations, as measured by the 5 year breakeven inflation rate, were also below the Federal Reserve's target prior to the election, but have since seen a big jump.

FIVE-YEAR BREAKEVEN INFLATION RATE



Source: Federal Reserve Bank of St. Louis | fred.stlouisfed.org

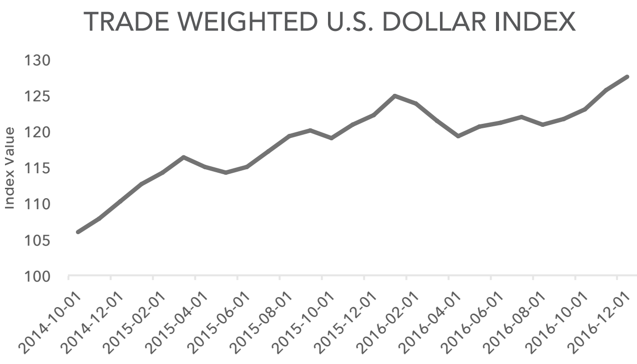
Higher inflation expectations result in higher yields and higher yields decrease bond prices, which explains the outflow that bonds have seen.

So, how much higher can the yield on the 10 Year Treasury rise? As of today, the yield on the 10 Year Treasury sits at 2.52%, which is a jump of approximately 0.7 percentage points since the election, and its trajectory will depend on the magnitude of what gets through Congress. The rule of thumb that I use to assess the yield on the 10 Year Treasury is that it should be close to the real GDP growth rate. This year, the economy is expected to grow below 2 percent and most of these policies will take some time to show up in the growth column. Until that happens, I would expect bond yields to go down or at least slow their rate of increase. Also, the yields on the U.S. Treasuries are higher than the yields in European countries which make U.S. bonds are relatively more attractive and increased foreign buying could also be a factor that keeps a lid on the yields in the coming months. Overall, as growth picks up, wages increase and inflationary pressures rise, and the Fed raises rates. I expect yields to be higher this time next year, however, if tariffs somehow become a reality, then yields will head down as it would significantly increase the chance of a recession.

Given that rates in the coming years are expected to be higher, shouldn't that be negative for stocks as higher rates increase a firm's cost of borrowing? Higher rates can hurt stocks unless growth expectations are higher than the rate increase. That is the dynamic that we see today. The Market is expecting Congress to implement these new growth proposals and higher growth is currently "trumping" higher rates. But, as far as stocks are concerned, it pays to be selective. Most of the positive action has been in financials and the negative action has been in the safer lower growth sectors like staples and utilities. Going forward, I think staples and utilities lag the market as people shift their investments into more growth oriented stocks.

With regard to the market as a whole, articles on Barron's and Business Insider list the major Wall Street investment houses' forecasts for the Standard & Poor's 500 ("S&P 500") to close out 2017 between 2300 and 2575. When calculated from the S&P 500's close as of Friday, December 16, 2016 of $2258.07, these forecasts would represent potential returns of 1.86% to 14.03% if correct, depending on the analyst. Each analyst has their own way of calculating market forecasts, and it should be stated that such estimates are no guarantee of market performance nor should they be relied upon for making investment decisions. There are any number of scenarios from disasters to new legislation that could drastically alter any such forecasts substantially, so they should all be read with a grain of salt.

Finally, what is going to happen to the dollar as these policies take effect? Higher growth and higher yields should increase the demand for U.S. dollars, since it makes U.S. assets more attractive causing it to appreciate relative to other currencies. The dollar index has increased since the election and some of that can be attributed to higher growth expectations in the U.S., but some of that can also be attributed to Trump's protectionist talk. Trump has talked about imposing tariffs on other countries' goods which may make Americans stop buying some foreign products. As a result, there could be fewer dollars supplied in the market, and the smaller supply would drive the value of the dollar upward. Obviously, the dollar appreciation makes the U.S exports less competitive and offsets some of the perceived benefits from the tariff. Again, this is the issue that I see not getting through Congress, as they don't want to be responsible for a trade war that possibly takes the U.S. into a recession. But, overall, most of the suggested policies should benefit the dollar in the near term.



Source: Board of Governors of the Federal Reserve System (US) | fred.stlouisfed.org

As unpredictable as 2016 was, it looks like 2017 will not be outdone by 2016 as we see the new administration take charge. For the time being, most of the proposals floated by the Trump team are pro-growth and should accelerate economic growth. It will be interesting to see what other factors come in play to affect the markets. Hopefully, common sense prevails and the Congress passes measures that help and not hurt the U.S. economy. Regardless, it should make for an interesting ride, as we see expectations turn into some form of reality.

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The S&P 500 Index is an unmanaged index that is generally considered representative of the U.S. stock market. The performance of an unmanaged index is not indicative of the performance of any particular investment. Investments offering the potential for a higher rate of return also involve a higher degree of risk. Actual results will vary.

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Ken Stern & Associates
A Registered Investment Advisor

NOBEL EXECUTIVE CENTER
3655 NOBEL DRIVE, SUITE 630
SAN DIEGO, CA 92122

800.529.2884
858.485.0404
www.kenstern.com