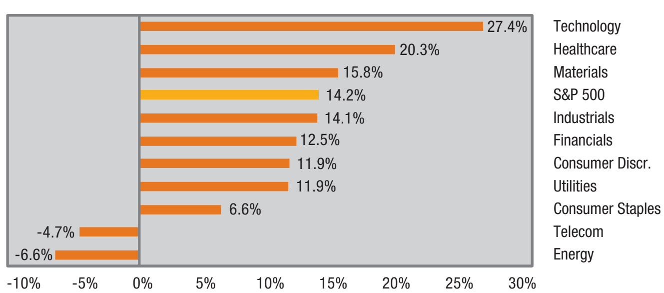
Inverness
Counsel

During the quarter, equity markets resumed their rallies, and the S&P 500 ended the quarter at 2,519—closing at a record for the 39th time this year. A synchronized global economic expansion is driving stock markets higher around the world. Domestically, economic fundamentals such as consumer spending, housing, and manufacturing remain healthy. Congress has recently moved on to tax reform after another failed attempt to repeal and replace the Affordable Care Act. A lower corporate tax rate coupled with repatriation of foreign earnings could have a significant positive effect on the market. Volatility in the market has been unusually low, but this could certainly change if the market starts to believe tax reform is following the same path as "repeal and replace." The Federal Reserve is expected to raise interest rates for the third time this year at its December meeting. With the global economy growing and stock markets rallying, central banks around the world are looking to move towards a more normal interest rate policy. We continue to position portfolios for modest growth.

The S&P 500 Index gained 4.5% on a total return basis for the quarter. The Technology sector led the way this quarter and for the year (see Figure 1). Consumer Staples was the only sector to see a decline this quarter and is lagging the index for the year.

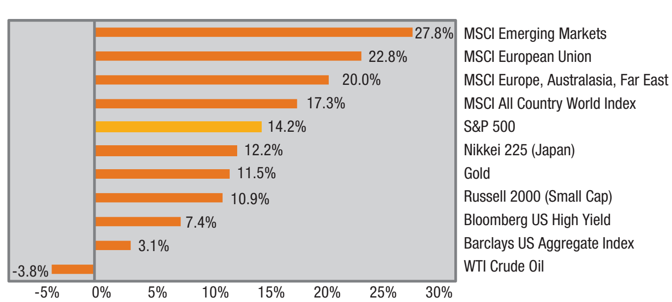
Figure 1: 2017 Performance by Sector



Source: Bloomberg. Data as of 09/30/2017.

From a broader perspective, the majority of the foreign markets performed better than the S&P 500 this quarter and extended their outperformance for the year (see Figure 2). Oil prices saw a modest rebound during the quarter but remain lower for the year.

Figure 2: 2017 Performance by Category



Source: Bloomberg. Data as of 09/30/2017. All returns in U.S. dollars.

The Economic Expansion Turns 100 Months Old

Residential investment and consumer spending continue to drive modest growth in the U.S. economy, as defined by Gross Domestic Product (GDP). GDP is estimated to have grown at a 3% annual rate in the second quarter—a level not seen since the first quarter of 2015. The Federal Reserve is currently looking for GDP growth of 2.4% in 2017 and 2.1% in 2018—in line with consensus expectations. At the end of October, the economic recovery that started in June of 2009 will be 100 months old, making it the third longest in history. The two records remaining are 106 months reached in the 1960s and 120 months hit during the 1990s. Eight years into this economic recovery, the U.S. is seeing healthy job and wage growth, a robust housing market, and corporate profits expanding at a rate that could accelerate with successful tax reform.

It's an old saying on Wall Street that economic expansions don't die of old age they are murdered by the Fed. Average real GDP growth during this expansion has registered 2.1% annually, well below the long-term average of 3%. This trickle of growth has been strong enough to drive the economy to full employment yet tepid enough to avoid sending wage inflation to cycle-ending levels. At the end of each of the last two economic cycles, wage growth was over 4%, and the Fed responded by raising rates aggressively. During the Fed's last tightening campaign, which began in 2004, it raised rates by 0.25% at each of 17 straight meetings.

Since December 2015, the Fed has raised rates four times, and the fifth increase is expected this December. Sluggish global economic growth, the use of negative interest rates by foreign central banks, deflation fears, and Brexit have put the Fed about a year behind its initial rate increase projections. The Fed plans to raise rates three more times in 2018 and twice in 2019, bringing short-term rates close to 3%. The market continues to believe that the Fed will need to move at a slower pace than its projections. With low wage inflation, flat commodity prices, and consumers benefitting from competition, inflation expectations continue to stay stubbornly below the Fed's 2% target.

The S&P CoreLogic Case-Shiller National Home Price Index rose 5.9% year over year in July—the fastest pace in three years. For 36 straight months, the index has risen at a 5%–6% annual rate. Although the fundamentals for housing remain favorable, affordability is becoming an issue again in certain markets. The national index is now 5% above the previous (2006) peak, and rising interest rates may have an effect in the second half of next year.

The consumer, who represents about 70% of the U.S. economy, remains healthy, supported by a strong housing market and wages growing faster than inflation. Consumer confidence readings have plateaued at robust levels, although the September reading may have been a bit muted by lower responses in hurricane-ravaged areas, such as Texas and Florida. Retail sales increased 3.2% in August on a year over year basis, slightly above consensus estimates. Replacement of flood-damaged vehicles and home repairs could boost growth in coming months. In addition, Deloitte is forecasting a 4% to 4.5% increase in 2017 holiday sales compared with 2016.

More than 40% of S&P 500 earnings are derived from overseas. A synchronized global economic expansion seems to be underway, and Europe and Asia are performing better than they have for years. This strength has been a major driver of year-to-date earnings growth. Interest rates and currencies in Europe and Japan have recovered from depressed levels, and a weaker U.S. dollar has benefitted many large multinational companies. This expansion has also helped the industrial segment of the economy. In September, the ISM Manufacturing Index—which monitors employment, production inventories, new orders, and supply deliveries—hit its highest level since 2004; it has been above 50, signaling growth, for the last 14 months.

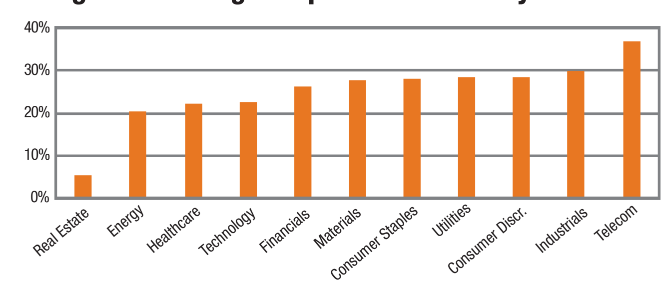
Tax Reform Investment Implications

In late September, the Trump administration released a nine-page plan proposing substantial changes to the federal tax code. Although many individuals could certainly benefit from this plan, the major focus for the market is corporate tax reform. With a top federal corporate tax rate of 39.6%, the U.S. stands out in comparison to global peers, whose corporations on average pay only 30%. The proposed plan would lower the U.S. corporate tax rate to 20%.

Early estimates are mixed. Goldman Sachs forecasts that a cut to a 20% corporate tax rate would boost S&P 500 annual per share earnings by $15—a gain of roughly 11%. Many experts believe that the rate after negotiations will be closer to 28%. The White House predicts this tax reform will add 1% to the GDP growth rate. The National Association for Business Economics, a group that tends to lean to the right, predicts only 0.25% of extra growth in 2018 from Trump's tax package.

The Telecom, Industrials, and Consumer Discretionary sectors stand to gain the most, as many companies in these groups operate largely U.S.-based businesses (see Figure 3). Domestically focused companies in the Consumer Staples and Financials sectors will also benefit. Conversely, some of the lowest current tax rates can be found in the Energy and Healthcare sectors, specifically those with significant overseas exposure.

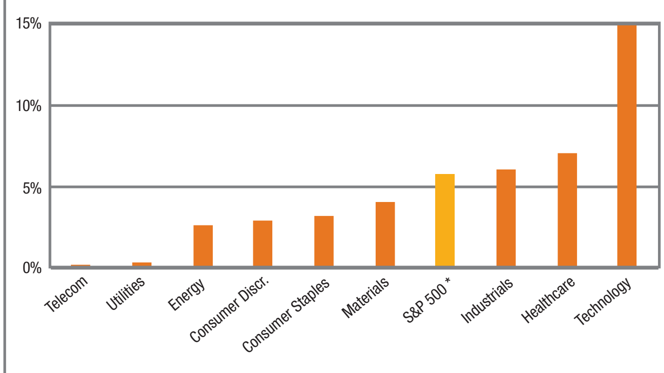
Figure 3: Average Corporate Tax Rate by Sector*



*Source: Bloomberg. Data as of 9/30/2017. *Based on S&P 500 holdings.*

The Trump plan also includes a repatriation tax holiday for cash held abroad. U.S. firms are holding $2.6 trillion of profits overseas to avoid paying the higher corporate tax rate, according to Strategas Research Partners. The Technology and Healthcare sectors have the largest cash balances overseas and could benefit the most (see Figure 4). These repatriated funds might drive new investment, potentially spur M&A, and allow for an increased return of capital to shareholders through dividends and share buybacks.

Figure 4: Overseas Cash as % of Market Cap



*Source: Bloomberg, FactSet. *S&P 500 average, excluding Financials and Real Estate sectors.*

Optimists believe tax reform can be passed this year, while others point to the first quarter of next year. Congress appears to be making some progress on key topics, including corporate tax rates, the expensing of capital spending, interest expense deductibility, a reduced rate for bringing cash stored overseas back home, and the establishment of a territorial tax system in which only income generated domestically would be subject to taxes.

Congressional rules pose a hurdle. To be eligible for the reconciliation process, which allows for a simple majority vote, a bill cannot significantly increase the deficit beyond 10 years. If it is determined that the proposed tax reform would increase the deficit by too much, Republicans may end up passing a tax plan that sunsets after a decade. Another obstacle is the opposition from GOP lawmakers in high-tax states who are against repealing the individual deduction for state and local taxes. These are votes the Republican Party cannot afford to lose.

Course of Action

Even without tax reform, earnings for the S&P 500 are expected to grow 15%–20% in 2017, after three years of no growth. A decline in the dollar, low interest rates, and a synchronized global economic expansion are driving this improvement. The Materials, Technology, and Financials sectors have the highest expected growth. The second quarter reporting season saw strong results, and guidance from many companies suggests further improvement.

The Technology and Healthcare sectors represent significant portions of the S&P 500, and we continue to have substantial exposure in these areas. We believe valuation in these sectors remains reasonable, but we will look to trim names that we feel have moved ahead of fundamentals. We also have meaningful exposure in Financials, which should benefit from higher interest rates, reduced regulation, increased capital returns, and perhaps lower taxes. Lastly, we have meaningful exposure in domestically focused industrial companies that may benefit from an improving economy, lower taxes, and new infrastructure plans.

We continue to be very cautious in the consumer-focused sectors. The weakness we have seen in the Consumer Discretionary sector has crept into Consumer Staples. Amazon in particular, and online retailing in general, are driving major disruption.

845 Third Avenue
New York, NY 10022

www.invernesscounsel.com

(212) 207-2122

Inverness
Counsel