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Stolper Asset Management

An Independent Registered Investment Adviser

Portfolio Comments
For the Quarter Ending December 31, 2017

Sometimes it's not only change, but the pace of change, that can be startling. From an investment perspective, we certainly do not live in stagnant times, with benchmark indices repeatedly shattering their previous ceilings, spurred on in part by the continued ascent of technology juggernauts. In parallel, erstwhile fringe terms such as 'cryptocurrency' and 'blockchain' are increasingly making their way into everyday vernacular, harbingers, perhaps, of a new paradigm.

In reflecting on the promise of radical change, John Kenneth Galbraith, the influential Harvard economics professor of the last century, remarked: "When you see reference to a new paradigm you should always, under all circumstances, take cover. Because ever since the great tulipmania in 1637, speculation has always been covered by a new paradigm. There was never a paradigm so new and so wonderful as the one that covered John Law and the South Sea Bubble - until the day of disaster" Mr. Warren Buffett perhaps put it more succinctly when he said: "Price is what you pay. Value is what you get." While it's true to say the market, in general, favored growth over value for much of this year, our focus will always be on understanding what we are getting in return for what we are paying.

For both the S&P 500 and The Dow Jones Industrial Average (DJIA), surpassing milestones and breaking highs came to seem like almost habitual events this year as both indices climbed with little abatement. The S&P 500 closed on December 31st at 2,674 representing a return of 6.64% for the final quarter of 2017 and 21.84% for the year. The Dow Jones Industrial Average posted a particularly strong final quarter as economic and political circumstances led investors to favor banks, industrials and energy sectors. The DJIA ended December at 24,719 for a return of 10.96% in the past three months and 28.09% for 2017.

The big news out of Washington as 2017 drew to a close was that the Republicans had reached agreement on their tax reform legislation. Republicans in the House of Representatives and the Senate managed to settle their differences and agree on a reduction of the corporate tax rate from its current 35 percent down to 21 percent, or close to the average for OECD (Organization for Economic Co-operation and Development) countries. The legislation was put to the vote and passed into law on December 20th.

Under the GOP plan, to help offset reduced corporate tax receipts, earnings that companies hold offshore as cash or equivalent will be taxed at 15.5 percent, while foreign income invested in non-liquid assets, such as plants and equipment, will be taxed at 8 percent. At an individual taxpayer level, headlines of the reform include a reduction in the tax rate for those earning $500,000 or over from 39.6 percent to 37 percent, and lowering of the loan value ceiling for interest write-offs for new mortgage loans to $750,000 from its current $1 million level. For those not at the highest earnings levels, bill proponents claim a household earning $150,000 will save $4,000 in taxes a year, and $75,000-income households will save $2,000. The combined changes represent the biggest overhaul to the U.S. tax code since the era of President Ronald Reagan, and are being ushered in with President Trump proclaiming: "We want to give you the American people a giant tax cut for Christmas."

It doesn't take much scrutiny to conclude that the biggest winners under the new tax regime are corporations, although not all are set to benefit equally. Analysts expect company earnings to be boosted by about 10 percent, on average, with U.S. Treasury secretary, Steven Mnuchin stating that cuts should start in February. Corporations poised to gain the most are those currently paying high rates, with mainly U.S.-based income, and that are not being significantly impacted by the charges on assets held abroad. In terms of sectors, the biggest beneficiaries are likely to include banks, oil refiners, railroads, and airlines. Such a skew in gainers could provide a boost in associated stock prices as traditionally value-based industries enjoy the greatest impact to their bottom line. A shift in investor sentiment has already been demonstrated by the strong year-end performance exhibited by the Dow Jones Industrial Average index.

As a new tax era makes its debut, another era is coming to a close; that of the term of Janet Yellen in her role as Chair of the Federal Reserve. At the start of the year Ms. Yellen will relinquish the position to her nominated successor, Jay Powell. By most accounts, she leaves behind her an admirable legacy. Namely, under her watch, Janet Yellen presided over a return to full employment with a jobless rate at 4.1 percent the lowest since the early 2000's, oversaw an improvement in real economic growth, and managed to initiate the reversal of the Central Bank's stimulus program without unduly unsettling the financial markets. As she leaves office, growth numbers are expected to come out at 2.5 percent this year, with the same forecast for 2018.

The Dallas Fed chief, Robert Kaplan, recently pointed out in an interview with the Financial Times that relative to the economy size, the U.S. equity market is now valued as high as it was during the turn of the century during the tech boom. The one puzzling factor for Ms. Yellen has been low inflation, which remains stubbornly below the Fed's target. Nevertheless, the Central Bank seems set on its continued course of gradual monetary tightening, having faith that an increasingly robust labor market will eventually nudge up inflation. Some concerning economic data such as the failure of large swathes of the country – particularly depressed manufacturing and rural areas – to meaningfully participate in the overall recovery are largely beyond the scope of the Fed's powers to intervene in.

Janet Yellen, almost always the sanguine diplomat, did take the opportunity of her departure to voice concern over the ballooning U.S. public debt, tepid productivity growth and the ever-more stark inequality between the wealthy and the not in this country. When specifically asked about the Senate proposal for a trigger mechanism to ensure tax cuts don't further inflate the national debt, Ms. Yellen remarked: "I would simply say I am very worried about the sustainability of the U.S. debt trajectory." She also stayed firm to her guidance that successive gradual rate rises will be a necessary component in preventing a "boom-bust" cycle at home. She stated that "dismally slow" productivity growth continued to place a dampener on the economic outlook given the accompanying lack of real wage growth. When pressed for an opinion on the administration's tax cuts, Janet Yellen commented: "While changes in tax policy will likely provide some lift to economic activity in coming years, the magnitude and timing of the macroeconomic effects of any tax package remain uncertain."

The Chair oversaw three rate rises during her last year in office, bringing the total under her stewardship to five, and left the benchmark 10-year Treasury yield at 2.4 percent at year end. Three more rate rises have been penciled in by the Fed for 2018. Its balance sheet reduction program, which has begun cautiously, will likely gather pace and the European Central bank seems set to end its own quantitative easing program. All these measures represent a slowdown or reversal of central banks' initiatives to aggressively stimulate growth and buoy up asset prices, leaving the markets to find their own equilibriums in more normalized environments. With built-in expectations that rates are going to continue to rise, banking stocks have received renewed positive attention, while capital-intensive growth stocks, such as those of many technology companies may feel the cost of higher interest rates.

Despite an undertone of acrimony on many major points, some concrete forward steps are being taken in negotiations between the U.K. and the European Union over the terms for Brexit. Significantly, at the start of December, Britain agreed to honor a bill for its departure that is estimated to cost at least $47 billion; a figure considerably higher than that originally proposed by Prime Minister Theresa May. An agreement was also reached on providing greater protection of the rights of E.U. citizens already living in the U.K. An issue that has proved one of the most contentious - how to avoid a hard border between Northern Island and E.U. member Ireland - was left largely unresolved. Up next will be further tough hurdles, with the E.U.'s chief negotiator, Michel Barnier, explicitly ruling out special treatment for Britain's financial services sector in terms of allowing passporting arrangements for them to trade in the E.U. The nature and terms of future trade deals, both with European countries and non-E.U. trading partners will also spark much debate, with the most favorable terms for Britain across the board not a feasible outcome; concessions will have to be made.

Political parties here at home will also be navigating some tricky territory over the coming year. While President Trump's first full year in office has been frequently peppered by inflammatory and accusatory headlines, alongside a slew of both voluntary and imposed departures, his Republican Congress has notched up some achievements that have pleased the party's core electoral base. On top of the tax overhaul, spending on defense has been ramped up and the number of appointed conservative judges has risen. On the campaign trail, however, the GOP recently suffered high profile defeats to the Democrats in both Virginia and Alabama, and the President's personal popularity has slumped in polls. Question marks over Russia's meddling in the 2016 U.S. Presidential election, as well as debate over whether anyone in Mr. Trump's camp was in collusion, also continue to swirl amid probes spearheaded by special counsel Robert Mueller. Abroad, tensions between the U.S. administration and North Korea continue to remain near the forefront.

A groundswell of dissent or suspicion doesn't, however, guarantee that Democrats are on track to sweep next year's mid-term elections despite current polls by The Wall Street Journal reporting that a solid majority of voters would like to see the Democratic Party running Congress this time next year. Structurally, in terms of which seats will be up for the vote and how staunchly these seats are held one way or the other, the landscape appears to favor Republicans for both the Senate and the House. Regardless, a lot can happen in the 11 months between now and midterms.

In terms of what we can expect for the economy and the markets next year, as reported in The Economist magazine, a poll conducted by the independent group Absolute Strategy Research (ASR) of 229 asset allocators management responsible for approximately $6 trillion of assets, reported a preponderance of optimism. The estimated probability of equities being higher by the end of 2018 was found to be 61 percent and the probability of shares beating bonds was reported as 70 percent. Little concern was expressed over rising interest rates and the chance of a global recession was put at only 27 percent. The polls instigators sounded their own cautionary notes, warning that even a slight slowdown in Chinese growth could have global economic consequences and warned rate rises in the U.S. could turn out to be at a quicker pace than priced in by the market.

Here at Stolper Asset Management we are well aware that in a consistently rising market value opportunities can be less abundant, but we remain confident that interesting individual situations will present themselves through our diligent research and monitoring efforts. As always, we are also not afraid to take a contrarian investment view with a longer-term outlook should we believe the circumstances warrant it. As the year draws to a close, we wish you, your family and your loved ones a time of enjoyment and peace as well as a happy and prosperous New Year!