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Washington D.C. and Tax Reform Continue to Drive Stock Prices.
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In the last Market Comment *(Dow Approaching 20,000, Now What? – January 3, 2017)* we talked about President Trump's pro-growth business agenda leading to anticipated earnings adjustments reflecting higher stock prices. This thesis is very much intact as stocks have recorded solid gains so far in 2017. For now, we maintain our 2400 target on the S&P 500, but we will continue to reevaluate, particularly since we have reached that level.

Treasury Secretary Steven Mnuchin and the Trump administration are committed to a major tax reform before the August congressional recess and have made clear their core focus is to get Gross Domestic Product (GDP) growth back above 3%. The administration is betting that tax reform will bring tremendous amounts of cash held offshore back to the United States and that slashing the corporate tax rate will lead to increased earnings resulting in a growing economy. We place high probability on tax reform and stand by our call that this will add $6-8 per share to earnings of the S&P 500 Index. This translates into forward adjusted earnings of approximately $130, or 18 times price-to-earnings (PE) multiple, which is not historically expensive. If the reform doesn't happen, the market is fully priced, trading currently around 22 times trailing earnings.

But many continue to distrust this rally, still remembering the 2008-2009 financial meltdown. We acknowledge Washington could be a major risk; after all it is much harder to enact policy than to talk about policy. Our current corporate tax rate of 35% is among the highest in the industrialized world. Any reduction will help, but the markets are pricing a larger probability that we will see this rate slashed to 20%. Trump is shooting for 15%, but likely this is a negotiation tactic to settle on the 20% rate. If a major cut doesn't happen, expect the markets to sell-off.

Another area of tax reform that is projected to pass is the ability for companies to expense capital investment. This was unveiled by Speaker Paul Ryan and has gained acceptance across the Republican Party. And yet another proposed tax reform gaining widespread support across party lines allowing overseas earnings by corporations to return home in a most likely "one-time repatriation" without an attached tax. It is estimated this will create an inflow of approximately $2 trillion, which most corporations will use to buy back outstanding shares of stock or issue "special" one-time dividends.

A much more controversial proposed tax policy is to "border adjust" imported goods by taxing them as they enter the United States. The original "border adjustment" thesis was written by Alan Auerbach, Professor at U.C. Berkley, who argues the value of the US Dollar would immediately rise, but foreign consumers would rush to buy US exports thus essentially offsetting the import tax and effectively neutralizing the "border adjustment" tax for importers and exporters. This proposal will remove taxes associated with goods produced domestically and consumed by foreigners, which should support a much stronger dollar.

It remains to be seen whether Secretary Treasury Mnuchin and President Trump's business style can work with career politicians. The markets believe this pro-business agenda will continue without significant opposition. We continue to monitor these developments and will see if much reform occurs before the August Congressional recess. In the meantime we remain invested and continue to look for opportunities.