
LJPR FINANCIAL ADVISORS

# 2017 Outlook

## What's Next?

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# 2017 Outlook

## What's next?

I've been writing Outlooks for a long time. Looking back, 2017 may be my most interesting year. I started in the business world in 1977, and have managed to see a lot of things, ranging from giant bull markets to technology revolutions, to real revolutions to real ugly recessions. Markets, economies, and people are resilient, we've made it through all of these things. But in the 40 years of my observations, I haven't quite seen the magnitude shift that we may be facing today. I might point out that this is unique in American history. So, recognize that we are all looking at uncertainty. As Janet Yellen, head of the Federal Reserve, recently stated, "We are operating under a cloud of uncertainty at the moment."[1] Here is our version of what may happen, and how we intend to respond in 2017.

If you are not going to read this whole Outlook, here's the nutshell:

- Taxes are going to change, which will probably be good for stocks, but create deficits.
- Infrastructure spending is probably going to increase, which is going to increase jobs and commodity prices, but create deficits.
- Immigration policy is probably going to change, which reduces the number of workers available and causes wages to go up, which causes inflation and a potential labor shortage.
- Trade policy is going to change which can have the effect anywhere from more domestic production and economic growth to a devastating trade war.
- Deficit spending puts pressure on debt, which causes interest rates and inflation to rise.

So, probably: lower taxes, higher inflation, higher interest rates, better US economy in the short run.

*now for the details...*

## Taxes

This is a big one, and we think tax reform will be an issue in the forefront and something that can be achieved relatively quickly – in political terms. The proposal is to change individual taxes, business taxes and the estate tax. If the business tax rate is reduced, that provides more profits for US businesses, which makes their value prospectively go up. There is a proposal of a 'tax holiday' to repatriate offshore profits. In the past, this has not provided major economic stimulus, but did start a wave of stock buy-backs and special dividends. We think a business tax cut is likely good for US businesses and US mid cap and small cap stocks (although both of those have rallied). We are concerned with the deficit aspects of a cut (more on that later).

Individual taxes will likely be simplified. After running about 850 tax returns, we found that the current proposal cut taxes for nearly two-thirds of our clients, and raised taxes or had no impact for others[2]. In general, tax cuts for individuals provide economic stimulus, particularly if the cuts are on a large number of taxpayers, like middle income. Recognize that according to the Tax Policy Center, 45.3%, or about 77 million American households, don't pay any Federal income taxes. So a cut doesn't affect those households. Our view of the current proposal is that it cuts Federal taxes more for the highest bracket taxpayers. We think a tax cut/simplification will be positive for the economy in the short run, but are concerned about the deficits a tax cut creates.

Estate and gift taxes are imposed on larger estates (generally over about $5.5 million for single people and $11 million for married couples – under this amount, estates are not taxed). The proposal is to eliminate the estate tax. From an economic standpoint, the federal estate tax provides a relatively insignificant portion of Federal revenue: 0.6% of the total, according to the OMB. We think it does little for markets and the economy, although yacht sales may rise.

One major aspect of the proposed changes is to allow businesses to deduct capital expenditures from taxable income. In our high-tech world, smart factories are expensive, and this is a prospective incentive to build and stay in the US.

## Infrastructure

The new administration has vowed to make significant repairs and improvements in the nation's infrastructure. We'd agree this is long overdue. Rebuilding roads, bridges and pipelines has the benefit of improving the efficiency of the economy, plus employing workers to do the construction. In addition, the raw materials (e.g., cement, steel) are generally of local origin, creating a cascading economic effect. The Economic Policy Institute estimates that a $250 billion dollar debt-financed infrastructure program would increase GDP by $400 billion.[3] We have taken a satellite position in our model portfolios in an infrastructure fund. We think the spending will be good for infrastructure investments. We are concerned about the deficits.

# Immigration

It appears there will be some change to the nation's immigration policy. Border security measures cost money, which is spending, which increases debt and deficits. We are skeptical about the wall, and more skeptical that Mexico will pay for it. At the same time, illegal immigrants do make up a significant portion of the US labor force. According to Pew research, about 8 million of the 11 million undocumented immigrants have jobs, about 5% of the US workforce.[4] Taking those workers out of the system in a relatively full employment scenario would likely cause inflation. Infrastructure spending and tax incentives will likely create demand for jobs (albeit skilled jobs), and removing 8 million workers exacerbates a worker shortage, particularly in lower paying jobs. We think a broad deportation policy would be inflationary.

# Trade

If I could offer one issue that gives me a nervous stomach, it is the issue of trade. The incoming administration ran its campaign vowing to eliminate or renegotiate trade agreements. The world is globalized, and global trade is prolific. According to the WTO, world trade in 2014 was about $18.5 trillion.[5] Our view is that trade policy changes can have a range of outcomes: If trade agreements are negotiated to be 'even' or what we'd call 'fair trade', then the economic effect will be positive, particularly for exporters. If the agreements turn punitive, we then have what I would call the 'Smoot Hawley' scenario. Smoot Hawley, (anybody? Bueller?), was a punitive tariff act passed in 1930 that in my opinion (and in Ben Bernanke's as well, and he's way smarter than I am) caused the Great Depression. The proposed cabinet members seem to be clearly on the side of fair trade and not in the punitive camp. If the president-elect follows through on his threats to punish some of our trading partners, a major trade war would be bad for all sides.

# Deficits

I have a friend whose Dad got a Mobil Speed pass for his sister. She thought it was very cool how she could wave the fob and be on her way, without any hassle of credit cards. Her Dad noticed the Mobil bills kept getting higher and higher until one day he asked just how much gas she was buying. She said she wasn't buying gas, just using the little thingy. She let her friends use it too. To her, the fob was free gas.

Hey, let's cut taxes! (yeah!). Hey, let's fix roads! (yeah!). Hey, let's deport! (yeah!) Hey, let's put tariffs on those guys! (yeah!). Hey, let's pay for it. Oops. Cutting taxes sounds great, how do you pay for it? The answer is you borrow the money. When you borrow the money, you have to raise the interest rates to get people to buy the debt (and don't ask me how you might get antagonistic trade partners to buy your debt). Deficits are OK in the short run, especially with a bad economy. However, we're at relatively full employment, sounds like we want to kick about 8 million workers out of the country, and want to put a bunch of money into the system. That spells inflation. We are considering additional investments that would perform well in an environment with rising interest rates and inflation.

## Energy

We have been bullish on energy though 2016. It appears that the new administration is friendlier to Russia. In addition, it appears that oil exploration in the US will be expansive. It seems with more domestic drilling, oil prices may be heading lower. Accordingly, we will likely reduce our energy position. We're reviewing what might be an alternative satellite position.

## Geopolitics

Geopolitics has always been tough to decipher. As far as I can see, here's about how it may be:

| Country | Pre-11/08/16 | Post 11/08/16 |
|---|---|---|
| **Russia** | We don't like them | We like them |
| **China** | We like them | We don't like them |
| **Israel** | We don't like them | We like them |
| **Syria (Assad)** | We don't like them | We like them |
| **Syria (Rebels)** | We like them | We don't like them |
| **Iran** | We like them | We don't like them |
| **Taiwan** | Who? | We like them |
| **Mexico** | We like them | We don't like them |
| **ISIS** | We don't like them | We don't like them |

## Bottom Line

I've said this before, the whole world has changed. We were playing checkers, now the game is chess. We are focusing on planning for 2017. We'll plan for volatility, for inflation, for higher rates, and more concentration on domestic economics.

[1] Janet Yellen, News Conference, December 14, 2016
[2] Internal LJPR Analysis, December 14, 2016
[3] Economic Policy Institute, "The Short- and Long-Term Impact of Infrastructure Investments on Employment and Economic Activity in the U.S. Economy", by Josh Bivens, July 1, 2014
[4] Pew Research Fact Tank, November 3, 2016. "5 Facts About Illegal Immigration in the US"
[5] WTO, World Trade and the WTO: 1995-2014

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