Southern Capital Perspective

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April 2017 Volume 25, Number 4

Has the Stock Market Advance Since November Been Based Solely on the Anticipation of Tax Cuts and Infrastructure Spending?

We believe that the answer is no. However, there is not much question regarding the beneficial impact on stock prices from lowering income taxes – especially corporate rates which in the United States are among the highest in the world. According to Investor's Business Daily: the broad stock market (represented by the S&P 500) would rise 7% with a five percentage point tax cut or 12% with a ten percentage point tax cut. President Trump has been calling for a fifteen to twenty percentage point corporate tax cut from a 35% rate down to a 15% or 20% rate.

Large infrastructure Buildup

The impact of a large infrastructure buildup is expected to be very positive but is much harder to quantify (there is no easy formula for an expected stock market increase per $100 billion of infrastructure investment). According to MONEYWATCH, there are two compelling reasons for America to make this investment:

> "First, investment in infrastructure can improve productive capacity and increase America's economic growth rate, which has been slow in recent years due to falling productivity. But investment in infrastructure could help reverse this trend.
>
> Second, wages have been stagnant, and labor markets haven't yet fully recovered from the recession. Government spending on infrastructure will put people to work, and as labor markets begin to tighten it will put upward pressure on wages."

As of the end of the first quarter of 2017, neither tax cuts nor infrastructure spending has been enacted. The failure of the Republicans to pass the healthcare act has likely delayed the implementation of the tax cuts and the infrastructure buildup until later in 2017 or maybe even 2018. Therefore, we need to consider the other factors that are going to fuel a market advance. Some of these factors are:

- the rollback of federal regulations,
- the dramatic increase in business and consumer confidence,
- the expectation of strong corporate earnings increases,
- continued strength in U.S. employment, and
- "global reflation" or improvement in world economies and markets.

Rollback of Fed Regulation

The rollback of federal regulation will have a profound effect on the American economy, especially small businesses which make up the bulk of the US economy. The Washington DC publication, *The Hill,* reported:

> "Recently, the National Small Business Association released a survey, the 2017 Small Business Regulations Survey, which showed that the average small-business owner is spending at least $12,000 every year dealing with regulations.
>
> When asked to estimate their businesses' first-year regulatory costs, the average fee was a whopping $83,019! Nearly one-third of small-business owners spend more than 80 hours each year complying with federal regulations.
>
> This burden is becoming a barrier to entrepreneurship and a likely driver in the lagging start-up rates we've seen in recent years."

The Administration's efforts to rollback regulations through Executive Order is a good beginning but Congressional legislation will be needed to make the effort long-lasting and effective. Nevertheless, earlier this year the small business confidence index jumped 7.4% and has hit the highest level since December 2004. This bodes well for the economy because the small business persons in the survey say they expect economic improvement and sales increases, therefore they say that now is a good time to expand.

The dramatic increases in consumer and business confidence during the end of 2016 and the first quarter of 2017 project an optimistic outlook. Consumer sentiment soared to 96.9 in March after being down around 87 in October.

https://ieconomics.com/united-states-consumer-confidence#

Consumer Confidence

What does Consumer Confidence measure and why is it significant? "In the glossary on its website, the Conference Board defines the Consumer Confidence Survey as 'a monthly report detailing consumer attitudes and buying intentions, with data available by age, income and region.' In the most simplistic terms, when their confidence is trending up, consumers spend money, indicating a healthy economy. When confidence is trending down, consumers are saving more than they are spending, indicating the economy is in trouble. The idea is

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that the more confident people feel about the stability of their incomes, the more likely they are to make purchases."

There are two business confidence surveys to focus on: first, the ISM Purchasing Managers Index (PMI). This index jumped from a level of about 52 in October up to 57.7 in February.

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"The ISM Manufacturing Index is one of the first pieces of news released each month, so it can greatly influence the tone of investor and business confidence. It is also a survey of purchasing managers who are at the forefront of their companies' supply chains. Manufacturers need to respond quickly to changes in demand, and they ramp up or scale back purchases of inputs to match demand. As a result of their position in the company, they are perhaps better positioned than anyone to speak to the ebb and flow of business conditions." – "When this index is increasing, investors can assume that the stock markets should increase because of higher corporate profits."

Second, the CEO Economic outlook Survey "is designed to provide a picture of the future direction of the U.S. economy by asking CEOs to report their plans for their company's sales, capex (capital investments) and employment in the next six months. The data are used to create the Business Roundtable CEO Economic Outlook Index and subindices for sales, capex and hiring expectations." This index has increased sharply since its fourth quarter of 2016 reading of 74.2 up to the first quarter of 2017 level of 93.3

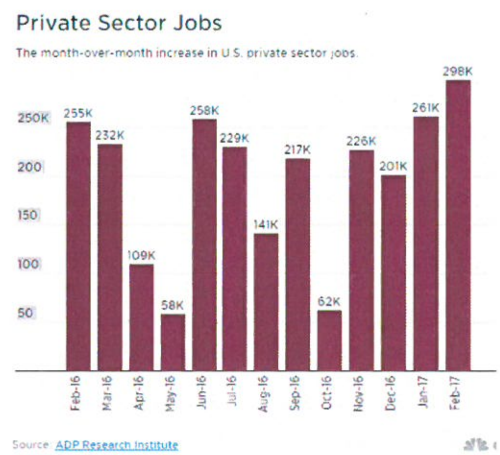
Corporate earnings are expected to increase from eight to ten percent according to Barron's magazine. An earnings gain of this magnitude would justify the market gains since November and lay the groundwork for further market appreciation.

Employment Growth

Employment growth continues at a brisk pace. In February, the ADP Employment (private sector) surged to 298,000 which was about 100,000 more than predicted. Quality jobs were created: 106,000 goods producing jobs, 66,000 construction jobs and 32,000 manufacturing jobs. Strong job creation is important for a healthy and strong American economy. Continued good employment numbers would be supportive of a vibrant stock market *(see graph on right).*

The term "global reflation" has been used to express a simultaneous rise in real growth along with a rebound in some inflation. This phenomenon is showing up around the globe in economic growth along with a rise in commodity prices benefitting most nations and their stock markets. As long as the inflation aspect remains under control, this reflation is positive because there has been real concern regarding deflation since the "great recession" of 2008-2009. As of the first quarter of 2017, global reflation is positive but bears watching that inflation remains subdued.

In summary, stock market investors should hope that tax cuts and a large infrastructure program get implemented in 2017. That would be the best prescription for equity portfolios, but the other five factors that we discussed are not insignificant and will likely be supportive for stock prices. All five are intertwined and are mutually impactful on each. However, the most important factor would likely be the rollback of regulations.



For exact quotation references, you may call our office 251-626-1140.

Outlook

The first quarter of 2017 was strong and reflected the optimism that began in November. The stock market in terms of the Dow Jones Industrial Average moved from a level of 18,000 up to a high of 21,000. This move has been uninterrupted, the market has not experienced a pullback or correction.

Normally, every year there is at least a 5% or more correction. We have not had one since the first quarter of 2016. A correction could be triggered by further delays in the tax cut legislation or the infrastructure program. The Federal Reserve could also shake things up by doing something unexpected in its gradual approach of tightening monetary policy. Nevertheless, we expect 2017 to be a positive year for the market in spite of a potential correction. The market advance would probably be at a slower pace than the first quarter. As always, unforeseen events (economic or geo-political) could significantly alter the market's performance.