October 1, 2017

Greetings,

Enclosed is your investment report for the nine months ended September 30, 2017. Your YTD return is 19.5%. The return of the S&P 500 is 14.2%.

The "market" continues to be remarkably quiet. During the summer, there was one day when the market dropped by 1% but that was about it as far as volatility is concerned. There is still yet to be a 3% pull back this year. That is far from anything resembling normal. Normal is a 10% correction every 12-18 months.

The economy, which has been in "slumber" mode the past 7 years is beginning to awaken. Whether the improvement is sustainable is another story. Since the great recession ended, there have been many false starts only to have the economy go back into slumber mode. Slumber mode to me is an economy that is growing so slowly that it is not in a recession but pretty much might as well be. The problem over the past 7 years is that since the stock market has done so well, it has masked the weakness in the overall economy. The free/easy money from the Federal Reserve is ever so slowly coming to an end. Short term interest rates continue to edge up at a snail's pace. Long term rates (which in my view are more important but receive less press) continue to go nowhere. One thing is certain, zero interest rate policy along with quantitative easing had very little, if any, positive effect on the economy. It has helped the stock market immensely which is why (in my view) things look much better than they are for the vast majority of people. We will find out soon as to whether the stock market can continue to do well without the Fed's help. My gut feeling is that as long as there is some improvement in the economy and corporate profits continue to be strong, then the market should chug along. It is unlikely that the market returns going forward will be as good as they have been the past two years, primarily because valuations are stretched.

After a long wait, an outline of the new tax bill was released last week. There are still plenty of details that will have to be worked out and it is only speculation as to how much of what is out now will become law. From what I see, I have mixed feelings about it. Perhaps I give these guys too much credit in that they have been waiting 20 years for this kind of an opportunity and from what I see on the surface, I think that they could have done better. One thing I like is that finally, the cash overseas held by multi-national companies (such as Apple, the biggest beneficiary of this) will be able to be brought back by paying a one-time tax and that there will be a new territorial tax system so that the earnings made overseas won't always have to be kept there to avoid additional taxation. What I find so discouraging (to put it mildly) is that for the past 7 years I have seen and listened to Paul Ryan (now the speaker of the House but for many years the head of the powerful Ways and Means committee, that writes the tax laws) say how much he wants to simplify the tax code by broadening the base, lowering the rates and eliminating the loopholes. I just saw Paul Ryan again on CNBC literally gush at how enthusiastic he is about this plan because of how much it will grow the economy. While I see the corporate rates being lowered, I see very few if any loopholes eliminated. During the campaign, now President Trump (then as a candidate) said a priority in tax legislation was to eliminate the "loophole" that allows hedge fund and private equity managers to have their compensation taxed at the capital gains rate (which is 41% less) instead of the ordinary income rate. Please keep in mind that these people make millions (in some cases hundreds of millions) of dollars a year and are among the wealthiest people in the country. It is unfortunate for us that these people who are writing the laws have all of a sudden come down with a serious case of amnesia. For full disclosure, Gary Cohn (The head of the President's economic council and one of his top economic advisors) said on CNBC (just before Paul Ryan came on) that the Trump administration fully supports eliminating that loophole so this is one area where the administration is at odds with Congress. Let's see who wins this one. I fully understand that when corporate America does better, then in theory everyone should benefit. With that in mind, the top corporate tax rate is (if it becomes law) being slashed by 43% to 20%. With all the loopholes still in place, most large multi-national corporations will pay significantly less than the 20% top rate. The people who are writing the tax laws (including the President) are convinced that by lowering corporate taxes significantly, for multi-national companies, with there after tax returns so much better, then management will be more motivated to make investments in their own companies. These investments should lead to more job creation and hopefully (since there should be more competition for labor), higher wages. I need to point out that companies such as Disney and Federal Express (two holdings of mine that I am very knowledgeable with) are already extraordinarily successful while paying a 35% tax rate. Disney is arguably (other than Apple) the most successful company over the past 40 years. It built Disneyland in the 1950's and Disneyworld in the late 1960's and early 1970's when the tax rates were higher than now. If someone wants to make an argument that Disney can't "compete" with companies in other countries because its taxes are too high, then I would welcome the conversation. The evidence over the past 40 years does not support that argument. Will Disney make more investments in its business going forward with a 43% tax cut? To be honest I really don't know. I do know the company will have a lot more cash available if they do want to make those investments and the stock price should also benefit from a lower tax rate.

A smart thing that the tax writers are looking to do is to lower the tax of the shareholders of the pass through entities. Pass through entities are Subchapter S corporations, LLC's and LLP's. This is very important as far as job creation because the major job "creators" are small and medium size business owners, not necessarily large multi-national corporations. More than 50% of the pass through entities are small and medium sized businesses. The top tax rate that is proposed for the shareholders of the pass through entities is 25%. This is a 35% tax cut from the top current personal rate and these shareholders don't benefit from the loopholes that the multi-national companies do. These business owners certainly don't have the cash available to invest in their business like Disney and Federal Express do, so the extra after tax return will be more relevant in their decision making as far as investing in the businesses and hiring. I believe that this tax cut should have a benefit to the overall economy and lead to further sustainable growth.

As far as the "middle class" and how they are affected, the standard deduction is proposed to be doubled so those who don't currently itemize their deductions will benefit. The problem (which is in the "fine print" and not talked about on TV by those pushing the law) is that the personal exemptions will be eliminated so much of the benefit to the "middle class" is lost because of the elimination of the personal exemption. Some of those who do itemize could, believe it or not have a tax increase since the only itemized deductions that are proposed to be allowed are mortgage interest and contributions. Add the elimination of the personal exemption and there could be some unhappy people in California, New York and other high taxed states. There is talk about the Alternative minimum tax and the estate tax being eliminated. Once the cost of these tax cuts with dynamic scoring (dynamic scoring accounts for increased growth in the economy as a result of the tax cuts) are figured out, who knows if the elimination of the AMT and the estate tax will make it through to be law. The estimated cost of all of these tax cuts are between $ 1.5-$2.2 trillion dollars. If the increased growth rate in the economy is sustainable (with no recessions), then this estimate will not be as high.

Please either call or email me if you have any questions or anything that you would like to discuss.