January 1, 2018

The 2018 Tug of War: Wages vs. Taxes

Dear Clients and Friends,

As many take time to reflect on a year filled with surprises, we are taking stock of trends that took shape in 2017, some of which may continue to influence investor expectations for the New Year. The bull market of 2017 took many by surprise. While we expect markets to move higher in 2018, our sense is performance may be less dramatic than it was in 2017. Corporate and individual tax cuts, paired with improving economic fundamentals, may drive markets higher than investors anticipate, while wages and inflation may then work to keep markets in check.

Q4 tops off the 2017 bull market

Before jumping into 2018, let's take a final look at what happened in 2017. Broader U.S. markets returned 6.6% in the fourth quarter, capping a year when the overall market achieved its highest annual return since 2013 (also the first year of a presidential term).

Micro and macroeconomic factors drove investor sentiment in the fourth quarter as low unemployment and inflation likely fueled U.S. GDP growth of 2.5% to 3%. In our view, this steady economic growth, which actually slowed modestly from the third quarter, also helped companies beat quarterly profit expectations and issue relatively favorable forward guidance. Emerging personal and corporate tax cuts also likely gave sentiment a boost.

Economic and financial gains in Q4 seem even more remarkable in light of significant changes at the U.S. Federal Reserve, which could have spooked investors. Heading into the fourth quarter, investors faced meaningful uncertainty with the prospects of a new Fed chair announcement, a third rate hike for the year, and tightening of the Fed's balance sheet by year end. However, investors took these changes in stride, perhaps due to incoming Fed chair Jerome Powell's emphasis on continuity with outgoing chair Janet Yellen's views.

Within this favorable market backdrop, we continued to refresh the FBB portfolio with companies that we believe can consistently meet or exceed investor expectations. We added Honeywell (HON) during the quarter on a view that investors have yet to fully appreciate the company's changing business mix and initial indications for 2018 suggest that this investment thesis is playing out.

We also added JP Morgan Chase (JPM) as a way to own a rising interest rate theme with less execution risk than Wells Fargo (WFC), which we trimmed. We also exited Cerner (CERN) as we viewed an unattractive risk / reward profile following a move up in the stock. Outside the U.S., we added to our developed international equity exposure as we take a more favorable view of Europe and Japan, which have finally started to participate in the global recovery.

Focusing on wages and taxes in 2018

As we move from an impressive 2017 to an unknown 2018, our sense is that stocks can deliver low double-digit returns, although wages and taxes may provide upside or downside pressures for 2018.

Our base case for 2018 involves ~11% corporate profit growth, plus 5% for tax cuts, minus 5% for lower investor sentiment, and finally adding 2% for dividends, suggesting a ~13% total return. In a more pessimistic scenario, higher wages could lead into a "cascade effect" of higher inflation, more Fed rate hikes, lower profit margins, lower earnings, and lower stock valuations, threatening a correction in the current bull market.

Meanwhile, subdued wage growth has been puzzling economists over the past few years, as a plummeting unemployment rate should be driving wages solidly higher. It is possible that 2018 could be the year that stubbornly low wages (and inflation) start to take off.

Though wages may be concerning in 2018, tax cuts may more than offset wage and inflation pressures. Bulls predict a ~15% boost to corporate profits from lower taxes, while personal tax cuts drive faster consumer spending. What's more, tax incentives may lead U.S.-based multinationals to bring overseas cash back home, potentially leading to stock buy backs and acquisitions that could boost markets. However, despite these more optimistic scenarios, we are taking a more moderate approach, predicting a 5% boost to stocks from tax cuts.

While we view wages and taxes as key to understanding 2018, we're also keeping an eye on potential infrastructure spending that could boost the economy, as well as concerns around geopolitical events such as the UK's exit from the European Union. Lastly, a weaker U.S. dollar helped American exporters in 2017, but rising interest rates could reverse that trend with a stronger dollar in 2018.

How are we positioning?

Our forecast scenario suggests steady economic growth and modest increases in interest rates in 2018, supporting our preference for pro-cyclical sectors such as technology, financials, and industrials. This steady growth scenario also suggests less enthusiasm for defensive sectors such as real estate, staples and utilities. However, if we view a higher probability of a domestic "wage cascade" described above, we will likely trim U.S.-based equities and step up our modest push into non-U.S. stocks.

Switching over to the bond market, we expect rising rates to make short term bond yields slightly more attractive for new purchases, although our sense is that bonds with 10+ years to maturity may see less upside for yields. That's because low bond yields outside the U.S. are driving up foreign demand for U.S. bonds, a trend that's pushing prices higher and yields lower for long-dated U.S. bonds.

As the calendar rolls to a New Year, we will continue to reflect on the trends of 2017 and chart our roadmap for the year ahead, all the while guided by our core investment principles and your evolving goals and objectives.

With Warm Wishes for a Happy New Year,

FBB Capital Partners

A Note on Tax Reform

As you are likely aware the New Year marks the beginning of some big changes to the tax code, and at first look this will impact many of FBB's clients. While a year-over-year comparison may be difficult to predict (2017 actual vs. 2018 estimate), we encourage you to work with your tax advisor during your 2017 preparation to discuss what adjustments you might consider for the year ahead.

As always, please feel free to coordinate any tax planning issues with your Portfolio Manager at FBB. We'd be pleased to work with you and your tax advisor to help craft a plan as needed.

One Final Note

Once again, we expect there to be multiple revisions to your 2017 1099s, so we advise against filing early.