TOWNELEY Capital Management Inc

2017 Year End Review

The new year is well underway, and that means it is time to review 2017. We sat down with Towneley Chairman and Founder Wes McCain, and Vice President of Investment Services, Ernie Garrett, for their take on 2017. We also discussed potential economic issues on the horizon, interest rates, inflation, energy costs, and the new tax bill. The interview was insightful, and we hope you enjoy the discussion.

What was your take on the economy in 2017?

Ernie: It was a banner year that ushered in a synchronized expansion of economies worldwide. All major regional economies are growing for the first time in almost a decade. The US economy had been sluggish as the year began, with US GDP climbing above an annualized 3 percent only once over the previous nine quarters. Since then, GDP has been accelerating slightly: growth was above 3 percent for two consecutive quarters and the final quarter of 2017 may add a third quarter to the run. Increased consumer and business confidence, sustained strong job growth, continued low inflation, and swelling corporate profits have driven growth. Recent income tax changes, which are expected to lower taxes for corporations and many people, have helped to bolster consumer and business confidence further and should provide a boost to the economy.

Looking beyond the United States, we see several other signs of the synchronized growth. China's strong rebound in early 2016 helped to launch the global economic expansion. Its government continues to realign its economy toward services and consumption, a shift that has led to more household income. As a result, Chinese consumers' appetite for foreign goods is increasing demand throughout the world. In Europe, unemployment continues to decline, and GDP has been expanding as consumers satisfy pent-up demand, boosting their spending. The Japanese economy, which has been mired in low growth and deflation for the past two decades, is showing signs of life with falling unemployment, rising confidence, and increasing exports. The strong global economic conditions of 2017 have kindled hopes that in 2018 we will see the fewest nations in recession on record (with data going back to 1980). Projections suggest that only six countries, which produce a mere 0.4 percent of world output, are expected to contract in 2018.

What were the reasons for the strong stock market performance in 2017?

Ernie: In 2017, increasing corporate profits and a strengthening world economy, along with the possibility throughout the year of tax reform, infrastructure spending, and deregulation, helped propel the domestic equity market to its strongest gain since 2013. Almost all stock market sectors did well. Growth stocks were the primary driver of equity returns throughout the year as large-cap growth (as measured by the Russell 1000 growth index) outperformed value (as measured by the Russell 1000 value index) by its largest margin since 2009, 30.2 percent to 13.6 percent. The main component of the growth category is the technology sector, which makes up 38 percent of the Russell 1000 growth index.

Technology stocks were up 38.8 percent for the year, led by the so-called "FAANG" stocks— Facebook, Amazon, Apple, Netflix, and Google—that comprise 10.8 percent of the Standard and Poor's 500 (S&P 500) and had gains between 33 percent and 56 percent.

The stock market achieved a first in 2017. The S&P 500 stock index ended all twelve months of the calendar year with gains. Since February of 2016, stocks have risen consistently. The index logged only one negative month over that period, indicating quite low volatility. The last correction of at least five percent was 79 weeks ago in June of 2016 when the fear of Brexit shook the market. For perspective, consider this: The average frequency of 5 percent corrections in large-cap stocks going back to 1926 was every ten weeks. A run of 79 weeks without a correction in the market is a stretch of nearly eight times the average.

International equity markets also enjoyed their best year since 2009. Developed markets (as measured by the MSCI EAFE Index) were up 25.0 percent and emerging market stocks (as measured by the MSCI Emerging Markets Index) were up 37.3 percent, both outperforming U.S. domestic equities. A key contributor to the strong performance for international equities was the weak US dollar, which was down 13.7 percent against the euro in 2017. A weaker US dollar helps international equity returns because profits in foreign companies with stronger currencies are worth more US dollars in exchange, boosting gains for investors in dollar-denominated countries. In 2016, as domestic equity markets were becoming more overvalued, we strategically rebalanced the equity portion of most client portfolios to increase international equity exposure from 25 percent to 30 percent. This rebalancing benefited most client portfolios during 2017, and we expect this trend to continue as international equities continue to be more fairly valued compared to US equities.

Wes: I agree. I think international equities are in a better position than US equities in the sense that foreign stocks are much cheaper. However, because so many large US companies have substantial international earnings and because the S&P 500 Index includes many of these companies, I see value in retaining current equity positions in large US companies at this time.

I think gold is returning to an interesting position of probably starting to outperform worldwide equities within a year or so. It may have already started to outperform, but we shall see. If you compound the returns of gold in every currency for the last 17 years and you compare that result to the total return on world stocks or US stocks, you find that gold far outperforms all the stock markets in the world in total return. Gold outperformed US stocks from 2000 until 2012; then it sold off sharply. US stocks have outperformed gold since 2012, but over the whole 17-year period, gold has outperformed. A key factor to watch will be the real, that is inflation adjusted, short-term interest rates in every currency. Since gold is not an earning asset, the cost of holding gold is the opportunity cost of having your money invested elsewhere. It is very difficult for gold to compete with high real short-term interest rates.

The gold price is the most stable of all commodities. I have done several studies comparing all commodity prices since 1970 when gold started trading freely, and gold has the smallest monthly standard deviation of any commodity price. Moreover, it is the only commodity that is being steadily purchased by Russia, Germany, and a number of other central banks. China is accumulating gold bullion at a very rapid rate for reserves. China is the largest producer of gold, and it buys gold, but it never sells gold. To the world's central banks, gold is still money.

What issues do you foresee in the economy going forward?

Wes: Consumers have been financing their spending by borrowing from the future. The strength in the U.S. economy is largely because 70 percent of the economy is consumer based, with a very low savings rate. Since 1900 the personal savings rate in America has averaged 8.5 percent. In recent times, it peaked at 17 percent in 1975. It bottomed in 2008, around 2.5 percent. It moved up to 9 percent in 2013 and is now back at about 3 percent. The personal savings rate is incredibly low compared to historical averages. This may not be so irrational. The real interest rate that the consumer can earn on deposits has been negative or zero for so long there is little incentive to save for the future.

At the same time, our national savings rate is abysmal. We have gone from zero to little debt at the founding of the country to a cumulative total of about ten trillion dollars in debt under President Bush, who expanded the debt hugely with the Iraqi war. President Obama doubled it with another ten trillion. Today we have twenty trillion plus in national debt, and we are probably going to see more than that soon.

This massive debt does not include the promises we have made to Social Security, Medicare, and Medicaid participants. These programs are creating gigantic future obligations. Just like Illinois is struggling under huge obligations, the whole country may look like that in a few years. I do not see any way out of this because what it comes down to is that the savings rate is really highly correlated to real GDP. If you have a positive change in the savings rate, two to three years later you have a positive return to real GDP; conversely, a low current savings rate implies a slowing future real GDP.

We have a very interesting, complex problem. We have an aging workforce. We have a low savings rate. We have a massive national debt. In the near term, I think things could be pretty reasonable. Looking out three years, unless the recent tax rate change results in increases in investment and substantially more tax revenue that currently forecasted, I see a slowing economy, slowing corporate profits, and a much weaker equity market.

What are your thoughts on interest rates in 2018 and 2019?

Wes: I suspect that interest rates are unlikely to go up very much because I do not think the United States government can afford the interest on its debt at much higher rates. The interest on the national debt would be huge if short-term rates returned to 4 percent. Interest payments would take a large portion of the current estimated revenue that the government collects. If interest rates started to go up, what would the Fed do? They talk about letting rates go up, but I cannot imagine how we would pay for entitlements, defense, and all the other government programs.

Perhaps history will repeat itself. From 1942 and during World War II until March 1951, the US Treasury conspired with the Federal Reserve. They pegged the interest rate on long-term government bonds at 2.5%, keeping it low so the government would not have to pay huge interest on its debt financing the war effort. In 1951, they agreed to let the interest rates be somewhat free, via the Treasury-Federal Reserve Accord. Interest rates started going up and peaked in the early 1980s at a very high level and high rates of inflation. Given the recent experience with Federal Reserve policy of near-zero interest rates and the well-known history of post-WWII interest rate manipulation, it is entirely feasible that the Federal Reserve and the US Treasury decide to conspire to keep rates low for fiscal purposes.

The Consumer Price Index has been running around 2 percent for 20 years and has been very stable. It is difficult to find another period in American history with that stability in the price index. Interest rates are low, consistent with a low rate of inflation. But the dollar interest rates are actually quite high, compared to Japan, which is negative, and the euro rates, which are negative. So, we would expect that sooner or later, rates would narrow as investors sell those currencies and buy our bonds because they could have a much higher rate of return, assuming a stable US dollar. But a steadily weakening US dollar in the last year would have made this strategy a poor investment.

Ernie: I agree. I do not foresee much of an increase in interest rates in 2018. The Fed has been increasing the Fed Funds rate and will continue to do so in 2018, so the shorter end of the yield curve will continue to go up. Longer-term interest rates stayed relatively flat in 2017 but will go up in 2018 if inflation expectations increase. As short-term rates have gone up and long-term rates have stayed flat, the yield curve (the difference between long-term and short-term rates) has become flatter over the last 12 months. In 2016, we increased the duration of client portfolios by decreasing the allocation to shorter-duration bonds. At that time, we also increased the high-yield exposure. These strategic changes boosted fixed income returns in 2017.

What are your thoughts on oil and renewables?

Wes: I think renewables are putting pressure on energy prices and that wind and solar are likely to become economically efficient. Battery technology has been a stumbling block, but we hear rumors about new battery technology that is cheap, recharges quickly, and will hold a huge amount of juice for a long time. If we solve the battery challenge, then we have solved the problem of inconsistent sunshine and wind because we can store the energy. Once we can store it, we will not need as much energy from gas turbine plants. And then all this other stuff—all the non-renewable energy—starts to go away. But let's be clear, this is a long-term scenario.

The US is the third-biggest oil producer in the world. Our ability to bring wells on very rapidly with oil shale and then close them down quickly and productively is a totally different kind of change. In Saudi Arabia, we are seeing that they have realized that Russia bumped them out of the top spot and they must do something. Norway announced that their sovereign wealth fund would no longer buy oil and gas stocks and may sell the $35 billion they own. I never understood why Norway invested its sovereign wealth fund, which was largely built on oil and gas, in oil and gas stocks, placing a double risk on itself. It was like Kodak employees buying Kodak stock with their savings, so their job and their savings were highly correlated. The same thing was happening with Norway.

I think the price of oil could be capped by the American shale producers. I did some research there about a year and a half ago indicating that 44 to 55 dollars per barrel was a pretty reasonable price. And the cost for US producers could probably drop below 30 with improving technology. Barring war, revolution and natural disasters I think we will see low energy prices for a very long time.

What are your thoughts on the tax bill?

Ernie: The tax bill that passed in late 2017 made sweeping changes to the tax code. The effects will depend on tax circumstances, but it will lower taxes for many individuals and corporations. Some of the more noteworthy changes include:

- Lowering tax rates for each bracket
- Doubling the standard deduction, so the majority of individuals will no longer itemize their deductions
- Doubling the child tax credit
- New limits on the deductions for state and local taxes

- subject to AMT in the future
- Replacing the graduated corporate tax rate that previously ranged from 15 percent to 35 percent with a corporate tax rate that is now a flat 21 percent.

One of the most interesting changes is the expansion of 529 plans to include tax-free distributions of up to $10,000 per student per year to pay for K-12 expenses, such as tuition and books. Over 30 states offer income tax deductions for 529 plan contributions, so this change could be a great way to save for private education.

Wes: The non-deductibility of state and local property and income taxes hits high-income taxpayers particularly hard in New York, California, Massachusetts, Illinois, and New Jersey. This may discourage business and individuals from moving to these states and/or encourage a move to lower tax states.

Another fundamental problem with the tax bill is that it taxes income at different rates depending on the entity being taxed. A perfect example of this problem is that C-corporations are taxed at a lower rate than pass-through entities. This tax rate differential may encourage entity arbitrage and increase the compliance cost of the IRS. Senator Ron Johnson from Wisconsin thinks all income should be taxed at the same rate, and he is dead right. The solution is to define all income as income without regard to whether it is derived from wages, stocks, bonds, interest, real estate, capital gains, or any other source. C-corporations, pass-throughs, and individuals would all be taxed at the same rate for a given income bracket. The result would be you could get rid of the guardrails that they have set up. What they are creating is a massive work program for lawyers and accountants because everybody will game the system. One good aspect of the new tax bill is that the move to tax on a territorial basis like most of the rest of the world. This should provide less of an incentive for US companies to move their headquarters abroad.

What about repatriation?

Wes: This discussion is very interesting. I listen to people talk about it and basically, what they believe is if the money comes back, it will not be used to build office buildings, factories, and put people to work or to increase wages. All big corporations will do is is increase dividends, buy back stock and repay debt. My view is that if a corporation is unable to find investment projects with high risk-adjusted expected returns, the best thing they could do with it is return it to the shareholders. I think it is good because when shareholders receive the money, they can reinvest it. When people talk about this, they stop at the point of the company buying back stock or paying dividends and think, "Oh my, it is not doing any good for the economy." But that thinking is wrong. It has removed sterile money from the company and put it in the hands of investors, who can now redeploy it in more productive investments.