SkyView Investment Advisors:

2018 Commentary --- Part 1 of 4 – It Was A Very Good Year – And Now?

By Andrew J. Melnick, Chief Investment Strategist (SkyView Investment Advisors, LLC)

November 29, 2017

Inside This Issue

This year, 2017, will be judged as a good one for the economy.

We divided our 2018 outlook into four self-standing commentaries. This first commentary focuses on the overall economy. The second examines the impact of tax reform on 2018 and longer-term. Then the third commentary looks at the Fed's policies and organizational changes. Finally, our fourth commentary offers our investment summary and conclusions.

So let's start.

2017 A Very Good Year—Including the Fourth Quarter

This year, 2017, will be judged as a good one for the economy. G.D.P. for the second quarter grew at a 3% clip. Moreover, the government just raised its "second estimate" of third quarter G.D.P. from 3% to 3.3%. The recovering oil and gas industries contributed an estimated 60% to the economic growth shown so far this year.

Our past commentaries showed evidence supporting expectations for a strong holiday shopping season. In line with that, the Atlanta Fed cites blue chip economists' forecasts averaging 2.7% growth for fourth quarter G.D.P. Both the New York and Atlanta Feds' forecasts call for even higher growth averaging about 3.5%. If fourth quarter G.D.P. growth comes in at 3% or better, it would mark the first time since 2004 that the economy grew at that level or higher for three consecutive quarters. In addition, the fourth quarter momentum should carry into the first half of 2018. One caveat, each year, initial first quarter G.D.P. estimates from the government tend to show disappointing results. This anomaly results from quirks in the government's seasonal adjustment calculations.

2018--Will Growth Continue?

... there seems little reason to expect an economic slowdown during the upcoming year.

Even without tax reform, muted but positive economic growth will likely result in 2018. At the same time, with no notable signs of economic excesses, there seems little reason to expect an economic slowdown during the upcoming year. Most economists expect 2018 economic growth to come in around 2.5%. If tax reform passes, there will be upside risk to those forecasts for reasons we cite further in our commentaries.

U.S. Exports—U.S. Global Earnings—the Weakening Dollar

Important to the domestic economic outlook in 2018 will be U.S. export growth. Expected global economic growth of about 4% in 2018 compares to an estimated 3.7% this year. With increasing global economic growth next year and the likely continued weakening of the U.S. dollar, stronger U.S. export activity should result. In addition, a declining dollar benefits U.S. global corporations when they translate their international earnings into dollars.

The Dominant Dollar—As the Dollar Goes So Goes Global Trade

A recent international monetary fund study showed the strong influence of the U.S. dollar on world trade. That study concluded the strength of the U.S. dollar—it labels the dominant currency--provides a key predictor to aggregate world trade volume. That study showed a stronger dollar, leads to a decline in world trade. We suspect the opposite case will also prove true as the dollar weakens.

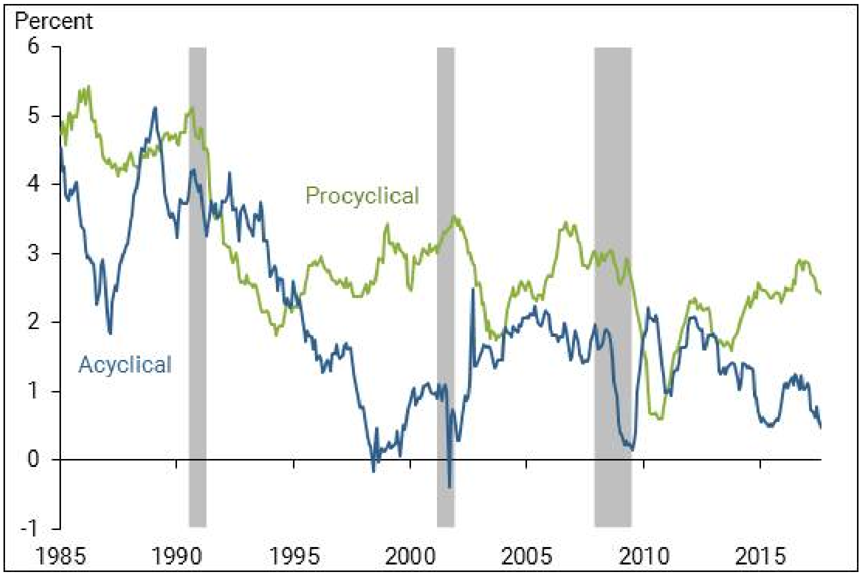
Lagging inflation poses a "mystery" to quote Fed Chair Yellen.

Inflation—Source of Low Inflation: Cyclical Vs Non-Cyclical Categories

Lagging inflation poses a "mystery" to quote Fed Chair Yellen. A recent study from the Federal reserve bank of San Francisco provides some answers. Their study points to modest price inflation in acyclical categories that tend not to be sensitive to overall economic conditions. In comparison, the study shows procyclical price inflation returned to pre-recession levels.

In their study, procyclical categories comprise 42% of personal consumption expenditures (P.C.E.) compared to 58% for acyclical categories. For reference, acyclical categories include health-care and financial services as well as clothing, transportation, and other small categories. The following graph shows the P.C.E. inflation for both categories.

Procyclical and Acyclical Core P.C.E. Inflation



Source: Federal Reserve Bank of San Francisco
Note: Gray bars indicate NBER recession dates

Without the drag from health-care services, the study suggests core P.C.E. inflation would range slightly above 2% for the post-recession period.

Acyclical--Health-Care Services Key Role

Health-care services represents the most important category contributing to low acyclical inflation. Most consumers looking at their medical insurance premiums would find it hard to accept that result. That category contributes about 35% of acyclical inflation and 20% of the entire P.C.E. core index.

Health-care services contributed the major drag to low acyclical inflation. Without the drag from health-care services, the study suggests core P.C.E. inflation would range slightly above 2% for the post-recession period. Reduced growth in Medicare payments contributed to this slower inflation. Possibly this may show a small uptick. The study indicates that inpatient Medicare payments will increase from 0.6% in FY2017 (ends Sept. 30) to 2% in FY 2018.

Pro-Cyclical

So far this year, overall annual wage increases total 2.7%. Even stronger growth of 3.4% shows up in the Atlanta Fed's wage tracker. In our opinion, wage increases will continue to strengthen. This will result from a combination of the continued recent economic improvement accompanied by historically low unemployment rates.

Over the last 12 months, in comparison to these levels of wage increases, the consumer price index increased only about 2% and 2.5% for the F.R.B.S.F. procyclical core P.C.E. inflation. We expect businesses to move aggressively to protect profit margins by raising prices. The recently improved economic growth rate gives more of a window for such price increases.

Improving Capital Spending—A Strategic Change?

> *Even without tax reform, capital spending seems to be accelerating.*

Tightening labor markets may also force businesses to substitute capital for labor to improve their productivity. Tax reform changes will also encourage such capital investment. Even without tax reform, capital spending seems to be accelerating. So far this year, capital spending increased over 7%. This represents the fastest growth rate in three years. Further evidence, in October, nondefense capital goods spending showed its ninth monthly increase in a row—the first time since 2004. No doubt, increasing capital-spending improvement comes as the business cycle moves through its maturing phase. Nonetheless, tax reform's provisions for stimulating capital spending should extend the current capital spending cycle for some time.

The next graph shows the Philadelphia Fed index that forecasts capital spending for the next six months. Last summer this index reached its highest level in 30 years. Perhaps increased capital spending will finally lead to improving the decade's lethargic U.S. productivity levels.

Source: Federal Reserve Bank of Philadelphia

SkyView Investment Advisors:

2018 Commentary --- Part 2 of 4 – Tax Reform – Reform Not Simply Tax Cuts

By Andrew J. Melnick, Chief Investment Strategist (SkyView Investment Advisors, LLC)

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Tax Reform—Will It Pass?

The chances tax reform clears Congress remains somewhat uncertain as of this writing. The odds increased significantly yesterday when it cleared the Senate budget committee. The bill now moves to the Senate floor for a final vote. If the Senate ultimately passes the tax reform bill, it still must go through the House-Senate conference committee to iron out important differences between both measures. For purposes of this commentary, we assumed passage of tax reform before year-end.

Timing of Corporate Earnings Impact

Most important to investors, tax reform will produce increased corporate earnings. The House bill immediately slices the current 35% corporate tax rate to 20% in 2018. The Senate bill postpones that reduction to 2019. Based on estimates from observers, the corporate tax reduction in the House bill could add 5-10% to earnings per share in 2018. Corporations with principally domestic earnings will show the greatest earnings benefit. In particular, mid and small cap and telecom stocks fit that description.

Tax Reform Not Just Tax Rate Reductions

In our past commentaries, we suggested Congress would wind up passing just tax rate reductions and not actual tax reform measures. In fact, this potential legislation contains important tax reforms. In our opinion, moving the United States from a global to a territorial taxation system will prove to be among the most important tax reform measures in the bill. That change, alone, will put U.S. corporations in a more competitive position; eliminate the attractiveness of inversion; and reduce their exposure to unwanted international takeover bids.

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Without getting into the details, the tax bill will also likely result in the repatriation of over $2.5 trillion of cash positions held overseas by U.S. corporations. That cash pile represents nearly 14 percent of U.S. GDP. Repatriated cash will find its way to increasing capital investments and dividends and most importantly increasing acquisition activity. Corporations could also use that cash to repurchase stocks. However, we would question whether that makes good financial sense for those stocks currently selling at record valuations---particularly tech stocks.

Tax Reform Repositions the U.S. Competitively

Overall, tax reform will effect corporations more so than individuals. Proposed tax reforms will reduce corporate tax expenses by an estimated $0.6- $1.1 trillion. This compares to a tax reduction of $200-$900 billion for individuals. The corporate tax reductions could cause rethinking of long-term business strategies for U.S. corporations. Reduced U.S. corporate tax rates could also encourage U.S. global and international corporations to locate more of their new facilities in the United States rather than overseas. It becomes somewhat of a chicken and egg question. The ultimate attractiveness of investing in this country will depend on U.S. economic growth relative to the rest of the world. If tax reform increases foreign direct investments in this country, then this country’s relative economic position will improve.

Tax Reform Should Produce Increased Capital Spending

> The interesting question will be whether such increased capital investments will ultimately move U.S. productivity off its current low base.

For the first five years of the new tax law, businesses will be able to immediately write-off their capital investments. Part I of our commentary showed increased capital spending already occurring with the maturing business cycle. The new capital spending incentive should spur and therefore lengthen this capital investment cycle. The interesting question will be whether such increased capital investments will ultimately move U.S. productivity off its current low base. In any case, rising capital spending certainly could produce higher economic growth. It will also add to the earnings growth of capital equipment suppliers as well as engineering, construction, and production equipment companies.

The Senate provision, if in the final bill, could negatively affect private-equity buyout activity.

Partial Limit on Interest Expense Deductions

One change that could negatively affect corporations, as well as private investment partnerships, will be the partial limit on interest expense deductions. The Senate and House bills differ importantly of key details of that limitation. The House bill caps the deduction at 30% of EBITDA. In comparison, a more restrictive Senate bill limits interest expense deductions to 30% of only earnings before interest and taxes. Therefore, the Senate version puts a greater interest expense burden on capital intense companies. The Senate provision, if in the final bill, could negatively affect private-equity buyout activity.

Tax Reform—Individuals and the Economic Impact

Many will see increased take home pay in their January pay checks. These individual tax changes will disappear in 2025.

Many, but certainly not all, moderate income Americans will benefit from a combination of lower individual tax rates and doubling the standard deduction. Many will see increased take home pay in their January pay checks. These individual tax changes will disappear in 2025. At that time, desiring to be re-elected, Congress will likely extend the tax changes for individuals. Moderate income Americans tend to spend--not save--most of their additional income from wage increases or tax reductions. Therefore, companies that focus on this market should benefit as these consumers receive bigger pay checks. At the same time, State and Local Tax (SALT) and other changes in the tax bill may create an increased tax burden for upper income W-2 tax payers. The result, sales of luxury housing may suffer.

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2018 Commentary --- Part 3 of 4 – The Fed - Change and Change

By Andrew J. Melnick, Chief Investment Strategist (SkyView Investment Advisors, LLC)

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Fed Funds Rate Where To?

Over the last 12 months, the Fed made two important policy reversals. Last December, it raised the Fed funds rate for the first time in nearly a decade. Our past commentaries outlined the reasons why we expected the Fed to be more aggressive with the frequency of its rate increases than investors expect. We dubbed that regularity the Fed's "ex-lax" policy. If our expectation proves correct, then the Fed funds rate will likely wind up at 2.00-2.25% by the end of 2018. For perspective, Goldman Sachs pointed out that the last time unemployment matched our current lows, the Fed funds rate stood at 5.25% and on its way up.

The Changing Federal Open Market Committee Composition

The Federal open market committee (FOMC) guides monetary policy. Its changing composition next year could lead to modification of our outlook for monetary policy. The FOMC includes the Fed's seven governors plus five voting presidents from the twelve regional reserve banks. When Congress confirms the new Fed chair, Jerome Powell, chair Yellen announced she would then leave the Fed. With her departure, there will exist four vacancies among the Federal Reserve's board of governors. Among the five voting presidents, New York Fed president Bill Dudley announced he would resign at mid-year. The outlook for monetary policy awaits the naming and confirmation of the new Fed governors.

The Yield Curve May Be Losing Its Predictive Power

In the past, the slope of the yield curve could prove to be a valuable predictive tool of economic activity. In particular, when short-rates moved above long-rates, it generally signaled slowing economic activity. Normally, the Fed then followed with rate cuts. Before the financial crisis, the Fed did not attempt to manage the long-end of the yield curve since it lacked the tools to do so.

...managing the yield curve by the Fed and other central banks may lessen the predictive powers of changes in the yield curve slope.

Today, the Fed attempts to manage both ends of the yield curve. It does this by combining the traditional management of the Fed funds rate at the short-end with the unconventional tools of quantitative easing and tightening at the long-end. As a result, managing the yield curve by the Fed and other central banks may lessen the predictive powers of changes in the yield curve slope. This manipulation may, therefore, lessen the interpretive value from the current flattening of the yield curve in the United States.

Quantitative Tightening (QT)—How Far?

Quantitative tightening will result in the Fed gradually shrinking its $4.5 trillion balance sheet. As a result, by the end of 2018, the Fed will let $30 billion of Treasuries and $20 billion of mortgage-backed securities mature each month without replacing them. Economists project the Fed will ultimately reduce its balance sheet to $2.5-$3 trillion.

No History Exists To Judge Quantitative Tightening (QT) Effect

Before the financial crisis, the Fed's balance sheet totaled less than $900 billion and held no Treasuries or mortgage-backed securities. As a result, the Fed primarily focused on moving the Fed funds rate either up or down to effect its policy shift. Therefore, much history exists for investors to judge the impact of such rate changes but none to judge the impact of QT.

Simultaneous Reversal of Two Monetary Policy Tools—No History and Greater Complexity

...judging the effect of just a change in the federal funds rate proves difficult enough for investors

Even with the advantage of history, judging the effect of just a change in the federal funds rate proves difficult enough for investors. Now add to that analytical difficulty by simultaneously reversing two monetary policy variables—not just one. As with the shift to QT, history provides investors with a little basis for making judgements when combining the reversal of two policies.

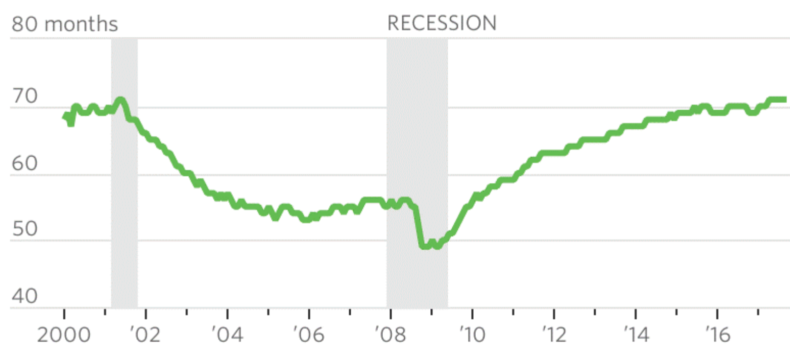
Quantitative Tightening and the New Treasury Department Strategy

In 2018, the Fed's quantitative tightening will gradually reduce its purchase of Treasuries and mortgage-backed securities. The result will be greater dependence on private sector buyers for absorbing their issuance. At the same time, the relative increase in the Federal deficit will add further to the supply of Treasury debt. More specifically, the federal deficit ran 3.5% of GDP at the end of October compared to 2.6% at the same time last year. Additionally, the enactment of tax reform legislation would add an estimated $1.5 trillion over ten years to this higher relative deficit burden.

The new Treasury plan would reverse a nearly decade-long strategy of issuing longer duration debt.

Therefore, the Treasury Department recently altered its strategy for issuing debt. They did so to reduce the upward pressure on long rates resulting from the Fed's reduced purchases of Treasuries. To do so, Treasury will increase its shorter-term debt issuance. As the graph below shows, the new Treasury plan would reverse a nearly decade-long strategy of issuing longer duration debt. With Treasury taking some pressure off long rates, this should also benefit the mortgage financing market. Rates in that market trade based on Treasuries and also face reduced Fed purchases from QT.

Average maturities of marketable Treasury debt outstanding, in months



Source: Treasury Department

Remember

We typically end our comments on the reversal of Fed monetary policies by repeating the old market adage, "do not fight the Fed." This past decade sure proved that advice to be correct.

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2018 Commentary --- Part 4 of 4 – Investment Summary and Conclusions

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The Economy Shows Little Excesses--Economic Growth Should Continue in 2018

Little economic excesses exist that would suggest a slowdown in 2018. This comfortable economic backdrop helps to underlay the current financial market “complacency”. The historically low volatility index—the VIX-- provides evidence of this "complacency." Last week the VIX experienced its lowest intraday reading on record—8.56. As a reminder, despite this favorable economic outlook, market corrections can occur without recessions. Such corrections normally prove to be short in duration.

Will the Fed “Put” Save Investors?

The relatively low market volatility would suggest investors feel confident that the Fed will quickly reverse its current policies at the first signs of an economic slowdown or financial market weakness. If the Fed shocks investors by failing to do so, a new market “tantrum” may result.

Reduced Import of Financial Engineering—Increasing Earnings per Share the Old Fashioned Way

Strategists point out that investors recently tended to reward companies investing capital for growth rather than buying back their own stock. In our view, this represents a very positive change. The last decade’s very accommodative monetary policies afforded corporations the opportunity to borrow cheaply; buyback their stock; and thereby create earnings per share growth greater than their net income. In our view, the Fed’s very accommodative monetary policies bear a share of the blame for the misallocation of capital spending for non-productive purposes. If this increasing capital investment shift grows in force, this may signal a return to building long-term earnings growth the old fashioned way through capital investments. In addition, investors may penalize businesses that grow their free cash flow by holding back on needed capital investments and substitute stock buybacks to spur EPS growth.

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Protecting Margins--Also the Old Fashioned Way

Over the next 24 months, more aggressive pricing could lead to increasing rates of inflation...

With the continuing decline in the unemployment rate, we also expect more businesses to raise prices to offset the wage increases required to attract skilled workers. By doing so, they would either protect operating margins or reduce their erosion. This represents another potential example of businesses returning to their old fashioned way of growing earnings--better business management. Over the next 24 months, if this proves correct, more aggressive pricing could also lead to increasing rates of inflation.

Some Assumptions of Tax Reform Enactment Already Built Into the Equity Markets

Investors cannot easily judge how much equity markets have already priced in the passage of tax reform. Empirically, some price effect already exists. This showed up when investors reacted negatively upon learning the Senate bill postponed corporate tax reductions until 2019. At the same time, the equity market bounced when the Senate budget committee moved the tax bill to the Senate floor.

Where to Look for Higher Earnings from Corporate Tax Rate Reductions?

Obviously, domestic companies will be a prime benefactor from lowered corporate tax rates. At one extreme mid and small cap companies with primarily domestic operations would see higher earnings. At the other extreme, telecoms and other communication service companies would also see their earnings jump.

Big Tech Companies Will Benefit Differently From Tax Reform

Tech companies will likely use their repatriated cash to increase both capital expenditures and dividends...

Major technology companies earn a substantial amount of their income outside the United States. Therefore, they already enjoy lower effective tax rates. At the same time, the tax bill will make it easier for tech companies to repatriate their huge hoards of cash "stored" overseas. Tech companies will likely use their repatriated cash to increase both capital expenditures and dividends and most important purchase public and private companies. With their stocks at peak current valuations, there seems less likelihood they would use this cash to repurchase stocks.

Capital Equipment Spending Will Be Accelerated From Tax Reform

We expect increased capital spending should benefit near-term economic growth.

The new tax bill will permit fully expensing capital equipment investments in the year incurred. Later next year, the resulting increased capital expenditures will add to the earnings of capital equipment suppliers as well as engineering, construction, and production equipment companies. Because this tax bill provision sunsets in five years, businesses will likely move quickly to speed up their long-term capital spending plans. This should benefit near-term economic growth. We expect increased capital spending should finally begin improving the sluggish growth trend of U.S. productivity.

Partial Capping Interest Rate Deductions May Affect High Yield Borrowers

In the past, underperforming businesses took advantage of low-interest rates to finance themselves in the high yield market. In the future, the tax bill's partial capping of the deductibility of interest expenses may limit that source for these underperformers. Investors should carefully review businesses with questionable cash flows that will need to replace current high yield financing, more than likely at higher rates, to remain in business.

Less Accommodative Monetary Policies Could Cap Stock Multiples Later This Year

Over most of this decade, expanding price/earnings multiples, more so than growing corporate earnings, drove stock prices higher. In our view, the Fed's very accommodative monetary policies stimulated that multiple expansion. Later in 2018, that could change as the Fed's reversal of its easy monetary policies could begin capping stock multiples.

Earnings Growth Rather Than Multiple Expansion Key to Future Stock Performance

Future equity market performance will increasingly depend on the outlook for corporate earnings growth...

With the possibility of an earnings multiple cap, future equity market performance will increasingly depend on the outlook for corporate earnings growth. With the greater focus on earnings growth, will investors continue singing the same old market song--buy growth stocks—despite their relatively high current market valuations?

Shift from Long to Short Duration Fixed Income Investments --Add Alternatives

...substituting some alternative investments for traditional long-term fixed income investments may make sense.

Higher long-term interest rates seem likely later next year when less accommodative Fed policies take hold. With that possibility, investors should consider shifting their exposure from longer duration notes/bonds to shorter-duration fixed income paper. As part of that shift, substituting some alternative investments for traditional long-term fixed income investments also may make sense. One caveat, this outlook also sounds familiar and repeats the same old song calling for higher interest rates. However, unlike the growth stock song, this one never seems to be sung.

Final Thought—For Perspective

An American economist, Hyman Minsky, examined the characteristics of the financial crisis. The following quote comes from his research:

"Stability leads to instability. The more stable things become and the longer things are stable, the more unstable they will be when the crisis hits."

So prosper from the current markets but keep those words as a reminder.