Fourth Quarter Newsletter

January 24th, 2018

"Let me tell you how it will be
There's one for you, nineteen for me
'Cause I'm the taxman, yeah, I'm the taxman

The Taxman,
George Harrison, the Beatles

No one likes paying taxes, not even the Beatles, according to their 1966 hit recording, *The Taxman*. Presumably George Harrison penned the song in reaction to the notoriously high tax rates that were in place at the time.

So, it should come as no surprise that the financial markets reacted positively to the news that Congress had finally passed the "Tax Cuts and Jobs Act," December 19th, setting into motion the biggest tax overhaul in decades. Indeed, since the end of summer when it appeared that passage of the bill was likely, the S&P 500 gained 8.2%--producing nearly one-half of the 2017's full year return in just 3 months. Regardless of where on the political spectrum you reside, most analyses of the tax package conclude that over the next few of years there should be savings for American people and businesses that could stimulate economic activity.

Let's Do the Numbers…"

Take individual cuts, for starters. According to the bi-partisan Joint Committee on Taxation in its recent analysis of the budget effects of the Act, American taxpayers will save $75 billion in 2018. In 2019, that annual savings jumps (and peaks) at close to $200 billion. Over the next 10 years, or until 2027, individual taxpayers are estimated to save a total of $1.1 trillion, capturing an estimated 60% of the total $1.456 trillion in tax savings for both businesses and individuals. Please refer to our email/newsletter dated December 22nd where we provided highlights of the tax bill's key features applicable to individuals.

The tax savings for corporations are equally compelling in the early years, with an estimated $129 billion in savings in 2019 and a peak of about $134 billion in 2020. While the business benefits start to trail off relatively quickly, they still add up to a total of $653 billion over ten years. For businesses, the key highlights are as follows:

- Reduces the corporate tax rate from 35% to 21%. The U.S. had one of the highest tax rates among 35 members of the Organization of Economic Co-operation and Development;
- Exempts U.S. corporations from future U.S. taxes on overseas earnings;
- Repeals the Alternative Minimum Tax for corporations;
- Applies a one-time repatriation tax to accumulated overseas earnings of U.S. corporations;
- Allows for 100% expensing of investment spending, which could spur investments to increase productivity.

Economy Could Get a Shot in the Arm

The general consensus is that we'll see a boost in economic growth as a result, possibly for the next couple of years. The Joint Committee, for example, estimates that the reforms will increase the level of Gross Domestic Product (GDP) by 0.7% on average annually over the next ten years, with the stimulus mainly coming from the higher spending by both individuals and businesses, and most of it front-end loaded into the first four (particularly two) years. There are precedents for how a stimulus like tax cuts can impact spending. And with the consumer typically accounting for two thirds of the economy, we think it's safe to say that we will likely see some economic benefit from lower taxes.

And So Could Stocks

This boost comes just at a time when the US economy—and the global economy for that matter—are already doing quite well. The signs are all around us: U.S. GDP growth in the third quarter came in at 3.3%, on top of the second quarter's 3.1% posting, the first back-to-back quarters of 3.0% GDP growth in many years. Both US manufacturing and services sectors have recovered to expansionary mode. Retail sales are equally encouraging.

As a result, corporate earnings growth is expected to be fairly robust, and analysts now expect earnings growth to accelerate in 2018 to a full year increase of close to 15%, marking the highest level of earnings growth since 2011. So even though valuation measures for stocks are high as measured by traditional metrics like the price-to-earnings ratio, better than expected earnings growth could help support higher stock prices in the near term at least.

International is Holding its Own

Not only is the U.S. economy rolling along, but our overseas trading partners are also picking up steam, with Western Europe (the U.K. excluded) and Japan all showing improvement over the past year. Emerging markets and other developing economies are expected to grow the fastest, or 4.9%, in 2018.

For this reason, we are maintaining our current exposures to stocks, particularly international stocks where we feel valuations are more compelling. Indeed, our decision to make a meaningful allocation to international equities paid off last year as international stocks outpaced those in the U.S. (the iShares MSCI All World ex-U.S. index fund increased 27.2% in 2017 compared to 21.8% for the S&P 500). Having said that, we are always focused on ensuring that we are well diversified and are paying close attention to risk.

Things to Keep an Eye On:

- Inflation: Pricing pressures, including wages, have been not only been subdued but have been disappointingly low. If unemployment drops much further, which it could, we may finally see wage pressures and inflation advance beyond current expectations.
- Interest Rates: The Federal Reserve has already raised the Fed Funds rate five times since the end of 2015 from a range of 0%-0.25% to the current level of 1.25%-1.50%. If growth and particularly inflation accelerate much beyond the Fed's current expectations, they could move more aggressively in pushing rates higher.

With the risk that inflation and interest rates move to the upside, we are also continuing our strategy with fixed income to minimize risk by maintaining a shorter time horizon.

We hope you all had a happy holiday season and wish you the best for 2018. As always, we are here to help coordinate all of your financial affairs. Many of us start thinking about tax time well before the April 15th deadline anyways, but with the passage of the Tax Cuts and Jobs Act, it is probably even more on our minds at the beginning of this year. We will happily work with you directly or with whomever provides you with tax advice to make sure we have a sound strategy in place that is best for you.

Sincerely,

Cribstone Capital Management Team

Sources:
Joint Committee on Taxation, Estimated Budget Effects of the Conference Agreement for H.R. 1, The "Tax Cuts and Jobs Act," Dec. 18, 2017; Macroeconomic Analysis of the Conference Agreement for H.R. 1, The Tax Cuts and Jobs Act," December 22, 2017
Joint economic study titled, "The Distribution of Wealth and the Marginal Propensity to Consume," published June 3, 2017 by Christopher Carroll, Dept. of Economics, Johns Hopkins University, Jiri Slacalek, DG Research, European Central Bank, Kiichi Tokuoaka, Ministry of Finance, Japan, Matthew N. White, Dept. of Economics, University of Delaware.
The International Monetary Fund
The Wall Street Journal
Factset