

"Cup of Joe"

The market has been on quite a run since November causing many to ask how long this rally can last. In this Cup of Joe, we will take a look at what's caused this recent surge in equities, what could derail this rally and how things are looking for the rest of the year.

After this parabolic run in the last few months, many market prognosticators have been weighing in on the cause of this massive surge in equities and when it will take a breather. We attribute this move to a number of possible reasons.

- The economy is at full employment and wages are finally starting to heat up. Since the 2008 financial collapse, the unemployment rate has gone from over 10% down to under 5%. With the majority of GDP coming from consumer spending, this has been a positive catalyst to the markets and the economy as a whole.
- The earnings recession over the last year due in large part to the collapse of oil has finally started to reverse and companies are starting to beat analysts' estimates quite handily.
- Many disenfranchised Americans who pulled out and never reinvested their funds after 2008 have sat on the sidelines for 8 years creating a massive amount of cash (roughly $5 trillion) on the sidelines. With a new administration emboldening these individuals, this massive amount of cash is starting to flow back into the markets pushing equities higher.
- Administration promises on deregulation and tax reform have given new life to sectors such as banking with companies such as Goldman Sachs skyrocketing to new highs. While regulations such as Dodd Frank are key to keeping bubbles from forming (2008 Financial Collapse), over-regulation can often times hurt small and mid-size companies. These promises of rolling back such regulations have sent these small and mid-cap sectors soaring.
- Promises of robust corporate tax reform have sent many companies hoarding money overseas to new highs. One of these companies we will use as a proxy is Apple which we happen to own. Apple has over $260 billion dollars overseas. If corporate taxes are lowered and companies are given a one-time tax holiday, this money will flow back to the U.S. where companies will have several options: 1) Buy-back their own stock causing prices to go higher. 2) It will be injected into capital expenditures. 3) It will be used for the acquisition of other companies 4) paid out in the form of dividends to their shareholders (YOU). All of this would be positive news for markets and especially for companies like Apple.

- A massive infrastructure (roads and bridges) bill that would inject anywhere from $500 billion to a trillion dollars into the economy.

All of these political promises have been factored into equities causing the market to boom. So, what could cause the market rally to derail?

- Wages start to overheat causing a domino effect. When wages overheat, inflation spikes causing the Federal Reserve to tighten their monetary policy and raise interest rates faster than expected. A massive jump in interest rates would put a damper on equities and cause losses in the bond market. (When interest rates are high stocks will die! When interest rates are low stocks will grow!)
- The recently emboldened Americans find themselves "irrationally exuberant" to use the quote from Alan Greenspan, pushing equity prices too high causing bubbles that eventually have to pop.
- Certain political promises don't pan out. When you lower taxes, you either increase the country's deficit or you have to find something to offset the loss of revenue (Cut spending or increase the tax rates of individuals) With a massive corporate tax cut, the government will have to find a way to pay for it. This makes the likelihood of a 15% corporate tax rate sketchy and turns it into more like a 25% corporate tax rate, causing the market to adjust and come back to reality.
- Border adjustment taxes. A border adjustment tax means that any goods being imported from other countries are taxed (they are looking at a 20% Tax on imports), causing the prices you pay for things you use every day to sky rocket. To give the simplest example, "Walmart" Anyone shopping at Walmart knows that most goods sold here are from China/Mexico. With a border adjustment tax, Americans would be spending 20% more for goods bought at retailers like Walmart, essentially draining money out of the middle-class and hurting the consumer. Any trade war would likely hurt the economy and the stock market.
- Manufacturing jobs are brought back to the U.S. from overseas. Examples in the news would be Ford cancelling plans to build factories in Mexico. When evaluating costs of labor, U.S. manufacturing on average is around $37.50/hour vs. Mexico at just over $5/hour. This drastically lowers companies' profit margins, forcing them to cut costs (reduce quality) in other ways or increase the price of the product. (Example: "as discussed on the financial news networks" the price of a Ford F150 could increase by $1500) A great example would be Lockheed Martin and the construction of the F35 fighter jets. The CEO explained that by raising the cost of labor and stopping the outsourcing of jobs, companies would then be forced to rely more on automation and the use of robots to cut costs. This in turn causes Americans to actually lose their jobs to cheaper, robotic automation.
- In reference to an earlier point, signing a large infrastructure bill would need to be revenue neutral. If this were not the case, either the deficit would increase or some type of tax/toll would need to be implemented to pay for such a project. To provide an example of this, let's look at the construction of new roads/bridges. Ideas have been tossed around that these new roads/bridges would have tolls to help pay for the bill. This would be a transportation tax so to speak. Any American driving on these newly constructed roads or bridges would have to pay a toll which would in turn, counteract the jobs being created for the endeavor. Again, sucking money out of the consumer's pockets. The other thought would be that not all infrastructure spending goes to roads and bridges. Airports, schools, and telecommunications are also included in bills like this. Well, when you think about it, you can't put a toll on a school or an airport again causing deficits to rise or taxes to be increased.

With hopes that the market will go up forever, we realize that such moves are not sustainable. We feel as though there will be a pullback sooner rather than later. Remember, this is normal and healthy for a market to keep equities fairly valued. When stocks get too expensive, they pull back to where they should be based on their underlying fundamentals. If this didn't happen, bubbles would start to form. (Prices are higher than the real value of the companies) Although we do see the market taking a

breather, we are optimistic on the economy as a whole, while keeping in mind that we still don't know what policy changes will occur. Apple, our biggest holding, has been on a great run that we don't see stopping anytime soon. We feel the iPhone 8 will be a game-changer that could cause a massive super cycle of phone purchases. And, the stock still remains cheap! We remain optimistic about Europe as well, with most of the political uncertainty either overblown or already priced in to current prices. Overall, we feel that our portfolios are well-diversified to benefit from any market move and we are happy with the performance year to date. Any pullback should be short-lived in our opinion and a great buying opportunity for money on the sidelines waiting to go in.

Thanks to all of our clients for your business and continued referrals. We hope you have a great spring and a healthy and prosperous 2017.

-Joe, Ryan, and the Chapel Hill Investment Team

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