

# PERSPECTIVE

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## ECONOMIC AND INVESTMENT OUTLOOK

### The Bottom Line: Fundamentals Over Fears

Despite strong economic growth and corporate performance, 2018 has not necessarily been a year of smooth sailing. At several points, a protracted bull market and future economic growth both appeared to be threatened by the prospects of a global trade war, friction between the US and its closest allies, and other geopolitical concerns. The risks are noteworthy, with the potential to disrupt global supply chains, which could affect economic growth, and by extension, asset prices.

However, in the tug-of-war between trade-related concerns and fundamentals, the pull of positive corporate and economic data has been stronger than trade-related headlines. Investors have ultimately focused on fundamentals and are reaping the rewards.

In our view, the market's solid performance to date is due largely to two factors: Corporate profits are on track to expand a staggering 23% this year, and economic growth in the US is poised to break through the 2% trend, a muddle-through level that has been a hallmark of the post-crisis experience.

With less than four months remaining on the calendar, the S&P 500 is once again on pace for double-digit returns. If it continues along this path, 2018 would mark its eighth year of accomplishing this feat in the past decade.

### Tax Reform Boosts Earnings

As the year progresses, economic data and corporate financial reports are beginning to offer concrete evidence that recent policy measures, including tax reform, are boosting growth and earnings.

If we drill down into the effects of fiscal policy, we can measure the impact tax reform is having specifically on the bottom line as corporate taxes fall from

*(continued on next page)*

a rate of 35% to 21%. Earnings are on track to grow 25% in the second quarter of 2018 versus the same period last year, and tax reform is expected to provide the S&P 500 with a 7% earnings boost (CHART 1), driving calendar-year earnings growth to 23%.

But even when the effects of tax reform are removed from the equation, earnings projections reach roughly 16%. That still puts the US ahead of every other developed market in the world and represents an acceleration from the 5.1% average annual growth rate we have seen over the past four years.

At the macro level, stimulative policy measures beyond tax reform helped propel the US economy, which expanded at a rate of 4.2% in the second quarter, its fastest pace in three years.

It seems evident to us that all these measures have helped re-establish the US as the primary driver of corporate profits and economic growth in the developed world. In fact, earnings were already gaining momentum before the tax code was overhauled in late 2017. But the data suggests tax reform is amplifying this growth in a meaningful way.

### **Will Companies Reinvest?**

Looking ahead, one of the most important questions for markets and the economy is what companies will do in the coming year with the record profits they are generating at home and the offshore earnings they will repatriate.

While survey data suggests a future improvement in capital expenditures, contributing to a sustained pickup in economic activity, trade policy uncertainty could make CEOs reluctant to approve new spending. So far, corporations have preferred to return capital to shareholders through buybacks and increased dividends. Buyback authorizations are estimated to total a whopping \$1 trillion in 2018, which would be a single-year record and represent roughly 4% of the S&P 500's entire market capitalization.

Tax reform is also freeing up capital for mergers and acquisitions. By the end of July, companies had already announced plans to spend a cumulative \$1.8 trillion this year, breaking previous records.

So far this year, executives appear to be allocating much of this newfound capital to record-breaking buybacks and M&A activity. These decisions may not move the needle for the US economy, but they could provide the US equity market with additional support through the end of 2018 and beyond, possibly contributing to further price appreciation and extending the life of this resilient bull market.

### **Repatriation Could Buoy Tech Stocks**

Companies with large overseas cash balances could be the biggest beneficiaries of tax reform, thanks to a repatriation provision that requires them to bring those earnings back to the US at a one-time, discounted tax rate as low as 8% for some firms.

The five largest holders of offshore earnings are all tech firms (CHART 2) and technology is the best-performing sector so far this year, returning more than twice as much as the market.

Moreover, when we compare indexes that factor in each company's market capitalization to indexes that are not weighted, we see additional evidence that the largest firms are benefiting more from fiscal stimulus and making outsized contributions to market returns. For example, the market-capitalization-weighted S&P 500 Index is on pace to return 4% more than its equal-weighted counterpart this year. That would represent the widest margin of outperformance in the past decade.

We appear to have shifted from a "beta" market environment, where a rising tide lifted all boats, to an "alpha" cycle, where selectivity and fundamental analysis are making more significant contributions to performance.

### **Are Stocks Priced for Perfection?**

Clearly, fiscal stimulus is contributing to stronger corporate results. In the second quarter, roughly 70% of S&P 500 companies beat sales estimates and 83% beat earnings forecasts.

It has also raised near-term market expectations considerably. While the average market valuation still seems reasonable, some companies appear to be “priced for perfection” and investors are quickly punishing them for missing sales and earnings targets. On average, their stock prices fell 6% the day after a disappointing earnings report (CHART 3).

On the other hand, the initial reaction among investors is to offer only modest rewards for companies that beat sales and earnings projections. Stock prices for companies that exceeded both top-line and bottom-line expectations gained an average of only 2.8% the day after an upbeat earnings report.

This asymmetric reaction illustrates lofty expectations, increasing the risk of disappointment. An extreme response to an otherwise solid earnings report suggests the market has priced

that stock for perfection. The margin of error for firms in that position is slim, and the margin of safety for an investor holding the stock is equally narrow.

### Keeping Trade Policy in Perspective

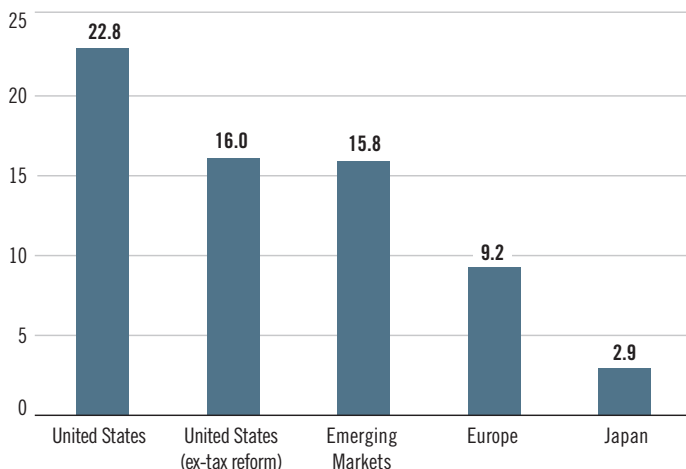
While the “knowns” related to fiscal policy are positive for the market, the “unknowns” accompanying current trade negotiations are not. To date, the Trump administration has announced three rounds of proposed tariffs aimed at China. The total value of goods to be taxed in the proposed actions is \$450 billion—a number regularly referred to in media coverage.

However, it is important to keep in mind that the actual tariffs levied on that \$450 billion worth of goods would be much lower if they went into effect, roughly \$52.5 billion. Midway through August, only \$12.5 billion in tariffs had been implemented, with the balance still in the proposal stage.

Putting this in perspective, the US economy is expected to expand by \$1.1 trillion this year. If all \$52.5 billion in proposed tariffs were enacted, they would represent just under 5% of nominal GDP growth in 2018. In the context of the current policy suite of tax cuts, deregulation, government spending and repatriation, tariffs are relatively small. In fact, the combined value of these measures should top \$1 trillion.

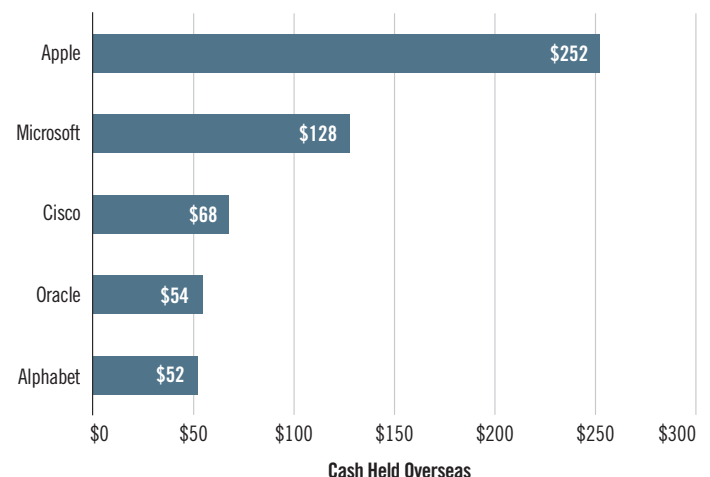
In summary, while the potential domino effect of tariffs is nearly impossible to quantify, the headline numbers pale in comparison to the expected benefits of the stimulative policies enacted by the government over the past year, as well as the expected growth of the US economy.

**CHART 1:**  
The US Regained Its Role as the Primary Driver of Global Growth  
2018 earnings growth forecasts (%)



Source: Bloomberg, as of 8/5/18.

**CHART 2:**  
Tech Firms Hold the Top 5 Spots in Overseas Cash Holdings  
USD, Billions

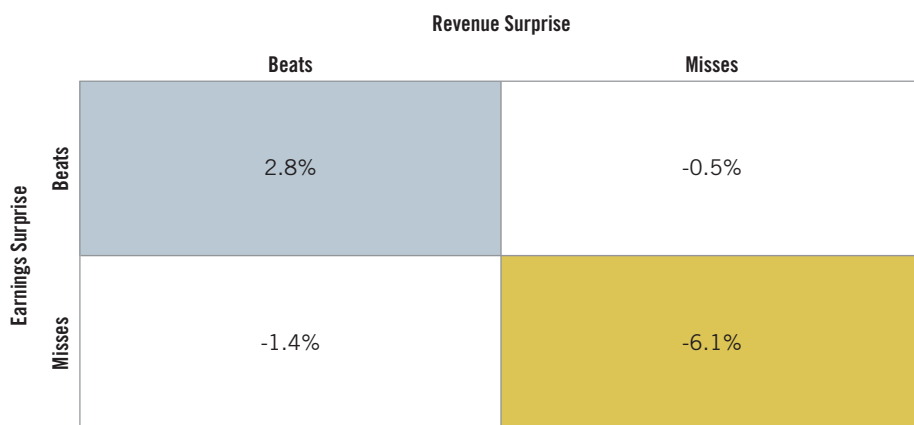


Source: Bloomberg as of 8/5/18.

### CHART 3:

#### Investors Are Punishing Stocks That Miss Financial Targets

Second quarter 2018



Sources: Standard & Poor's, Thomson Financial, FactSet, Credit Suisse.

### The Bottom Line: Fundamentals over Fears

While much remains uncertain on the trade and geopolitical front, what is clear is that both the US economy and corporate backdrop are on solid footing. The benefits of fiscal policy have helped lift corporate profits, support economic growth, and fuel gains in the equity market. Assuming the trade conflict doesn't escalate, we believe markets will continue to focus on strong corporate and economic signals and reward companies that have strong fundamentals.

That's not to say we believe 20% earnings growth and 4% economic growth is the new trend. Market returns have exceeded earnings growth for several years now, and this trend is unlikely to continue in the years ahead. Still, we believe returning to a more "normal" growth rate for both earnings

and the economy would bode well for the life of this lengthy equity bull market.

Even if 2018 proves to be the peak in earnings, we still see a constructive environment ahead for US equities.

Lastly, shifting government policy—from monetary to fiscal—is contributing to greater market differentiation, drawing a sharper line between winners and losers. This should usher in a new regime where alpha opportunities are more prevalent and just "owning the market" may not prove as fruitful as it has for much of this post-crisis cycle.



**RONALD J. SANCHEZ, CFA®**  
Chief Investment Officer  
September 1, 2018

*Kyle Hutchinson, Assistant Vice President, contributed to this report.*

### KEY TAKEAWAYS

- **Fiscal Policy Boosts Earnings and Supports Equities**  
Lower taxes, deregulation, and repatriation are freeing up cash for companies to spend on shareholder-friendly buybacks and M&A, which support the US equity market.
- **Trade Tensions Present Risks, but Keep Them in Perspective**  
Tariffs could threaten global supply chains, GDP growth, and equity prices. But so far, US fundamentals have been strong enough to prevent them from upending the market.
- **A Rising Tide Lifts Some Boats More Than Others**  
Fiscal stimulus is increasing return dispersion, separating winners from losers, and rewarding investors who actively select the right stocks.

## Looking Inward: New Opportunities Beneath the Surface of ‘The Market’

Despite recent concerns surrounding trade rhetoric, the benefits of fiscal policy are boosting momentum in corporate earnings, contributing to economic growth and supporting the US equity market. Therefore, our “risk-on” asset allocation remains in place, with an overweight to equities and underweight to fixed income.

### Equities: Tilting Toward Mid- and Small-Caps

In the US, we are overweight mid- and small-cap equities. Since both categories have more of their revenue derived domestically, they should benefit from tax reform and other fiscal policy measures that are stimulating the US economy. This dynamic could also help to serve as a hedge against any adverse trade actions. Additionally, mid-caps could be buyout targets for larger corporations as we witness a pick-up in shareholder-friendly corporate actions, including M&A activity.

In international developed markets, we continue to favor Japanese equities. Japan has seen a cyclical uptick in economic data and corporate earnings continue to be supported by a weaker yen. This, in addition to improving corporate governance, should provide tailwinds for Japanese equities, which remain priced at valuations we consider attractive.

In emerging markets, we maintain a neutral view. Recently, emerging market headlines have been driven by idiosyncratic issues related to Turkey and Argentina. We believe the risk of contagion is limited, since most other EM countries are fiscally and structurally stronger than they have been historically.

### Fixed Income: Positioning for Higher Rates

Rising rates were a major theme for investors throughout the first half of the year, driven by multiple factors: The supply of Treasury bonds is increasing as new bonds are issued to fund government spending, while demand from the Fed as a buyer is fading. The Fed has also expressed increased confidence in the direction of economic growth, which could encourage higher rates.

Within our fixed income allocation, we prefer US investment-grade credit over government bonds and we are maintaining our short-duration bias relative to our

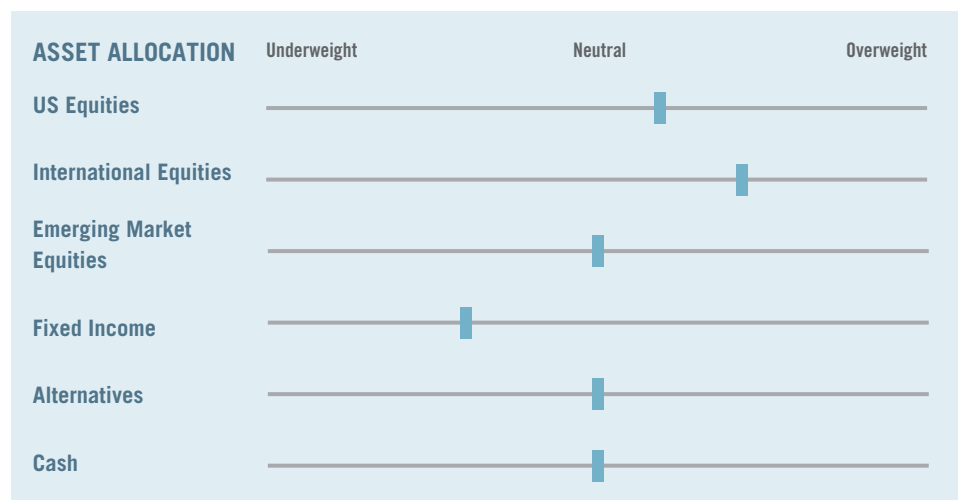
benchmark to guard against interest rate risk. For investors in high tax brackets, the municipal bond market continues to offer tax-advantaged income.

### Alternatives: A Hedge Against Market Volatility

With more geopolitical events moving global markets, we see new opportunities for alternatives to generate alpha. Alternatives could also offer valuable downside protection for multi-asset-class portfolios, especially if issues such as tariffs keep market volatility levels elevated compared to 2017.



**VIRAJ B. PATEL,**  
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Head of Asset Allocation



## Tax Planning Tips for 2018: Steps to Take Before Year End



Tax season is approaching rapidly, and this year brings new legislation put in place by the Tax Cuts and Jobs Act of 2017. While tax reform lowered tax rates and nearly doubled the standard deduction, not all taxpayers will see their tax bill reduced. Many expenses that could be claimed as itemized deductions in the past have been eliminated or severely restricted.

Director of Tax Services Craig Richards offers timely tips to consider as you tackle the new tax law. Of course, everyone's financial situation is different, so be sure to work closely with your Fiduciary Trust advisors as you prepare for the new tax season.

### **Q: What changes could have the biggest impact on taxpayers?**

**CRAIG:** The number of tax brackets remained the same, but rates have been reduced and the top tax rate is now 37%. The standard deduction has been increased, but many previously allowable itemized deductions have been reduced or eliminated, possibly leading to higher tax bills for certain taxpayers.

Items no longer deductible include personal exemptions, interest on home equity loans not used to improve your home, foreign real estate taxes paid, investment expenses and tax prep fees. Beginning in 2019, alimony payments for divorces finalized after 2018 will also be added to the list.

In addition, the maximum state and local income tax deduction has been reduced to \$10,000 per year. This includes any combination of state and local income, real property and sales taxes. Interest on new mortgages is restricted to \$750,000 of indebtedness.

### **Q: Can charitable donations still provide tax benefits?**

**CRAIG:** Charitable donations are deductible only if you itemize, which may be a less likely scenario for many taxpayers now that the standard deduction has been increased. On the bright side, taxpayers who do itemize can deduct cash contributions to public charities of as much as 60% of their adjusted gross income, up from the previous limit of 50%.

If you are making charitable donations, it may make sense to bundle them into a single year so that your itemized deductions add up to more than the new, higher standard deduction in that year. For instance, if you are

a married couple and pay \$10,000 in state income and property taxes and \$10,000 in mortgage interest, you would need to donate more than \$4,000 to charity to exceed the new \$24,000 standard deduction threshold and be able to itemize.

Instead, you could consider “doubling-up” your charitable giving in one year and cutting back on your donations the following year. This could allow you to take an itemized deduction in the first year and then take the standard deduction in the second. You can still “even out” the amount that goes to charity by using a Donor Advised Fund. The fund provides an immediate deduction for the donation, while allowing you to disburse the donation to charity over multiple years.

### **Q: Beyond charitable contributions, did tax reform present other opportunities?**

**CRAIG:** New opportunities are scarce, but there are several worth considering.

529 plans now offer more potential tax savings for parents of school-aged children. You can now use up to \$10,000 a year from a 529 plan on

tuition for Kindergarten through high school, in addition to college. Tax-advantaged 529 plans provide federal tax-free growth and tax-free withdrawals for qualified expenses as well as potential tax credits or deductions for contributions that may be offered by your state if you use their plan.

Second, if you own a pass-through business such as a sole proprietorship, partnership or S-corporation, you may be eligible for the new 20% deduction on qualified business income. This deduction is contingent upon the type of business and is subject to certain income limitations, so be sure to speak to us for further guidance.

Also, the child tax credit was increased to \$2,000 per qualifying child for the 2018 tax year on children who were under the age of 17 in the current tax year.

### **Q: Were changes made to the Alternative Minimum Tax for individuals?**

**CRAIG:** Yes, exemptions for the Alternative Minimum Tax (AMT) have been increased to \$109,400 if married filing jointly and \$70,300 if you are filing as a single taxpayer, and

now start to phase out when income exceeds \$500,000 for individuals and \$1 million for couples. However, fewer taxpayers might be subject to the AMT since many of the most common AMT adjustment items have been reduced or eliminated.

### **Q: How should taxpayers prepare?**

**CRAIG:** If you haven't already, you should be working with your CPA or tax advisor to make sure you understand how the new tax act applies to you. You want to be sure that you are paying in the proper amount of estimated tax or withholding for 2018 and prepare yourself so that there aren't any surprises when your 2018 tax return is finalized.



**CRAIG RICHARDS,**  
**CPA/PFS, CFP**  
Director of Tax Services

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