RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

2017 YEAR-END MARKET COMMENTARY

January 2018

STATE OF THE MARKETS

2017 ended on a high note for U.S. equities with the major indices pushing to new all-time highs into year-end. A major catalyst for the continued strength of the markets was the U.S. Tax Cut and Jobs Act, which changed elements of the U.S. tax code on both the corporate and personal income sides. We discuss the market impact of these changes in detail below. The RDM Capital large-cap value equity composite finished the year up about 10%, net of fees, with a fourth quarter return of about 3.5%, net of fees, consistent with the value indices that most closely resemble our strategy, such as the Russell 100 Value Index.

In addition to tax reform, positive economic data and strong corporate earnings growth throughout the year drove equity markets higher, with volatility remaining at historic lows. Within equities, growth strategies again outperformed, led by large, high-growth technology stalwarts like the "FANG" stocks (Facebook, Amazon, Netflix and Google). With an expected pick-up in economic and corporate earnings growth in 2018, we are convinced that a strategy rotation will occur and value strategies such as our own will lead the markets. We also believe that sectors that we have emphasized in recent years, such as financials, energy, and healthcare, will benefit from a lower corporate tax rate and the cash repatriation tax reforms discussed below.

On the fixed income side, we remain cautious with respect to the impact of rising interest rates in the U.S. While timing interest rate decisions has proven to be difficult, it seems clear that the Fed is committed to a policy of higher rates to ensure the economy does not overheat, which would then necessitate a more rapid, economically destructive rise in rates. Therefore, we intend to maintain diversification in our income investment exposure and seek alternative sources of income for clients in or near retirement to minimize capital depreciation in a rising rate environment. However, we are optimistic that traditional investment-grade fixed income will eventually become more attractive in the medium term as interest rates rise.

Looking ahead to 2018, we expect a positive year for U.S. equities, albeit with greater volatility and greater dispersion of equity returns as markets focus more on economic fundamentals and earnings quality and less on monetary policy. We feel that equities are well overdue for a healthy correction consistent with the average of two or three 5% corrections in a typical bull market year. As in 2017, monetary policy will continue to dissipate as support for equity markets in 2018 and beyond.

We currently project the S&P 500 will hit 3,000 by the end of 2018 (approximately a 12% gain). Factors that could lead to the S&P 500 exceeding our expectations include Washington passing a bipartisan infrastructure reform bill (which is unlikely in an election year) and unexpectedly high corporate earnings due to corporate tax reform (much of which is already baked into the market). The S&P 500 likely will underperform if, among other things, the tax reform bill causes inflation to rise too quickly, leading the Fed to raise rates more than expected, or there is a "black swan" event, such as war with North Korea, a major terrorist attack in the U.S. or a government shutdown.

Review of the Fourth Quarter

Tax Reform Package and Impact for Investors

The U.S. Tax Cut and Jobs Act loomed over all other developments in the fourth quarter. The law presents a significant change for businesses and individuals alike, and its long-term impact is just beginning to be fully understood.

On the individual side, the law's changes to personal income tax rates and deductions present a mixed bag, with winners and losers based on one's income, residence and other individual factors. For example, residents of New York, New Jersey and other high-tax states who own homes and itemize deductions may feel an immediate negative impact due to the $10,000 maximum deduction for state and local taxes and limit on mortgage interest deductions. An example of someone who may benefit from the tax law changes is a wealthy commercial real estate owner in a low tax state, who likely would welcome the reduction in taxes on pass through business income and the lowering of individual income tax rates.

More importantly for the market, the new law makes major changes to taxes on U.S. corporations that should be a net positive for the market, at least over the short-term. While monetary stimulus through the Federal Reserve played a significant role in the post-Great Recession recovery, there are limits to the ability of low rates and large-scale asset purchases to stimulate the underlying fundamental economy. We have expressed in earlier commentaries that more fiscal stimulus was needed to stimulate earnings growth. With respect to corporate taxes, the tax reform bill is an effort to provide this fiscal stimulus most notably by the following reforms:

1) <u>Lowering the corporate tax rate to 21% from 35%.</u> The U.S. had the fourth highest statutory tax rate in the world in 2017 and the highest of all industrialized nations. The cut to 21% brings the U.S. tax rate to slightly below the global average of 22.9%, but still well above, for example, Ireland (12.5%) or Cayman Islands (0%) (a traditional corporate tax haven). This should stimulate business formation in the U.S. rather than overseas and deter U.S. companies from engaging in manipulative accounting practices to avoid recognizing profits in the U.S., such as tax inversion mergers.

2) <u>Enacting a temporary repatriation holiday for cash and assets held overseas by U.S. businesses and switching to a territorial tax system for overseas profits.</u> U.S. corporations have long held trillions of dollars in assets overseas to defer incurring taxes on the profits when the funds are brought back to the U.S. If these corporations were to repatriate their profits to the U.S., they would incur up to a 35% tax. Under the tax reform bill, a one-time repatriation holiday is provided such that liquid assets would be taxed at 15.5% when repatriated to the U.S. while illiquid assets would be taxed at 8%. This holiday should stimulate corporations to bring funds held overseas back to the U.S. The bigger unresolved question is whether corporations will reinvest these assets in hiring, business expansion, etc., devote more funds to dividends and stock buybacks, or some combination of these options.

3) <u>Allowing full expensing of new capital investments for the next five years.</u> An underrated corporate benefit included in the tax reform bill is it allows short-lived capital investments (e.g. machinery) to be immediately fully expensed when purchased during the next five years. Under prior law, businesses received fifty percent bonus depreciation of new short-lived capital investments. This reform is intended to stimulate business investment in new plants and

equipment that could particularly help growing manufacturing businesses, for example, and increase employment in many blue-collar industries that have suffered since the Great Recession.

In summary, the corporate tax changes are a net benefit for domestic businesses and investors in those businesses in the short run and should continue to boost the market heading into 2018. While the short-term benefits of the tax law changes are relatively clear, we are continuing to review how these changes will impact the economy and the markets over the long-term and will have more to say on this issue in future market letters.

Our 2018 Equity Market Projections

1. Banks, Healthcare, Energy and Consumer Discretionary Companies, Along With Certain Large Multinationals, Will Disproportionately Benefit From Corporate Tax Cuts

The tax reform law will benefit those companies with large U.S. operations and high effective tax rates, as well as corporations with large cash hoards overseas that will now repatriate those funds and re-invest them to grow their businesses. Those that will benefit the most are:

- <u>Banks</u>. U.S. banks currently pay one of the highest effective tax rates in the country at 27.5%. Banks may opt to return some of the cash savings to shareholders assuming compliance with regulatory capital requirements.

- <u>Healthcare</u>. In particular, insurers and service providers will benefit as they pay a relatively high effective tax rate compared to pharmaceutical companies.

- <u>Energy</u>. The energy sector is a capital intensive sector that will also benefit from tax reform changes intended to stimulate capital investment within domestic manufacturing.

- <u>Consumer Discretionary</u>. Retailers, such as large department stores, stand to benefit on both the revenue and expense side from the tax cuts as they pay higher effective tax rates and will also potentially receive higher demand from consumers that receive a tax cut.

- <u>Companies with a Large Amount of Overseas Cash</u>. Those companies with a high percentage of overseas cash compared to their market capitalization will now have an opportunity to repatriate that cash at a far reduced rate. Some examples in the RDM Large Cap Value Equity composite include: General Electric (14% of market cap), Microsoft (20%), Oracle (22%), and Apple (25%).

2. The Rotation From Growth to Value Equity Strategies Will Accelerate

Much like 2015, 2017 was a year in which growth stocks heavily skewed the overall market's return higher. In particular, the FANG stocks rose approximately 50% in 2017 compared to the S&P 500 return of approximately 19%. The Russell 1000 Value Index rose approximately 11% for the year. Historically, growth stocks tend to outperform in years in which underlying fundamental earnings growth is moderate and the market as a whole is fairly-valued to slightly overvalued, as it is today. This is because investors will pay more for fast growing businesses and for projected earnings growth in the future when the stock prices of more stable, moderately growing businesses are fairly valued. However, when earnings growth picks up as the economy improves, investors tend to re-focus on value stocks and speculate less on future growth potential of highly-priced stocks. In the lead-up to the release of the tax reform bill, there were signs of this strategy rotation with the technology sector trading down somewhat as investors took gains in growth stocks and rotated funds towards more value-oriented sectors, such as financials. We see this trend continuing into 2018.

3. *The S&P 500 Will Hit 3,000 in 2018 As The Bull Markets Fully Matures*

At the end of 2017, the forward 12-month price-to-earnings ratio was somewhat elevated at 18.4, above the five-year average of 15.8. However, S&P 500 earnings growth was strong, rising 9.6% according to Factset. While earnings growth was somewhat skewed by the drastic recovery in the energy sector off an unusually weak year in 2016, S&P 500 earnings growth excluding energy still was 6.9% with all sectors reporting earnings growth for the year. Earnings growth was largely driven by increased revenue rather than temporary accounting manipulation or cost-cutting, as S&P 500 companies reported 6.2% revenue growth in 2017 - the strongest revenue growth in six years. Therefore, while valuations may have become somewhat high, this valuation is supported by earnings growth, not to mention extremely low interest rates.

Against the backdrop of strong earnings, elevated but reasonable valuations, and low interest rates, we expect 2018 to be another strong year for equities. The positive momentum from tax reform should carry forward into 2018, although we are cautious regarding the potential for a round of selling at the start of the year from investors who delayed capital gains until 2018. Assuming consensus projected earnings growth of 11.8% for 2018 is realized, the S&P 500 should reach 3,000 before year-end. We would not be surprised to see earnings growth exceed expectations due to corporate tax reform and/or valuations expand further if there is a bipartisan infrastructure reform bill. We also would expect the market to miss our target if inflation increases rapidly or there is a significant black swan event.

From a portfolio management perspective, we have maintained healthy cash balances in client accounts throughout 2017 in anticipation of a temporary market pullback. While equities have remained very strong during the year, this period of low volatility is not the norm and we expect 2018 to provide more opportunities for value investors to deploy capital. We expect to continue our overweight position in financials and healthcare, as discussed above. We also will look for new opportunities in consumer discretionary, due to improved consumer finances from tax reform and low unemployment, and industrials, due to continued economic growth and a revitalization of U.S. manufacturing.

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In closing, we thank all of our clients for your continued trust and confidence in us in 2017. We look forward to working with you again next year and wish you and your families a happy and prosperous 2018!

RDM Capital Associates, Inc.

Notable Wealth Planning Rules for 2018

Retirement savings contribution limits:
- $18,500 ($24,500 if aged 50 and over) to a 401K
- $5,500 ($6,500 if aged 50 and over) to an IRA

Income limits to make a fully deductible IRA contribution if covered by a retirement plan at work:
- Single taxpayers covered by a workplace retirement plan, $63,000 with a phase out up to $73,000 (individual filers)
- Married taxpayers where the spouse making the IRA contribution is covered by a workplace retirement plan, $101,000 with a phase out up to $121,000 (married filing jointly)
- Married taxpayers where the IRA contributor is not covered by a workplace retirement plan and is married to someone who is covered, $189,000 with a phase out up to $199,000 (married filing jointly)

Income limits to make a Roth IRA contribution:
- $120,000 with a phase out up to $135,000 (individual filers)
- $189,000 with a phase out up to $199,000 (married filing jointly)

Long-term Capital Gains Rates:
- 0% (up to $38,600 for individual filers; up to $77,200 for married filing jointly)
- 15% ($38,600-$425,800 for individual filers; $77,200-$479,000 for married filing jointly)
- 20% (over $425,800 for individual filers; over $479,000 for married filing jointly)

Estate and Gift Tax:
- $15,000 annual gift tax exclusion
- Amount of assets that are exempt from the estate and gift tax is $11,200,000
- Due to the spousal portability election, the total exemption for a couple is $22,400,000

Social Security:
- Cost-of-living adjustment of 2.0%.
- Amount of workers' income that is subject to Social Security tax is $128,400