FVCM

U.S. MARKET REPORT

F&V Capital Management, LLC
805 Third Avenue, 12th Floor
New York, NY 10022

H. Terrence Riley III, CFA
January 25, 2017

Contact: Karin Mueller-Paris
+1(212) 326 9533 kmm@fvcm.us

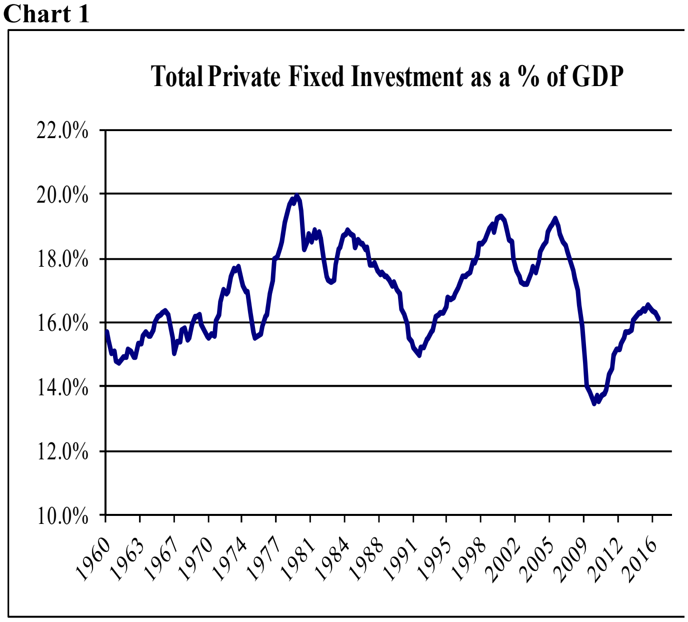
An Optimistic View Among the Hysteria

- U.S economic growth expected to accelerate in 2017 due to Trump policies.
- Capital spending by U.S. corporations expected to accelerate.
- Nominal bond yields heading toward a cyclical high.
- U.S. dollar expected to stay at low end of the roughly \$1.05 - \$1.15 range with Euro.
- Corporate earnings now rebounding after more than a year of decline.
- Stocks could head much higher in year or two ahead.
- Risks to stocks from trade policies and potential tightening of monetary policy.

Trump Determined to Accelerate Growth

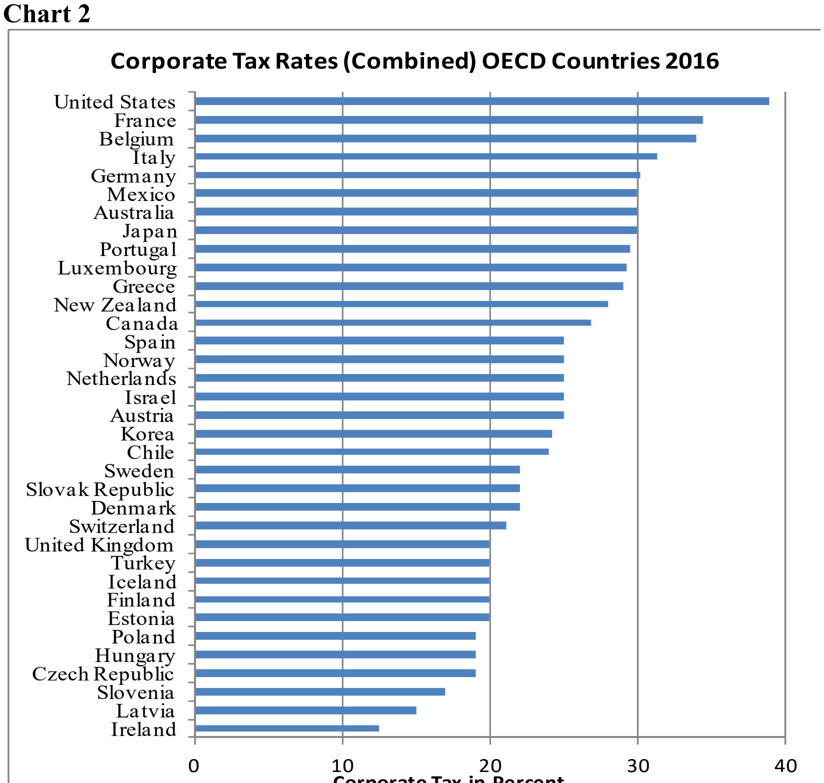
Capital spending, economic growth and productivity gains have been depressed in the U.S. during the current recovery. After falling as much as 20% during the 2008-9 recession, total private fixed investment has not rebounded to previously seen levels in relation to GDP (see Chart 1 below). A couple points: First, while corporate tax rates have been lowered in many countries, nothing has been done in the U.S., which now has the highest combined federal/state corporate tax rate in the industrial world (see Chart 2). Nothing has been done in the U.S. because the politics of the previous administration precluded a deal that would lower taxes on the wealthy. Indeed, our second point is that much of the focus of the past eight years has been on income inequality rather than growth. Capital spending has almost certainly been depressed by the high level of taxation on capital as well as the perception, right or wrong, that the outgoing administration was hostile toward business.

Chart 1



Source: The Federal Reserve, FVCM

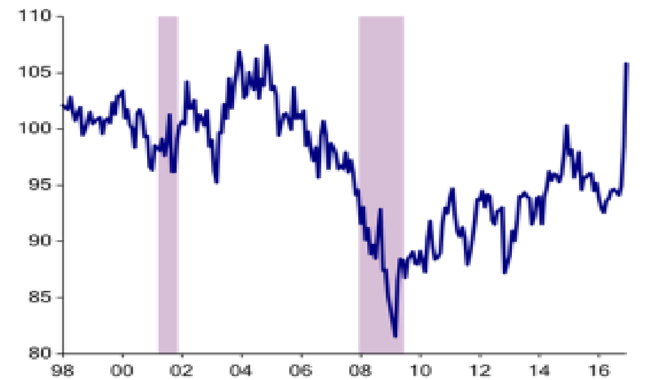
Chart 2



Source: OECD

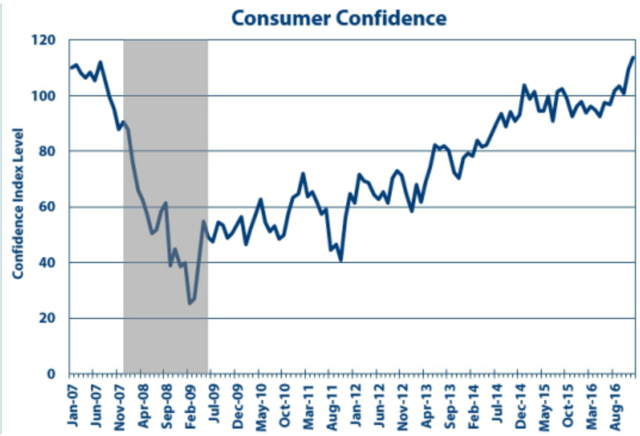
There is already substantial evidence that the recent election has stirred "animal spirits." In his famous book, <u>The General Theory of Employment, Interest and Money</u>, John Maynard Keynes noted that "our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits—a spontaneous urge to action rather than inaction." Keynes was referring to emotions and thoughts of people as economic beings and how business decisions with long term consequences, like capital spending, can be greatly influenced by such spirits. In addition to the recent jump in stock prices, there has been an extreme spike upward in optimism among small businesses (Chart 3). Consumer confidence has also risen (Chart 4). This is evidence that Trump's pro-business proposals, such as a reduction in the U.S. corporate tax rate, as well as planned reductions in personal rates that affect small businesses, is already having an impact.

Chart 3
U.S. Small Business Optimism Index (NFIB) Dec: 105.8



Source: Evercore ISI

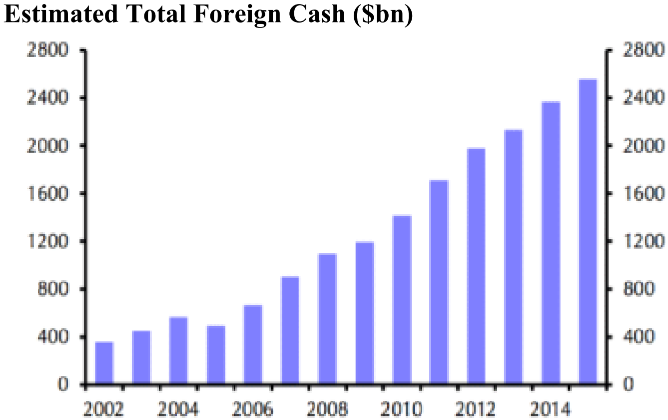
Chart 4



Source: The Conference Board

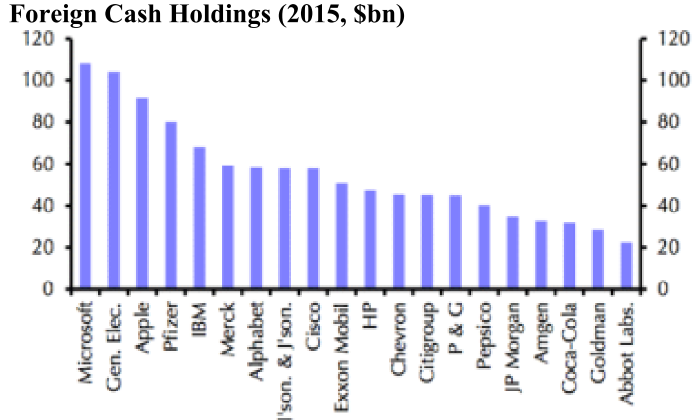
Trump's proposal to reform the U.S. corporate tax system is particularly important. U.S. businesses are reportedly holding more than two trillion dollars in cash in foreign accounts in order to avoid U.S. taxes (see Charts 5 & 6). Corporate profits earned overseas are only taxed in the U.S. when the money is repatriated to the U.S. Trump has proposed a onetime tax of 10% for cash repatriation. Going forward, the new administration plans to reduce the federal statutory corporate tax rate to 15% from the current level of 35%. There have been many "inversions" in recent years where U.S. businesses merge with a smaller firm in places like Ireland in order to cut their tax rate. With the new Federal rate at a competitive level of perhaps 15%, businesses will have more incentive to keep capital in the U.S. and to spend on capital projects in the U.S. rather than direct cash flows toward foreign investment or dividend payments and the repurchase of stock.

Chart 5
Estimated Total Foreign Cash ($bn)



Sources: Business Insider, Capital Economics, SEC, Audit Analytics

Chart 6
Foreign Cash Holdings (2015, $bn)



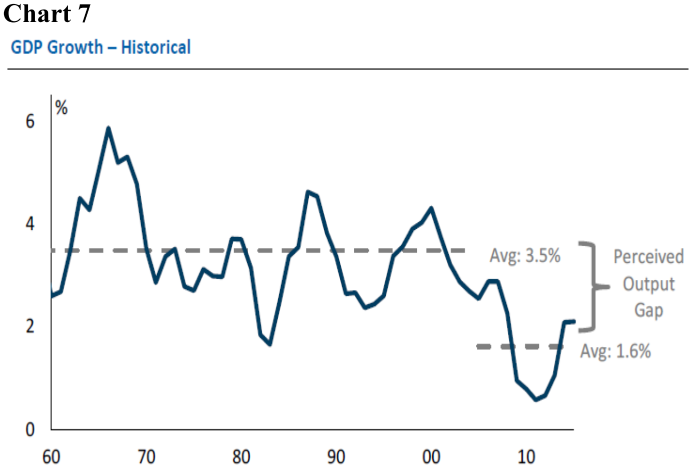
Sources: Business Insider, Capital Economics, SEC, Audit Analytics

The Tax Foundation, the premier U.S. think tank which studies tax policy, published a meta-analysis in 2012 of economic studies on the effects of taxes and found the following:

- Every study over previous fifteen years found negative effect of taxes on growth. Of those studies that distinguish between types of taxes, corporate income taxes are found to be most harmful, followed by personal income taxes, consumption taxes and property taxes.
- The results supported the Neo-classical view that income and wealth must first be produced and then consumed, meaning that taxes on the factors of production, i.e., capital and labor, are particularly disruptive of wealth creation.
- Corporate and shareholder taxes reduce the incentive to invest and to build capital. Less investment means fewer productive workers and correspondingly lower wages.
- Taxes on income and wages reduce the incentive to work. Progressive income taxes, where higher income is taxed at higher rates, reduce the returns to education, since high incomes are associated with high levels of education, and so reduce the incentive to build human capital.
- Progressive taxation also reduces investment, risk taking, and entrepreneurial activity since a disproportionately large share of these activities is done by high income earners.

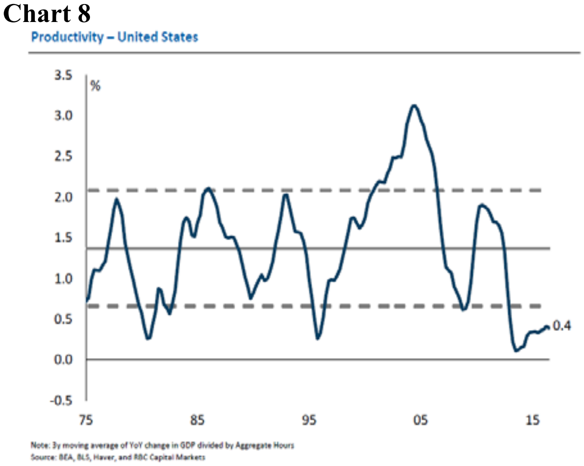
In addition to proposed changes in taxes, animal spirits have been stirred due to Trump's promise to reduce the weight of government in other ways. During the Obama administration, the Federal Register of Regulations has increased faster than at any other time in U.S. history. Trump has promised to reverse many of the regulations affecting the financial, energy, healthcare and other sectors, and his choices for leadership positions make this very likely. Besides a rollback in business regulation, plans have been proposed to reduce the number of personnel in the Federal bureaucracy by 10% to 20%. As shown in Charts 7 and 8, the economy and productivity have grown at below normal rates during the current expansion. Trump plans to embark in a policy experiment of to see if these trends can be reversed.

Chart 7



Source: RBC Capital Markets

Chart 8



Source: RBC Capital Markets

Trade protectionism is the biggest known risk from Trump's policies. But even here, we are learning that the risk may be much less than the harsh rhetoric suggests. For example, Wilbur Ross, Trump's proposed Commerce Secretary and someone considered to be one of Trump's "hardliners," recently made some illuminating statements while under questioning from U.S. Senators during his approval process. Ross acknowledged the negative effects from the Smoot-Hawley across the board tariffs in the 1930s. Instead, Ross advocates a narrow case-by-case use of tariffs in order to "correct inappropriate practices (and) as a negotiating tool," and not in any generalized, across-the-board way. Trump has also clarified that he favors bilateral trade agreements rather than the large multinational agreements like the Trans Pacific Partnership (TPP) negotiated by the Obama administration. Furthermore, it has become clearer that Trump's objections on trade are focused more on low wage countries like Vietnam (part of TPP) and

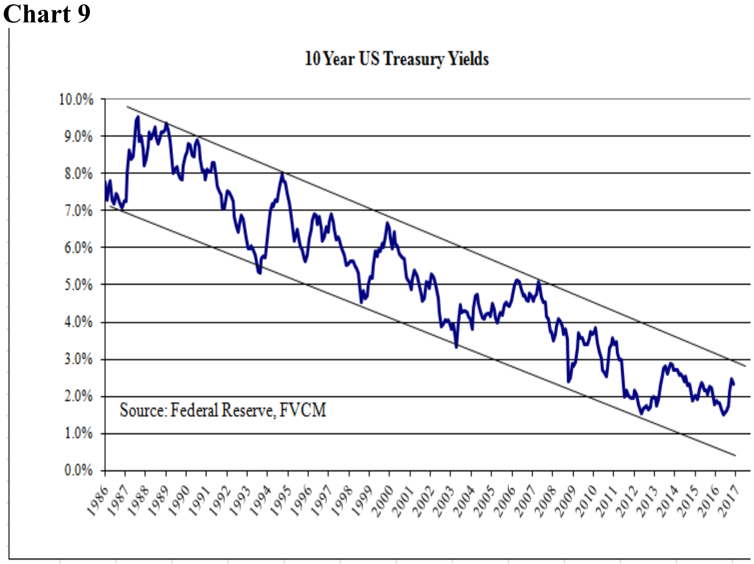
China, and not with high wage countries like Canada, the U.K. or Germany. Furthermore, the threat of targeted tariffs appear to be a negotiating tool, especially with countries like China that are accused of "unfair" trading practices and requirements that foreign companies enter joint ventures with Chinese state owned firms with local majority ownership, the transfer of intellectual property, restrictions on capital withdraws, etc. <u>If Trump is successful in hardline negotiations with the Chinese, it may also help countries like Germany which have suffered from similar problems.</u>

Bond Market Volatility

Long term bond yields spiked up because of expectations of faster growth and Fed officials have become more hawkish. Trump's fiscal policies have changed the medium term dynamic in the fixed income markets since they come at a time when unemployment is already below 5% and attention must be given to inflationary pressures that could build in the years ahead. Public statements made by Fed officials as well as indicators like Fed Funds futures contracts suggest that short term rates are likely to be increased at least a few times this year. Of more concern, some formerly dovish Fed officials, such as Fed Governor Lael Brainard, have even started talking about allowing the Fed's balance sheet to shrink as securities mature. If the Fed does get more aggressive by shrinking its balance sheet, such policies represent a risk to the economy and equity markets and we will have to carefully monitor this situation.

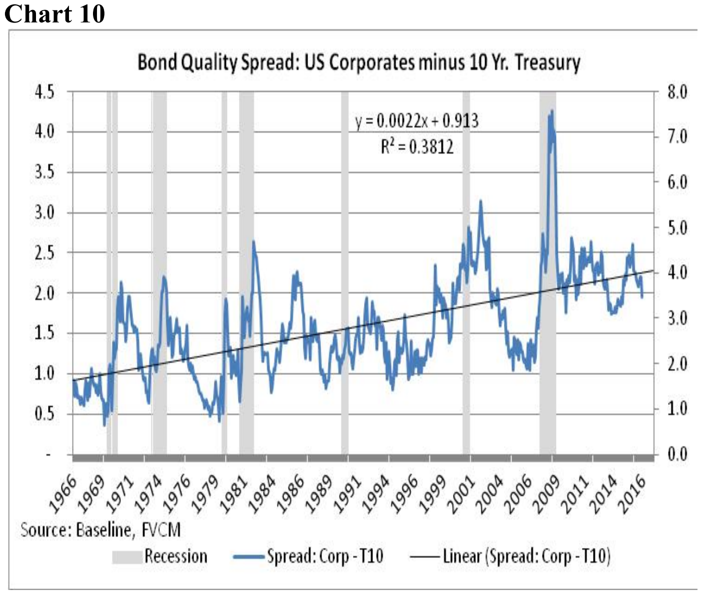
Bond yields still have room to increase further as new economic policy helps elongate the business cycle. Yields have been in a downward trend for more than thirty years as part of the great disinflation that began with Paul Volker and Ronald Reagan since the early 1980s (see Chart 9). As we wrote in our report last October, there are powerful secular forces that are putting downward pressure on spending, inflation and interest rates. Some extreme condition--like a war and a material increase in government spending--could reignite inflation and change this dynamic, but that possibility seems remote. In our opinion, the most likely scenario is that Trump's fiscal policies will accelerate growth for a period of perhaps a few years. And, at least for now, we don't expect yields to break out of the downward channel they have been in for more than 30 years. With regard to corporate bonds, spreads have fallen below trendline (Chart 10) but appear reasonable considering the likelihood for faster growth this year and in 2018.

Chart 9



Source: The Federal Reserve, FVCM

Chart 10



The Dollar-Euro Range Continues

During 2017, we expect the USD/Euro to stay in the \$1.05-to-\$1.15 range it's been in for the past two years (see Chart 11). There are several competing forces affecting the USD/Euro rate at present that we think have created a stalemate that may last considerably longer.

Hurting the Euro:
The Euro has been in a major declining trend since its peak in 2008 (see Chart 12). The likely cause of this poor performance is the very slow or no growth in the Eurozone since the financial crisis. Stagnation has not helped investment, and the seemingly intractable problems in Greece and Italy do not help. Furthermore, the European banking system, particularly in Italy, has an extremely high level of non-performing loans and there is no clear resolution. With the ECB attempting to keep the European ship afloat with quantitative easing (QE), there is little incentive for foreign capital to relocate into Euros. In contrast, the fiscal policy changes planned by Trump are attractive to capital. Rising interest rates in the U.S. also attract capital.

Helping the Euro:
First and foremost, the Euro is cheap based on its purchasing power, which is its fundamental value. Absent a major catastrophe, like a major inflation or a breakup of the currency block, the Euro should do well over the next ten years. Also, Donald Trump has set as one of his major goals the return of manufacturing jobs that have left the U.S. in recent years. To achieve that goal, Trump has already tried to "talk down" the dollar because a strong dollar stifles exports and encourages imports. Recent data has also indicated that European growth is beginning to accelerate. Lastly, eventually the ECB will end quantitative easing. The Euro's f/x value should benefit.

On Balance:
Investors have been struggling with these competing forces for two years now and the USD/Euro has mostly stayed within the \$1.05-to-\$1.15 range. These trading bands, once established over a period of years, usually don't end easily. The election of Trump certainly changes things, but for the months ahead, we think the range will likely hold.

Chart 11

Source: Baseline

Chart 12

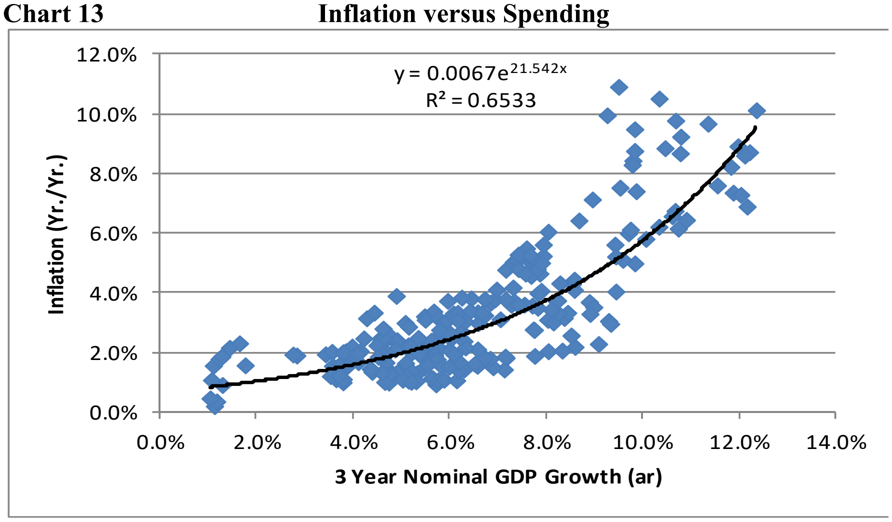
Source: Baseline

Inflation: A Key Factor for the Markets

We remain confident that a surge in inflation is not on the horizon, which is key to a bullish outlook for stocks. As we have written before, there is virtually nothing as corrosive to the markets as inflation. Both bond values and the valuation of broad stock indices like the S&P 500 are directly related to inflation, which eats away at the present value of interest and dividend payments. Also, inflation puts extreme pressure on the central bank to tighten credit and raise short term interest rates, which will typically lead the economy into recession. For that reason we look carefully at the way *the Federal Reserve is managing nominal spending through its levers of money and credit.*

As displayed in our model in Chart 13, we believe there is a direct, but lagging, relationship between the rate of spending growth in the overall economy and inflation. More specifically, the current level of inflation reflects changes in spending over the previous three years. In this regard, we think the Fed's policies have been on target. Nominal spending (GDP) has grown at a modest, non-inflationary rate of 3.4% over the past three years. Broad measures of inflation like the GDP deflator are likely to remain below 2% for at least the year or two ahead. <u>Furthermore, unlike inflation, real economic activity reacts quickly to changes in spending. Therefore, if Trump policies lead to faster spending, the first iteration effect will be the ideal of faster real growth while inflation lags behind at a low level.</u>

Chart 13 **Inflation versus Spending**



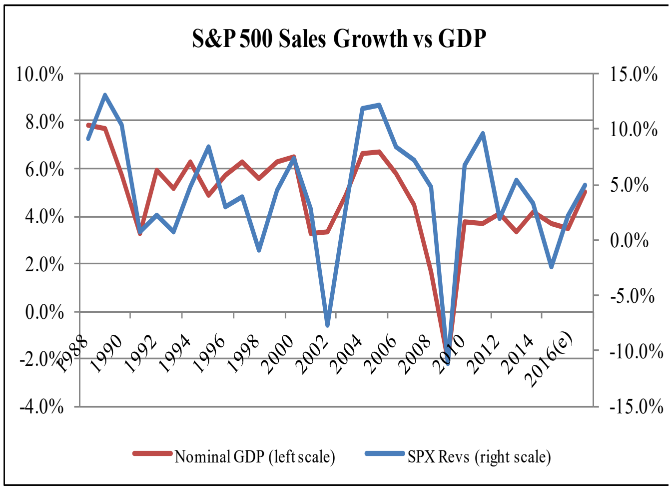
Source: The Federal Reserve, FVCM

Earnings Rebounding

Earnings for the S&P 500 have been rising since the second half of 2016 and more gains are likely ahead. While the earnings rebound is due partly to the relative stability in the dollar's foreign exchange rate, the Energy sector has played the biggest role. Losses by the Energy sector were at their maximum during the fourth quarter of 2015 when losses resulted in a negative contribution of about 10% to overall results for the index. The Energy sector turned back to profitability in the 2016 third quarter as energy prices rose. By the 2016 fourth quarter, energy earnings are estimated to have had a positive 2% contribution to S&P 500 index earnings. Additional gains are likely in 2017 with oil staying at about the $50 per barrel level.

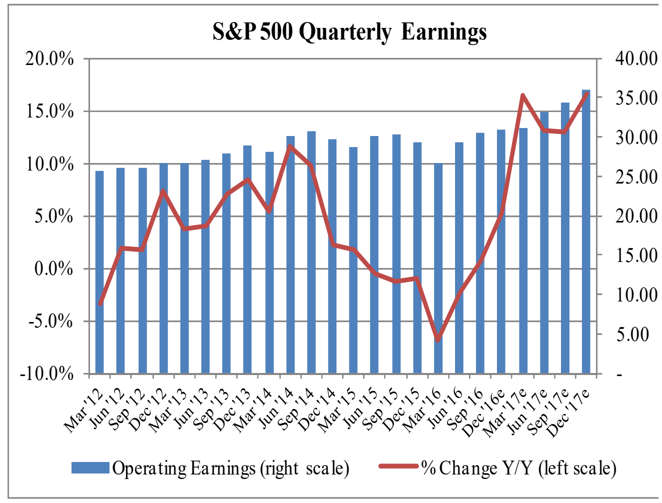
Since November, estimates of operating earnings for the S&P 500 have jumped upward. The consensus estimate for S&P 500 earnings is now 118.01 for 2016 and 128.23 for 2017. Along with continued improvement in the Energy sector, revenues for the S&P 500 are projected to rise about 5% thanks to better growth in the general economy (see Chart 14). Despite upward pressure on wages, the effects of operating and financial leverage should translate into better profit margins in 2017 as well. We estimate that earnings for the S&P 500 could reach 134 in 2017, which is considerably higher than the current consensus estimate of 128.

Chart 14



Source: The Federal Reserve, Thomson Baseline, FVCM

Chart 15

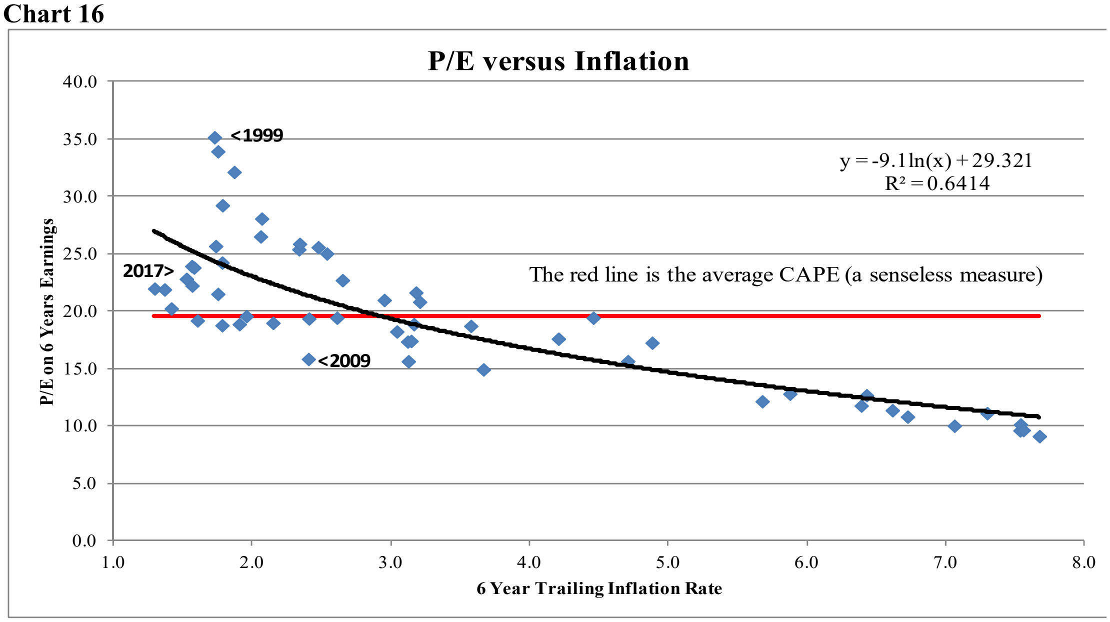


Source: The Federal Reserve, FVCM

Stocks Near Fair Value

We believe that the so-called Shiller P/E is conceptually flawed and that the S&P 500 is reasonably valued considering the low rate of inflation. Without diving deep into all the gory details, we have always found the Shiller cyclically adjusted P/E (CAPE) to be unhelpful because it simply benchmarks the present CAPE to the historic average. We would argue that P/E ratios must be viewed in the context of current/expected inflation in the same way that bond yields only make sense in the context of current/expected inflation. As shown in our valuation model in Chart 16 (the curved black line), periods of high inflation lead to low stock valuations (P/Es)—as well as high yields on bonds. Periods of low inflation, like now, justify high P/Es. So whereas the current CAPE is above the simple average (the flat red line), it is about 8% below our curved line that accounts for period inflation and indicates a modest level of undervaluation. Notice that during the panic of 2009, the S&P 500 was nearly 30% undervalued.

Chart 16



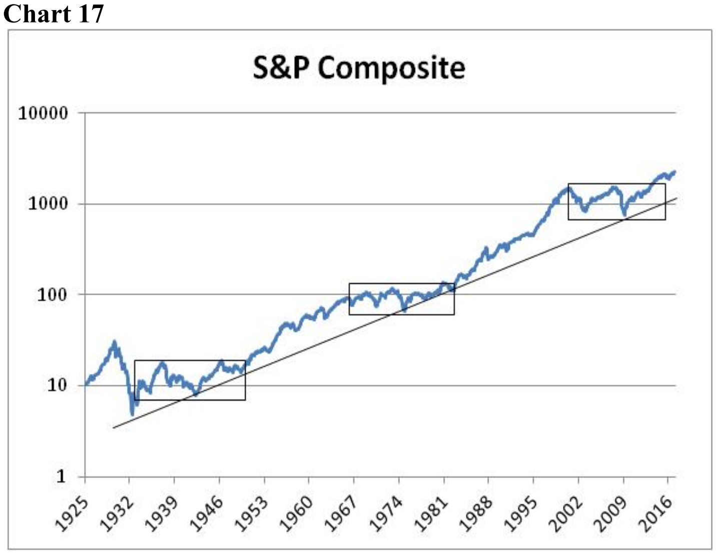
Source: Standard & Poor's, The Federal Reserve, FVCM

Stock Prices: We Expect Higher for Longer

Conditions are ripe for significantly higher stock prices in 2017. The same factors that have driven stock prices sharply upward in recent years remains in place. First, as was previously discussed, inflation is not yet on the horizon and stock valuations have further room to expand before becoming excessive. Second, the fiscal policies being planned by the Trump administration—with the exception of trade policy, are likely to lead to an acceleration in both economic and corporate earnings growth. With both the "E" (earnings) and the "P/E" potentially rising, stocks could move sharply higher. Much will depend on the avoidance of land mines like a bilateral trade war between the U.S. and China, or even a real shooting war which would, obviously, be very negative. Also, as previously mentioned, it will be important to closely monitor the Fed and watch for an indication that they may allow the Fed balance sheet to contract. If that were to happen, bond yields could materially rise, the dollar could shoot upward, and stocks would suffer.

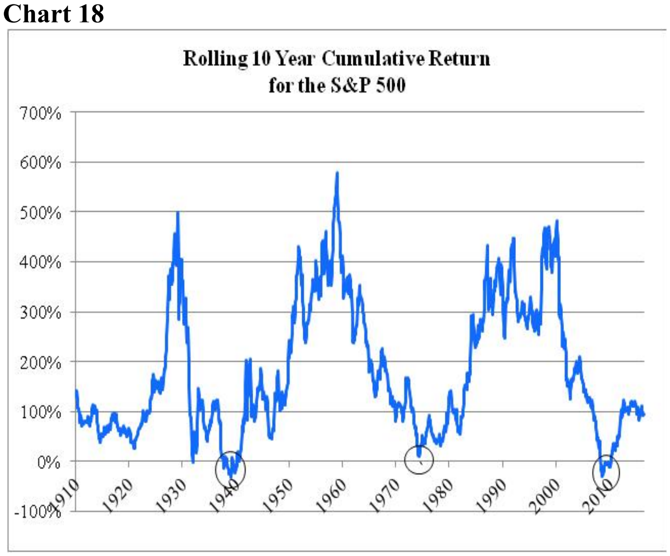
Stocks feel like they have done well in recent years, and they have. But looking at long trends, there could be much further to go. As shown in Chart 17, it took nearly 14 years for the S&P 500 to finally break out of the high set back in March 2000. This bear market resembles two other long periods during the past century when stocks were in a secular bear market—starting during the Great Depression of the 1930s and the Great Inflation of the 1970s. Chart 18 looks at the same phenomenon in another way: It shows the cumulative rolling 10 year return for the S&P Composite. Notice that over the past century there have only been three periods where stock investors could have held stocks for 10 years and either lost money or about broke-even. One of those three periods ended in 2009 and the upswing could be long. Philosophically, we believe that each era is new and that, truly, future events will be unique. But, if past patterns are any guide, we may be only at the beginning of a very long secular bull market after having recently broken free of the third secular bear market of the last century.

Chart 17



Source: Shiller, Yale University; FVCM

Chart 18



Source: Shiller, Yale University; FVCM

The information contained in this report is intended solely for the clients of F&V Capital Management, LLC (FVCM) in the United States, and may not be used or relied upon by any other person for any purpose. Such information is provided for informational purposes only and does not constitute a solicitation to buy or an offer to sell any securities under the Securities Act of 1933, as amended, or under any other U.S. federal or state securities laws, rules or regulations. Investments in securities discussed herein may be unsuitable for investors, depending on their specific investment objectives, risk tolerance and financial position.

The information is obtained from specified sources and is believed to be reliable, but that accuracy is not guaranteed. Any opinions contained herein reflect FVCM's judgment as of the original date of publication, without regard to the date on which you may receive such information, and are subject to change without notice. FVCM may have issued other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance.