The Colony Group

Colony Market Perspectives

In This Report

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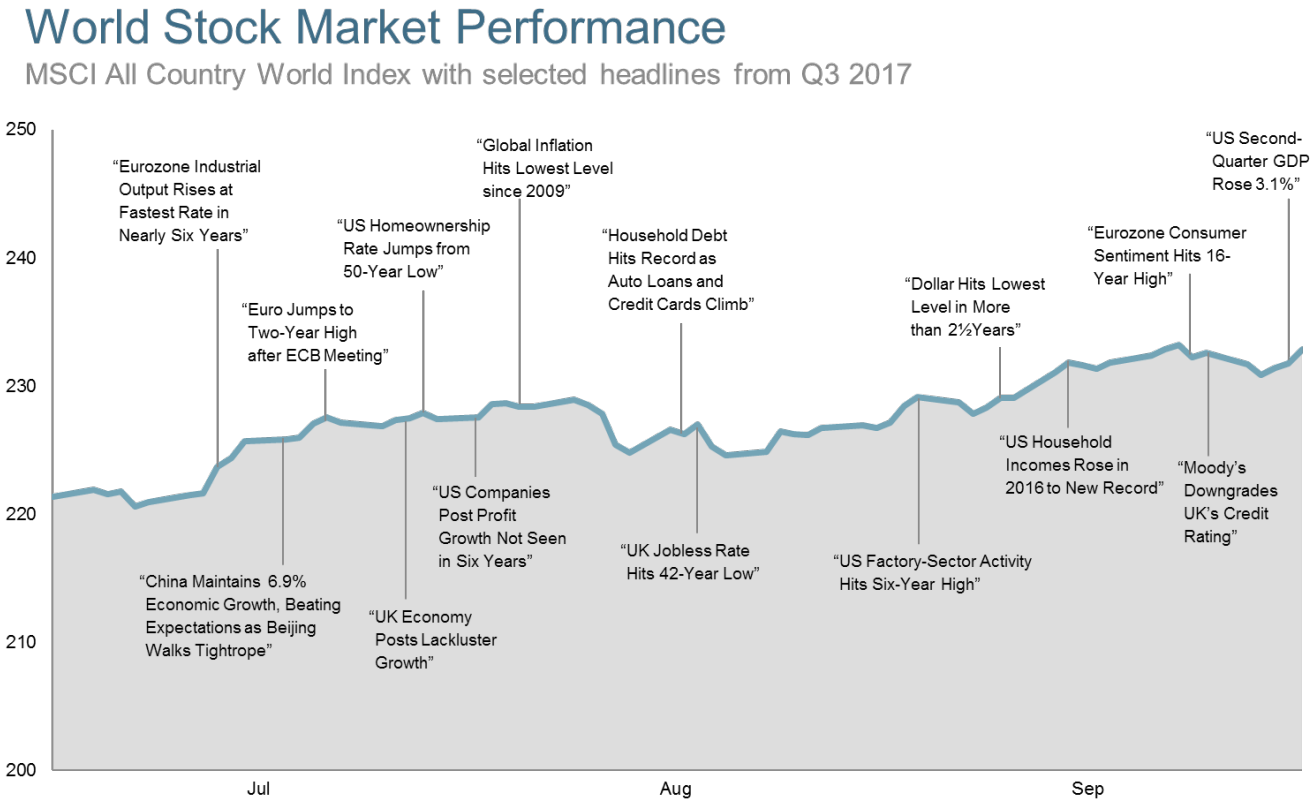
Introduction

Strong and sweeping global growth outweighed mounting geopolitical rancor and devastating natural disasters, sending risk assets higher during the quarter. Equities gained the most, as corporate earnings recovered from the earnings recession that bridged parts of 2015 and 2016. Domestic equities returned 4.5% (as measured by the S&P 500) for the quarter and 14.2% year-to-date. Not to be outdone, international stocks had a total return of 6.2% (MSCI All Country World Index ex-U.S.) for the quarter and 21.1% year-to-date. These results reflect strong economic growth, low inflation, and a monetary policy environment that remains accommodative despite four interest rate hikes by the Federal Reserve.

U.S. interest rates were generally unchanged, as a rally in bond prices earlier in the quarter was offset by a selloff in September when markets responded to hints from central banks that they were inclined to tighten policy. The Barclays U.S. Aggregate Bond index returned 0.9% for the quarter and 3.1% year-to-date. Global inflation continues to run below central bank target levels, keeping interest rates subdued. The spreads on corporate bonds - the difference between the yields on corporate bonds and treasuries - are at historically low levels, a result of strong earnings growth and healthy corporate financials.

Wall of Worry

Some equity investors are grappling with an extensive list of concerns of late. Valuations are high. The current bull-market is aging. The Federal



These headlines are not offered to explain marketplace returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

Graph Source: Dimensional Fund Advisors. MSCI ACWI Index [net div.]. MSCI data © MSCI 2017, all rights reserved.
It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. **Past performance is not a guarantee of future results.**

Reserve is raising interest rates. While it may be counterintuitive, these apprehensions may lend support to the argument that the market may continue to move higher over the near-term.

An old Wall Street adage states that bull markets "climb a wall of worry." Anxious investors that are overly focused on what might go wrong generally have cash parked on the sidelines waiting for a better opportunity to invest. This cash becomes the fuel that pushes the markets to new highs as investors' worries do not materialize and they capitulate from fear of missing out on further gains. It is not until the last marginal investors have deployed their remaining capital that the market tops out, which is usually the point of maximum euphoria. As the adage goes, bear markets "decline on a slope of hope."

What this means – Historically, markets do not peak until investors become overly optimistic. At that point in time, investors unwittingly disregard risk, as the pain of not participating becomes too intense. We do not believe we have reached that point, as investor sentiment is not yet at an extreme.

In fact, market fundamentals may support a continuation of the current trends. Global economic and profit growth is expected to remain strong moving forward, and, despite the current rate hike cycle, financial conditions remain accommodative. Valuations, although seemingly stretched, have historically been a poor timing indicator.

Tax Reform

The administration has turned its attention towards tax reform after failing to pass legislation repealing the Affordable Care Act. While there arguably is greater bipartisan support for tax reform, the contentious atmosphere in Washington means that its fate is uncertain. At the end of September, President Trump released a report called the "Unified Framework for Fixing Our Broken Tax Code," a blueprint of his tax reform plan. As the bill works its way through the legislative process, its details likely will change. Nevertheless, we thought it is appropriate to review the plan's highlights and discuss the potential impact to investors and taxpayers.

The tax plan was reportedly negotiated among the so-called "Big Six," a group that included Treasury Secretary Steven Mnuchin, National Economic Council Director Gary Cohn, and top Republicans in the House and Senate. In its current form, it is reported to increase the deficit by as much as $2 trillion over the next decade according to the Tax Policy Center and the Committee for a Responsible Federal Budget. Weeks earlier, Senate Republicans agreed that a tax package should not add more than $1.5 trillion to the deficit. This difference illustrates just one of the many obstacles legislators will have to sort through during the coming months.

For individuals, President Trump's plan calls for a reduction in the number of tax brackets from seven to three. Under the proposal, the top rate would fall from 39.6% to 35%, while the lowest bracket would increase from 10% to 12% - an aspect Democrats surely will argue favors the wealthy. Republicans will counter that this concern is addressed by a doubling of the standard deduction and a "substantially higher" child tax credit.

President Trump's report lists other elements that would impact individuals. It calls for the elimination of the alternative minimum tax (AMT), which forces many taxpayers with an outsized number of deductions to pay higher taxes. In addition, it eliminates the estate tax, often referred to by Republicans as the "death tax." Lastly, it proposes the elimination of all itemized deductions, with the notable exceptions of mortgage interest and charitable giving.

Corporations would benefit from three proposed changes. First and foremost, the proposal calls for a reduction in the top corporate tax rate from 35% to 20%. Second, so-called "pass-through" businesses would be taxed at a top rate of 25% rather than taxed at the individual's rate, which currently is as high as 39.6%. Lastly, the plan changes how multinational companies are taxed on their profits earned outside the U.S. The framework changes the existing system to a "territorial system," whereby profits derived from overseas would no longer be subject to U.S. tax. Additionally, it would offer a reduced one-time tax rate on profits already earned overseas to entice companies to repatriate this money.

The Republican proposal has a long way to go before it becomes law. Moreover, many of the provisions mentioned above likely will be watered down or changed in any final legislation. Nevertheless, it is our first substantive look at what the administration and the Republicans hope to achieve with tax reform.

What this means – Individual taxpayers could gain in two ways from this plan. For starters, these changes represent a tax cut in aggregate, leaving more money in people's pockets to spend or save. Individuals could also benefit from the multiplier effect associated with fiscal stimulus. As lower taxes translate to higher corporate profits, companies may decide to hire additional workers and increase capital investment.

Equity investors should also benefit. RBC Capital Markets' Chief U.S. Economist Tom Porcelli estimates that every percentage point reduction in the tax rate generates an incremental $1.50 in earnings per share for the S&P 500. Assuming a current effective tax rate of 27% - a result of many U.S. companies sourcing a significant amount of earnings from lower tax-regime countries - the reduction to 20% could generate an incremental $10.50 per share of profits. At its current price-to-earnings multiple, this could add approximately 200 points to the S&P 500 index or an increase of more than 7%. To the extent that higher corporate profits are not reinvested, shareholders could also see greater returns of capital in the form of dividends or share repurchases.

The impact of tax reform on the bond market is potentially less cheerful. While the elimination of the exemption of municipal bond interest income from taxation did not make it into the proposal as originally feared, municipal bonds may decline in price as lower tax rates may reduce the demand for them by taxable investors. Regardless of where the tax rates end up, however, we expect that the taxable equivalent yields on municipal bonds will remain competitive with other bond types.

Another concern for the bond markets involves a widening budget deficit. If the government does not replace the lost revenue from lower taxes, it may need to issue more government debt to finance the widening deficit. An increase in the supply of bonds would push prices down, causing yields to rise. Rising yields may offset the impact of fiscal stimulus, as cash flow may be diverted towards higher interest payments.

These are just some of the investment implications that could result from tax reform. Until there is a final piece of legislation, it is difficult to predict how markets might react. Based on trading following last November's election and, more recently, after the release of the "Unified Framework for Fixing Our Broken Tax Code" report, we believe investors would embrace the proposed changes.

Conclusion

Tax reform promises to be top-of-mind for investors over the coming months. The blueprint released near the end of the quarter provides us with a first comprehensive look into what the administration is thinking. More details are needed, and much will change before a bill is signed into law. Nevertheless, President Trump's stated objective is to stimulate growth. We believe this should benefit risk assets - all else being equal - over the short-term.

The sentiment setup also appears to be positive for risk assets. Each new market high is greeted by a note of caution from investors. This skepticism is not generally associated with market tops. Trying to guess the direction of the market over the short-term typically is not something we are prone to do. With that caveat in mind, we would expect more signs of exuberance before the next bear market begins.

In any event, we certainly continue to believe that the best chance of meeting your investment goals is through a commitment to a long-term investment plan.

Colony Spotlight

- The Colony Group made its 10th appearance on Barron's national ranking of Top 100 Independent Investment Advisors with Colony's CEO ranking #6 nationally and #2 in New England.
- Members of The Colony Group team generously supported and contributed to the American Red Cross in the wake of Hurricane Harvey.
- The expertise of our team was highlighted when members of the Colony team were featured in articles and a video published in *Financial Advisor magazine*, *Advisor Perspectives*, and *Financial Planning*.
- We congratulated the firm's seven newest Principals with a celebration in the Boston office.

From left to right: Jeremy Kuhlen, Ian Barclay, Craig Jones, John White, Tim Jester, Rod Macdonald, Bill Weydemeyer

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