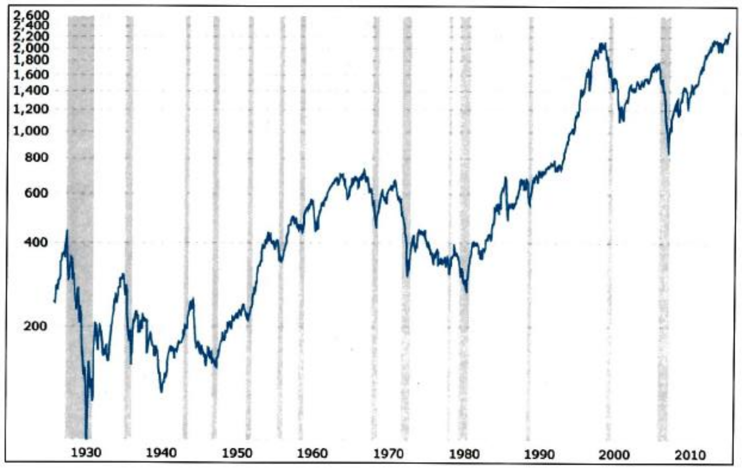
The "New Normal" is moving back to the "Old Normal"

Since the financial crisis of 2008-09, developed nations embarked on a strategy of monetary easing. Led by the Federal Reserve in the U.S., global interest rates declined significantly in the ensuing eight years. This had many positive effects, including significantly lower borrowing costs, reduced inflation and rising asset values. This last factor was clearly evident in rising equity values since the great recession of 2008-09.

Chart I
S&P 500 Index – 90 Year Historical Chart

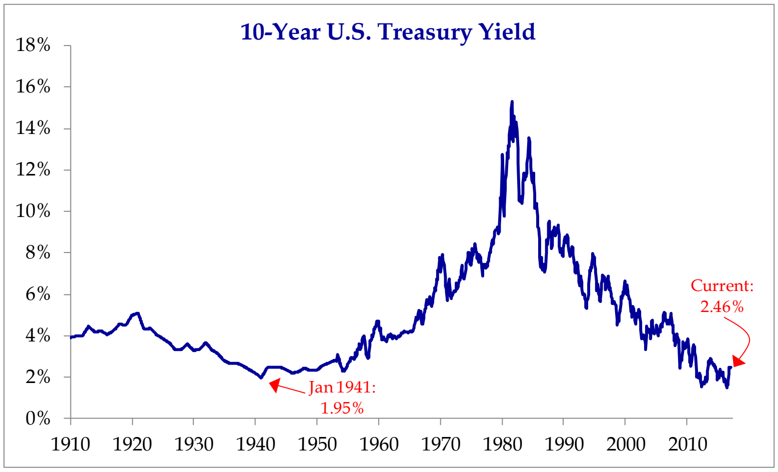


Source: Goldman Sachs
Interactive chart of the S&P 500 stock market since 1927.
Historical data is inflation-adjusted using the headline CPI and each data point represents the month-end closing value.
Shaded bars indicate recessions.

As Chart I demonstrates, the equity market has had a fairly steady climb to current levels from the recession trough of 2009. In 2016, the market finally surpassed the peak reached in 2000. It is important to note that historically, significant declines in the stock market are directly correlated to recessions. At this juncture, no real evidence of a recession is apparent.

The decline in interest rates in the last few years likely caused U.S. economic growth to slow to less than 3% in the same time frame. Low interest rates allowed corporations to redeploy cash flow away from capital expenditures and toward financial investments such as mergers and acquisitions (which hurt job formations), share repurchases and dividends. It also created a deflationary effect on goods and services. Wage growth was stunted with the slow economic recovery and slow job growth overall. The positive impact from low interest rates was also more beneficial to wealthy individuals than low income individuals. Finally, low interest rates and GDP growth helped to keep the U.S. dollar weak versus global currencies.

Chart II



Source: Strategas

Chart II clearly shows that the Fed pushed interest rates to historically low levels in recent years. It also graphically shows the aberrational period of high interest rates reported in the late 1970s and early 1980s. The decline in interest rates from 1980 to 2016 coincided with a strong bond market. As interest rates begin to return to normal, the bond market is likely to be under pressure in the next few years.

The monetary easing policy ended in the latter half of 2015, as the U.S. Federal Reserve finally reversed direction and began to raise interest rates off the extremely low levels. This move was in response to the gradual rise in inflation coupled with the unemployment rate declining. Additionally, we saw a gradual rise in real wage growth after years of stagnation. The government is now attempting to embark on a series of fiscal policy stimulus efforts. These efforts center on the following:

- Significant tax reform, including lower tax rates for individuals and corporations
- Infrastructure spending
- Lower taxes on repatriated corporate profits
- Increased focus on improving our trade deficit

These are ambitious programs, and we expect Congress to debate each initiative over much of 2017. Nevertheless, the groundwork had been laid to see our economic growth accelerate to historical norms as some of these programs take hold in 2018 forward. With interest rates likely to edge higher in the next 12-18 months, we may finally reach a point where a more normal economic business cycle ensues.

Nevertheless, this agenda is ambitious for any administration to get implemented. Trying to implement these programs in conjunction with the Federal Reserve raising rates makes the process that much more difficult. Regardless, if any combination of these policies are enacted in the near future, we would expect economic growth to accelerate to more historical norms. Hence, we may finally see a more normal business cycle in the coming year.

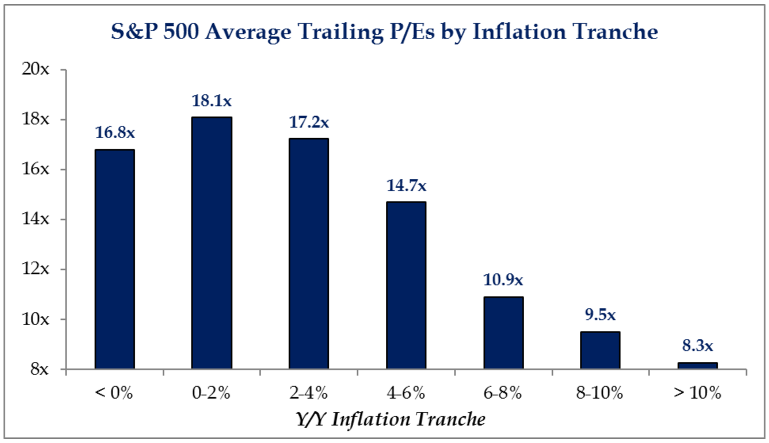
A byproduct of returning to a more normal business cycle will be higher interest rates and, thus, a negative impact to equity valuations. Artificially lower interest rates tend to depress the "risk-free rate" which is critical in valuing equity prices. To offset this effect, corporations will need to demonstrate stronger revenue growth and profitability in the future. ***In a normalized environment, this is the critical factor in allowing equity markets to move higher over the coming years.*** Clearly, corporate tax reform, infrastructure spending, and streamlining/reducing government regulations should help in this endeavor. In addition, these measures should also result in a GDP growth closer to our historic norm of +3.0%.

Conversely, should these fiscal stimulus programs be considerably delayed or not enacted, corporate profit growth expectations will weaken. We point out that corporate profits in the last few years have been flat to modestly rising. Thus, it is critical to see a strong rise in corporate profits to allow for continued strong gains in the equity markets.

PORTFOLIO FOCUS & OUTLOOK

One of the more recent additions to our core portfolio is Intercontinental Exchange (ICE). This is the largest owner of global equity exchanges and clearing houses in the world. It is also a large data provider to the financial services industry. ICE owns the New York Stock Exchange and many other exchanges globally. The company benefits from volatility (which has been unusually low in recent years), but this should pick up as the U.S. economy begins to reflect normal cyclical trends going forward. It should also be a chief beneficiary of any significant streamlining in financial regulations as well. We expect at least 10% earnings growth in the future without any tailwind from planned changes in fiscal policy. The equity is reasonably valued and generates significant free cash flow. We continue to seek out companies like ICE that not only meet our financial criteria of high free cash flow and return on invested capital, but also provide good profit growth in the current environment.

Chart III



Source: Strategas

With inflation at about 1.5%, the equity market appears fairly valued at approximately 19X projected earnings. With the sharp rally in stock prices after Trump's election, we believe the market at least partially discounted some form of corporate tax reform later this year. Nevertheless, it is clear that to sustain the current equity market advances, earnings growth must ensue.

Many strategists are expecting corporate profit growth of 5-10% in 2017. Usually, profit expectations tend to be too optimistic in the early part of the year; however, signs of a recession or poor growth are not in evidence. Indeed, global economic trends are beginning to modestly accelerate. The U.S. government is intent on moving aggressively in fiscal policy programs. Inflation and wage growth is beginning to accelerate. At this juncture, the equity markets appear fairly valued. Should these trends continue, we would expect another 12-18 months of positive returns.

We are sensitive to some cautionary issues that have recently emerged. Congressional debates could again lead to no real progress on fiscal policy initiatives. The U.S. yield curve continues to flatten, and the equity market is discounting some progress on tax reform. We are always focused on capital preservation and will continue to be so in this transitional economic period.

We are pleased to announce that KPCM has again been ranked in the top 1200 financial advisors by Barron's magazine for 2016. We have enclosed the Barron's cover of the rankings. We have also attached a copy of our annual ADV brochure and privacy statement for your records. Please contact our offices with any questions.

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