Chart of the Month

November 2016

Last Tuesday, Donald J. Trump was elected to serve as President of the United States for the next four years. Given the contentious campaign and the highly emotional outcome on both sides, we recognize that it is *morning* in America for about half of the voters and *mourning* in America for the other half.

Interestingly, the Dow Jones Industrial Average was up every day last week. It rose on Monday and Tuesday when Hillary Clinton was expected to win and then advanced Wednesday, Thursday, and Friday after she had lost. The Dow extended its gains on Monday and Tuesday this week. While the market may be stretched in the aftermath of the recent rally, stock prices could benefit from a pro-business agenda that is likely to include tax and regulatory reform designed to boost economic growth.

Trump and Speaker of the House Paul Ryan have each outlined plans to reduce tax rates across the board while consolidating the number of brackets from seven to three and lowering the top individual rate to 33 percent. The standard deduction for joint and single filers would more than double to $30,000 and $15,000, respectively, producing an effective tax rate of zero for lower-income individuals and families.

If enacted, the Trump Plan would retain the existing capital gains rate structure (maximum rate of 20 percent) and repeal the alternative minimum tax as well as the 3.8 percent Obamacare tax on investment income (capital gains, dividends, interest, rents, and royalties). It would eliminate the estate tax (currently 40 percent of the amount above the $5.45 million exclusion) but tax capital gains over $10 million at death.

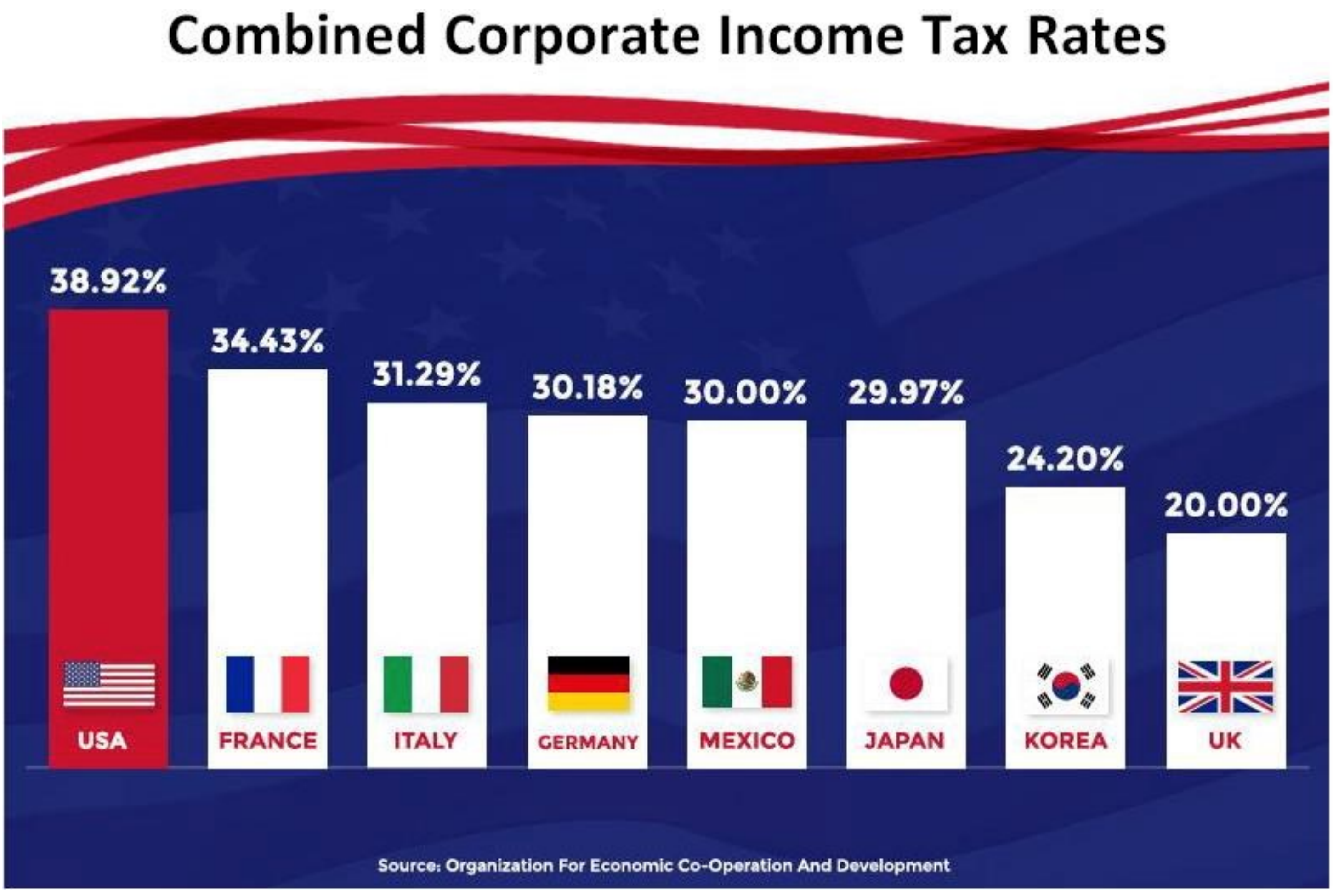
The Trump Plan would also lower the corporate tax rate from the highest in the industrialized world (see chart below) to 15 percent. Ryan has proposed to reduce the rate to 20 percent. Either way, American competitiveness would be restored, if not elevated, incentivizing more domestic and foreign companies to conduct business here.

Of note, lower tax rates would result in higher corporate profits after taxes and the increase in net income, all things equal, should lead to a corresponding rise in stock prices. To illustrate, let's say the XYZ Enterprise makes $1 billion in pre-tax profits. At the current federal tax rate of 35 percent, it would pay $350 million in taxes and report $650 million in net income. At a price-earnings multiple of, say, 15, XYZ would be valued at roughly $10 billion. However, at a federal tax rate of 20 percent, it would pay $200 million in taxes and report $800 million in net income. At the same P/E of 15, XYZ would be worth $12 billion, an increase of $2 billion or 20%.

In addition, Trump would tax corporate profits held offshore at a one-time rate of 10 percent. The repatriation of as much as $3 trillion could generate revenues of $300 billion for the federal government and allow companies to invest in additional plant, equipment, and labor as well as to free up cash to boost dividends, make acquisitions, repurchase shares, and/or pay down debt. Listed in the order of their overseas cash balances, Apple, Microsoft, Cisco Systems, and Alphabet (formerly Google) would be four of the biggest beneficiaries on such repatriation.

Meanwhile, the yield on the 10-year Treasury has increased by roughly 50 basis points (0.5%) since the election in anticipation of stronger growth with somewhat higher inflation in the years ahead. The yield curve has also steepened, which is fully consistent with an economy that is expected to expand. Furthermore, the dollar has strengthened versus other currencies over the past week, suggesting that the U.S. markets are likely to be the most attractive for the foreseeable future.

As we have counseled numerous times over the past several years, bear markets occur following tight credit conditions that cause recessions and declines in corporate profits. Bear markets do *not* take place during periods of accommodative or neutral monetary conditions, expansions, and rising corporate profits. The U.S. economy will experience a recession at some point but such a downturn is unlikely anytime soon. That said, stock prices will continue to ebb and flow, even in the most bullish of times.



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