Wimmer Associates

Quarterly Report

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Letter from Kathy

"It's like a jungle sometimes.
It makes me wonder how I keep from goin' under! "
The Message, Grandmaster Flash and the Furious Five

Dear Friends,

The first quarter of the New Year got off to a wild start. In January, equity markets swung ahead by 8.1%, reaching an all-time high. They then fell off the vine in February, writhing in despair, as the broad markets saw a decline of 10%. On February 5, 2018, the Dow and the S&P 500 indexes sustained their worst one-day point loss in history. It seems that fears of rising interest rates, rising oil prices and intemperate comments from world leaders regarding trade, nuclear weapons and election tampering led to a collective panic. This topsy-turvy behavior in the equity markets was especially unsettling after the smooth sailing of 2017, when volatility was tempered and equity markets enjoyed their longest period ever without a 3% correction. Yet, "since 1945 there have been 77 market drops between 5% and 10% and 27 corrections between 10% and 20%" according to Forbes.

It is helpful to cope with market fluctuations by acknowledging the fact that no one can consistently pick tops and bottoms of market cycles. Market timing is a fool's errand. Selling out of fear almost always guarantees that investors who do so end up on the sideline and then miss a significant portion of any price rebound when markets recover. We are living in an age of uncertainty. The economic recovery from the Great Recession in 2007 is the second longest in history (albeit the recovery pales compared to other historic recoveries). This tepid but long-dated recovery appears to have legs. The federal tax overhaul will provide a potent *fiscal* stimulus to the economy which should help mitigate the withdrawal of *monetary* stimulus by the Federal Reserve.

We remain constructive as to corporate earnings, current stock price valuations and the resilience of the synchronized global recovery. Investors should take a breath and try to relax, as volatility returns to equity markets after a long absence. Below we will discuss the first quarter returns in the market, as well as the general state of the US economy. We will end with our thoughts and expectations for the balance of 2018.~

Cordially,

Kathy Wimmer, CFA, CIC
President

Key Facts for 2018

- *Annual gift exclusion $15,000*
- *Estate, gift and generation-skipping tax exemption $11,200,000 per individual*
- *Highest marginal estate tax rate 40%*
- *IRA contribution limits $5,500, plus another $1,000 for those over fifty*
- *SIMPLE IRA and 401(k) contribution limits $12,500, plus another $3,000 for those over fifty*
- *401(k) contribution limits $18,500, plus another $6,000 for those over fifty*
- *SEP IRA contribution limits 25% of compensation, max of $55,000*
- *Top Federal tax rate is 37% on income over $500,000 (single filers)*
- *Top Federal tax rate is 37% on income over $600,000 (married filers)*

Inside this issue:

First Quarter 2018

January of 2018 saw the 10th straight month of gains in the overall stock market, as the S&P 500 Index reached an all-time high, with a monthly gain of 8.1%. Alas, the good times were short lived. The menace of a trade war was fuelled in the Twitterverse, as President Trump and the Chinese government exchanged threats of countervailing tariffs in the hundreds of billions of dollars. On February 5, 2018 both the Dow Jones Industrial Average and the S&P 500 Index suffered their largest daily point losses in history, although there have been greater one-day losses in percentage terms.

The broad based S&P 500 Index, which continues to be dominated by the FAANG stocks (Facebook, Amazon, Apple, Netflix and Google - aka Alphabet) fell 1.2%, notching its first quarterly loss since 2015. Notably, Facebook fell 9.4% in the first quarter, as shares suffered fallout from US Congressional hearings. Members of the House and Senate committees took Facebook to task for sharing its user information with a now defunct consulting group, Cambridge Analytica, which used the Facebook data to target individuals in the 2016 election. Facebook users, moreover, were outraged, at least temporarily, by veiled Russian ads on the Facebook feed. Yet, Facebook shares have since rebounded strongly, indicating investors care more about growing revenues and profits than feigned outrage over the use of consumer/user data by the social media giants.

Oil prices have rallied 29% over the past year, as West Texas Intermediate crude oil (WTI) settled at $64.93 per barrel on March 31, 2018, compared to $50.35 per barrel in the previous year's period. The reason for the strong price action in oil is the Saudis and the Russians formed an alliance in January of 2017 to prop up oil prices by restricting oil production by as much as one million barrels a day. Production cuts, along with growing worldwide consumption and the near collapse of Venezuelan oil production, has reduced worldwide crude oil inventories and led to the firming of oil prices. Interestingly, WTI crude oil trades at a large discount to North Sea Brent crude oil, caused by the inability of the US to produce its crude in an optimal manner, owing to a lack of adequate infrastructure, i.e., crude oil pipelines. Rising global oil prices have underpinned previous US and foreign country recessions, as consumers scale back purchases of non-energy items in order to heat homes and fill up gas tanks.

The yield on the US Treasury bond climbed to 2.74% at March 31, 2018, compared to 1.94% at the same time last year. The rise in US interest rates is a product of a stronger economy and the Federal Reserve's tighter monetary policy of gradually raising interest rates, along with scaling back purchases of long-dated Treasury bonds, also commonly known as Quantitative Easing. The US rising interest rate environment should lead to a strengthening of the value of the US dollar. A stronger US dollar will make US exports more expensive and US imports cheaper. Yet, the US dollar declined in value during the first quarter of 2018. Threats to withdraw from the North American Free Trade Agreement and US tariffs against Chinese goods led foreign exchange traders to think that the US dollar was overvalued in the face of a threatened trade war, however unlikely.

Housing prices continued to rise throughout the US at the start of the year, as reflected by the S&P/Case-Shiller national index, which grew 6.8%

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The US rising interest rate environment should lead to a strengthening of the value of the US dollar.

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compared to a year ago. Rather than cooling off, as many housing experts have expected, home prices are accelerating. The 6.8% annual gain in the closely-watched 20-city index was the strongest since mid-2014 and finally broke above the peak it last touched in 2006.

According to Reuters I/B/E/S, analysts' consensus estimates for year-over-year earning growth for S&P 500 companies recently aggregated at 21.5%, which is simply stellar growth. Moreover, earnings per share (EPS) should rise sharply, as earnings rise (the numerator) and companies have announced $650 billion in share buybacks (the declining denominator) for 2018. It appears that analysts have "baked" into their projections the rising corporate cash flow from tax reform. Critics can argue that the tax reform will solely benefit corporations and wealthy shareholders. There is evidence, however, that companies are increasing their capital investments, which should further benefit future productivity. The latest minutes (March) of the Federal Open Market Committee of the Federal Reserve stated that "business fixed investment continued to grow strongly" in the first quarter as tax reform now allows for immediate expensing of capital outlays rather than amortizing costs over a period of time. The Fed further stated that "job gains have been strong, on average, in recent months and the unemployment rate has stayed low".

In fact, preliminary April unemployment numbers show the US unemployment rate has declined to 3.9%, the lowest level since December of 2001. Just as striking as the decline of unemployment is the record length of the expansion of job growth: a staggering 91 months. Wage growth remains moderate but has firmed rising 2.6% from a year earlier in April. Economists are confounded that wage growth has been so moderate considering the tightening labor markets, where the number of people seeking employment approximates the number of jobs available in the economy. Anecdotal evidence shows that qualified personnel in manufacturing and technology are receiving sizable signing bonuses because there is a limited pool of skilled labor. We are likely to see further wage growth inflation should the economy continue to expand.

The Institute of Supply Management (ISM) released their April Purchasing Managers Index (PMI®), which indicated that new orders, production and employment in the manufacturing sector continued on a nearly two-year record of positive growth. The PMI® came in at a strong 57.3% level (any amount over 50 indicates a positive trend in manufacturing). A reading below 50 indicates that manufacturing is contracting and is often a harbinger of an oncoming recession. According to Timothy Fiore, Chairman of the ISM,"the April PMI® indicates growth for the 108th consecutive month in the overall economy and the 20th straight month of growth in the manufacturing sector. "The past relationship between the PMI® and the overall economy indicates that the PMI® for April (57.3 percent) corresponds to a 4.3 percent increase in real gross domestic product (GDP) on an annualized basis." We remain a bit more sanguine regarding the prospective US GDP growth estimate for 2018 and find we are more aligned with the IMF's projection of a positive US growth rate of 2.9%, after raising the number from 2.7% following the US tax overhaul. The average annual US GDP growth rate between 2009 and 2016 was up a tepid 1.5%, but that period includes a negative 2.8% decline in 2009 at the depth of the Great Recession.~

Housing prices continued to rise throughout the US at the start of the year, as reflected by the S&P Case-Shiller national index, which grew 6.8% compared to one year ago. Rather than cooling off, as many housing experts have expected, home prices are now accelerating.

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We strive to optimize our clients' financial well being by coordinating investment decisions with other professionals in the fields of taxation and estate planning.

LOOKING FORWARD

"The function of economic forecasting is to make astrology look respectable". John Kenneth Galbraith, Cambridge, MA

While remaining unsure what the stars may tell us, we nevertheless can gauge the positives and negatives in the market, as well as the economy, and render an opinion on where we stand. First, let's look at the tailwinds facing investors and the economy.

Corporate earnings are projected to rise approximately 20% in 2018. This tepid but long-dated recovery continues to breathe life. In addition, the tax overhaul provides a potent *fiscal* stimulus to the economy which should mitigate the withdrawal of *monetary* stimulus by the Federal Reserve. More specifically, the tax reform overhaul reduced US corporate Federal tax rates from 35% to only 21% allowing for increased capital spending and dividends, as well as share repurchases to drive the market higher.

Stock prices seem neither too high nor too low, with forward valuations of share prices versus earnings being within the historical norm. The forward twelve-month Price/Earnings (P/E) ratio stood at 16.95 as of March 31, 2018, compared to the average P/E ratio of 15.31 since 2007. The average P/E ratio for the past eleven years is grossly understated because it includes the deep losses of the Great Recession from 2007-2009.

The macroeconomic environment remains favorable and synchronized world growth continues, while inflation remains under control. The IMF in its latest World Economic Outlook "projects that advanced economies as a group will continue to expand above their potential growth rates this year and next before decelerating, while growth in emerging market and developing economies will rise before leveling off."

The US economy is also expecting a fillip to growth from the rollback of regulations under the current Administration. Monetary policy remains benign for now, as inflation appears moderate. Business and consumer confidence registers strong at historically high levels.

Headwinds in the US market and economy range from geopolitical threats in the Middle East to possible conflict on the Korean peninsula. It is easy to draw the conclusion that threatening "tweets" and saber-rattling pronouncements have a negative, albeit temporary, effect on stock prices. Rising global oil prices may contribute to an increasing rate of inflation and to reduced consumer spending in the US. It is important to note, however, that even with the collapse of Venezuelan oil exports and growing worldwide demand for petroleum, we see ample supplies of Saudi and Russian oil ready to reenter and balance the market should prices rise too quickly.

Volatile trade policies, including the threat of tariffs and import quotas, create uncertainty and the loss of confidence. Businesses tend to hold back on making new capital investments in uncertain environments, because they are unable to confidently project demand for their products. Thus, policy uncertainty often leads to higher risk aversion on the margin for capital investments.

Despite the wild rhetoric, we think it probable that the threats of a trade war are negotiating ploys for posturing trade officials, rather than a desired course of action by any country. Global trading partners are well aware that an actual trade war would decrease worldwide trade. This would hurt all producers via a reduction in world economic output.

While we cannot rule out the possibility of individual "event risks" going forward, we think that the overall positive macro-fundamentals provide tailwinds, which will continue to drive the US economy and US stock market forward and upward, barring any unforeseen occurrences. We remain bullish on the US for 2018.~