Quarterly Point of View
Coming Home

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Driven by stronger than expected revenues and earnings, a conflux of expanding worldwide economies and hopes for a U.S. corporate tax cut which did materialize by year end, stock market averages powered to all-time highs in 2017. Despite often intense political turmoil at home and abroad, market volatility swooned to historic lows. The S&P 500 saw a gain in every single month of the calendar year, the first time in at least 47 years, while the Dow Jones Industrial Average rose for nine consecutive months, its longest streak of monthly gains since 1959[1]. At year-end, the S&P 500 was still extending its longest stretch on record (well over a year) without suffering a peak-to-trough slide of even 3%. We could cite statistics all day long regarding the ridiculously low levels of market volatility, but it's probably easier to simply visualize an escalator moving up, as that was the embodiment of the market last year.

The biggest event from an investment and economic perspective was The Tax Cuts and Jobs Act that Congress passed in December. Likely responsible for a large portion of the sanguine sentiment across Wall Street since the 2016 election, it was a major coup for U.S. corporations, while a mixed bag for individual taxpayers. Since 1993, the top federal corporate tax rate has been 35%, one of the highest levies in the world, fostering a culture of overseas expansion by U.S. companies. The new rate of 21% is momentous, changing incentives to invest and operate in the United States. We'll circle back to that positive concept in a bit, but first we should review what didn't get done with this law.

Foremost in our mind, this was not tax 'reform,' as it remains the same game with a different set of rules, particularly for individual taxpayers. The original objectives of President Trump's tax reform plan were to simplify the tax code, target relief focusing on working families, and close loopholes for corporations and wealthy taxpayers. It seems evident those objectives were not fully met. The final bill is anything but simple (did not even reduce the number of brackets, maintaining seven) and though it seems to provide a modicum of relief for working families, it certainly did not close important loopholes. Case in point is the treatment of so called 'carried interest.' This provision has for decades enabled managers of certain partnerships in the private equity, hedge fund and real estate arenas to pay the lower capital gains rates on their income, rather than the rate on ordinary income, which would be much higher. This carried interest loophole emerged intact in the new bill, a glaring illustration why this was a tax cut - and unfortunately – not 'reform.'

The bill also needs to be scrutinized in relation to any potential effect on budget deficits. After accounting for the added revenue the bill is expected to produce by boosting overall economic growth, roughly $1 trillion will be added to budget deficits over the next decade, says the Joint Committee on Taxation. Depending on the rate of growth created by a boost to economic activity by the lowered rates, and the potential duration of any expansion, the impact may be smaller or larger. Either way, deficits are not immaterial to our country's long-term health, and they seem to be another critical issue that's perpetually 'tabled' by lawmakers.

While considering these drawbacks, we should also ponder a grand idea… The notion that this new globally competitive corporate tax rate may be the final catalyst, sparking a 'reshoring' of American business - particularly U.S. manufacturing. According to the Tax Foundation, the worldwide average corporate tax rate was 22.9% as of the end of 2015, making the United States now immediately competitive at 21%, notwithstanding other structural advantages, namely the rule of law. When this is added to other positive trends in place this decade, we may look back years in the future and see that this was a tipping point for an American manufacturing 'reshoring.'

Ten, twenty and even thirty years ago, the undebated premise in the global economy was that corporations couldn't manufacture anything competitively in the United States, and that logic was vividly illustrated in America's jobs data. Manufacturing jobs peaked in 1979 at just shy of 20 million, and slowly gravitated lower for two decades until the turn of the century. At that point, the decline went from slow to sharp, as the country lost factory jobs seven times faster between 2000 and 2010 than it had between 1980 and 2000, landing at 11.45 million in February 2010[2].

This trend, which appeared unbreakable, has produced some green shoots in the last 8 years, in large part for these reasons:

- U.S. costs are becoming more competitive. Wages have increased at double digit rates in many emerging economies, while staying roughly level in the U.S., closing the cost gap. Boston Consulting estimates that China's overall manufacturing-cost advantage, for instance, has shrunk to just 4%, but when adjusting further for other productivity and shipping factors it can be more economical to produce many things domestically.
- Not only are oil and gas fuels, they are also feedstocks. These feedstocks are broken down to produce things such as polyethylene and polyvinyl chloride, the world's most utilized plastics. They in turn make up the stuff of contemporary life, like computer cases, car bumpers and soda bottles. Due to the advanced technological drilling technique referred to as "fracking," America has undergone a revolution in the production of cheap oil and gas this decade. These less expensive fuel sources and feedstocks, and the independence they provide, are added catalysts for manufacturing competitiveness.
- The feverish cycle of innovation that consumers have grown accustomed to in electronics has pervaded all facets of consumer categories. As a result, product life cycle is speeding up, and time to market and the ability to be nimble has become ever more vital. One example: To cut production costs, General Electric moved assembly of low-energy water heaters to China from their storied Appliance Park production facility in Louisville, decades ago. In 2012, they returned that manufacturing to Kentucky, not only because the Chinese cost advantage had narrowed considerably, but because they could reduce critical time to market by 4-5 weeks[3]. America remains the wealthiest end market, and it's easier for companies to act quickly when their newly created products are close to their customer, and not on a ship in the Pacific Ocean.
- Regulatory scrutiny is lifting. For the first time in six years, the Business Roundtable, a corporate lobbying group in Washington D.C. reported last month that "regulatory costs" were no longer the primary concern for American executives. Mark Zandi, chief economist at Moody's said that although regulation was still a top concern in their survey of business confidence, it was rapidly losing ground to questions about the availability of labor. President Trump said he's taken 67 deregulatory actions so far in office, while enacting just three[4]. The environment on the

regulatory front is likely providing another layer of incentive, and one that would not have been predicted just a few years ago.

February of 2010 marked the nadir for manufacturing employment at 11.45 million jobs, and today that number stands at 12.51 million. On the surface that doesn't appear to be much to write home about, but it does indicate 8 years of stabilization, the longest period of 'non-decline' in three decades. Primarily because of the factors outlined above, American manufacturing employment has stabilized a negative trend, and seems on the verge of something brighter.

It may be too early to tell whether the U.S. will experience a manufacturing renaissance, but the legitimate potential exists owing to many important factors now in place. The new tax bill, and the competitive corporate tax rate that comes with it, may just serve as the tipping point for many businesses to 'reshore' their manufacturing operations in the United States after a generation of moving them elsewhere. The icing on this cake would be if these jobs do in fact start to return, it will be for a myriad of converging reasons, offering genuine hope they likely wouldn't be leaving again anytime soon.

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Respectfully,

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Statistical and analytical data provided by Factset.