NEVILLE, RODIE & SHAW, Inc. / *INVESTMENT COUNSEL*
Established 1933
200 MADISON AVENUE, NEW YORK, N.Y. 10016

TELEPHONE: (212) 725-1440
FAX: (212) 689-8746

December 2017

Year End Review and Outlook

As this rather tumultuous year nears its close, it is probably appropriate that the direction and attendant fluctuations in our investment markets be reflective and reflexive of political actions in Washington. This connectivity became quite evident one year ago and prevailed during much of 2017.

Despite the controversies which persisted all year long and the hand-wringing about raucous and divisive political and social preferences, it has been a remarkably non-volatile year for our stock and bond markets. Equities have turned in surprisingly strong results, and longer maturity bonds have earned their coupons. There have been few broad or prolonged declines in either sector, and investor doubts seemed to slowly dissipate without morphing into irrational exuberance.

In our view, this year has been a textbook example of economic developments outshining political dysfunction and dissonance. The steady strengthening of the U.S. and major world economies has been a motive force for global trade and an upturn in capital spending. These factors have supported further growth in employment and an encouraging impetus for wage growth. Critical and not widely acknowledged relaxation and cancellation of many regulatory measures have spurred renewed confidence in longer term corporate outlays, many of which have positive implications for gains in productivity and profits.

A final and vital element is the just-passed tax reform legislation which had faced monolithic opposition from the minority political party and the mainstream media outlets. While the reform act does not gratify every voter or constituency, it does offer significant near-term and longer-term stimulus to the U.S. economy and measurable tax reductions for virtually all income sectors. The claims that the bill is a “giveaway” to the wealthy and big business do not stand up to scrutiny by reliable analysts on either side of the political aisle.

The negative messaging by the loyal opposition has been effective to date in tilting popular opinion against the legislation. But, the reality is that more than one-half of the anticipated income tax reduction will flow to individuals and small businesses in 2018, and only five percent of individual tax payers will see a tax increase. As investors, we are already seeing corporations beginning to adjust and plan for the tax benefits; and, we expect that consumers will receive a pleasant surprise by February in their net pay.

Again, as investors, we are weighing the many provisions in the new rules as to their near-term and longer-term implications for growth and profitability. In addition to lower tax rate brackets, key positive elements such as repatriation of overseas cash, significantly increased depreciation schedules for capital equipment purchases, and the move to a territorial tax system which eliminates the double taxation of certain foreign-source income will have sustainable benefits for reported profits and shareholder returns.

While we are doubtful that 2018 will deliver the same relative placid market outcomes as we enjoyed in 2017, we do expect that the new year will experience positive economic and corporate growth accompanied by enhanced fundamentals in the important consumer sector. The new tax structure requires that we put the microscope on the major industry sections and our current investment exposures. The tax changes are definitely important catalysts, but the existing product and financial positioning still will be primary considerations. More will be gleaned in upcoming company reports and conferences, and some portfolio adjustments will undoubtedly result.

Projected growth in revenues and earnings, coupled with strong attention to corporate balance sheet management will continue to be the foundation of our portfolio structuring. We do expect that some opportunities in the broad industrial and consumer sectors will surface and will provide some new options. The energy-related segments have been generally underweighted in our equity portfolios and should be major beneficiaries of lower tax rates. Maintenance and stability in supply and demand for energy supplies will be necessary for confidence in longer range operations and investment returns.

Our long-standing commitment to the varied technology areas has generally served us well. We keep a close eye on valuation levels amongst these diverse companies and will make adjustments to holdings when judged appropriate. In terms of current and projected growth, technology issues offer superior fundamentals coupled with reasonable relative valuations. The exposure to corporate customer spending on cloud applications, workplace automation and increasingly important software services are in place. In addition, new technological offerings are becoming steadily embedded in consumer products and life styles.

So, given that this report so far sounds as if it was written by Doctor Pangloss, what could go wrong? Firstly, the response to the tax changes could be very tepid, with little boost to corporate investment spending and a sharp increase in consumer savings rates. Secondly, the response is too exuberant, leading to a market melt-up and a resultant prolonged equity market decline driven by profit-taking. Thirdly, new Federal Reserve leadership, either in reaction to or in anticipation of spiking economic growth and speculation, raises interest rates and reduces monetary liquidity. Global chaos ensues. Lastly, a new or heightened geo-political crisis erupts, and traditional alliances fall apart.

While the foregoing listing of caution signs could surely be extended, it is usually the unexpected "black swan" that paddles in and causes havoc and prolonged uncertainty. Which is a sound reason for maintaining some appropriate measure of safety or relative protection against undue volatility. For our accounts, we feel it prudent to have some cash reserves or high quality, intermediate maturity bonds. The prospects for a measurably stronger U.S. economy may put upward pressure on inflation which could lead to the Fed lifting managed interest rates more aggressively. We will watch this closely with an eye for opportunities at either end of the maturity curve.

To wrap up, we are feeling positive about prospects for our economy and corporate and consumer sectors in 2018, but we are still committed to our promise to remain wary. We may not be prescient in regard to the "black swan", but we will be alert to its presence and importance in a year of both favorable potential and challenges.