AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

Quarterly Investment Commentary

First Quarter **April 2017**

Michael D. Axel, CFA

Jacob D. Benedict, CFA

Ryan A. Kay, CFP®

The post-election rally continued in the New Year. U.S. stocks returned 6.1%[1] in the first quarter while international developed stocks and emerging market stocks returned 7.4% and 11.5%, respectively.[2] Bonds returned 0.5%,[3] reflecting the low level of interest rates.

U.S. stocks have had quite a run since the depths of the crisis – they have now returned nearly 18% per annum![4] This is a great reminder to try to keep your head when those around you are losing theirs.

But have stock prices gotten ahead of themselves? Warren Buffett gave an excellent interview February 27th on CNBC, during which he stated:

> [W]e are not in a bubble territory or anything of the sort. Now, if interest rates were 7% or 8% percent then these prices would look exceptionally high. But you have to measure, you know, you measure everything against interest rates, basically, and interest rates act like gravity on valuation. So when interest rates were 15% in 1982 they pulled down the value of any asset.

As we've written many times before, all investments compete with each other at the margin. With interest rates at such depressed levels, it makes sense that stock prices would reach above-average valuations, as they have the last several years, alongside a generally decent economy. As long as interest rates remain depressed, stock prices don't appear overextended. (Though this of course does not mean that stock prices can't fall meaningfully from these levels – this is *always* a possibility.)

But isn't the Federal Reserve raising interest rates? Yes, but that doesn't mean long-term interest rates are on a one-way path straight up from here. The Federal Reserve has hiked the short-term rate that they control twice since November of last year, with plans for more hikes later this year. Yet the 10-year U.S. Treasury sits below 2.4%, *roughly even* with where it was last November. The Fed influences rates, but global macroeconomic factors play a much larger role in setting long-term interest rates. And we've argued that there is a distinct possibility – and historical precedent – that rates may stay subdued for an extended period of time. It would be hard for U.S rates to shoot up to 7% or 8% while European rates remained around 1%. Everything is connected, or as Buffett put it, you always have to ask "and then what?"

Although we think the chances are decent that rates remain low for some time, the prospect of much higher inflation – which would bring with it higher interest rates – is a concern. While this seems unlikely at present, the effects on investment portfolios would be adverse. Despite all of the campaign rhetoric, and the fact that economic growth has been underwhelming, the economy is actually in decent shape from an employment perspective. If growth does pick up and wage pressure materializes, we could see higher inflation and increased rates. We've been actively looking for investments that could do comparatively well in such an environment, not because we think it's necessarily likely, but because diversification against such risks always makes sense if it isn't cost prohibitive.

---

[1] As measured by the S&P 500 index.
[2] As measured by the relevant MSCI international indices.
[3] As measured by the Citigroup 1-10 Year Government Bond index.
[4] Measured from the end of February, 2009 through March 31, 2017.

We don't want to discuss any political debates here, nor take a stab at guesstimating the economic impacts of various policy proposals. But we would recommend Jamie Dimon's recent letter to JPMorgan shareholders.[5] We've long admired Dimon, the Chairman and CEO of JPMorgan Chase and, alongside Warren Buffett, one of the few CEOs who writes a meaningful, thoughtful annual letter to his shareholders (we wish many more would follow his lead). In this year's letter, Dimon dedicates a lot of space and effort to a discussion of bank regulation specifically and public policy more broadly. Among the issues he highlights, we'd offer some thoughts on just a few:

- The U.S. has the highest corporate tax rate in the developed world. Whether one thinks the overall tax burden should increase or decrease, this disparity risks disadvantaging American corporations versus their foreign competitors and can incentivize companies and entrepreneurs to move and invest abroad.

- A large percentage of our STEM (science, technology, engineering and math) graduates are non-U.S. citizens. Many of our country's most innovative technology companies were founded by foreign-born entrepreneurs. Legally securing top talent in these fields is important to American corporate competitiveness.

- There is a worldwide push away from the globalization policies of the past several decades and towards tougher stances on trade deals. If this tips into trade wars, it could threaten economic growth and disrupt U.S. companies that both export their goods and operate major subsidiaries abroad.

Finally, on the topic of corporate tax reform: We've seen a lot of analysts, investors, and commentators assume that if the corporate tax rate is cut from, say, 35% to 20%, then that extra 15% will fall straight to companies' bottom lines. In many cases, this is probably a flawed assumption. Warren Buffett explained why back in 1989:

> When the corporate rate is cut, do Berkshire, The Washington Post, Cap Cities, etc., themselves soak up the benefits, or do these companies pass the benefits along to their customers in the form of lower prices? This is an important question for investors and managers, as well as for policymakers. Our conclusion is that in some cases the benefits of lower corporate taxes fall exclusively, or almost exclusively, upon the corporation and its shareholders, and that in other cases the benefits are entirely, or almost entirely, passed through to the customer. What determines the outcome is the strength of the corporation's business franchise and whether the profitability is regulated…[In a] price-competitive industry…the free market "regulates" after-tax profits in a delayed and irregular, but generally effective, manner…In these industries, therefore, tax changes eventually affect prices more than profits. In the case of unregulated businesses with strong franchises, however, it's a different story: the corporation and its shareholders are then the major beneficiaries of tax cuts.

So if corporate taxes are reduced, some, but certainly not all, U.S. corporations will benefit. Large multinational companies based in the U.S. that already pay reduced corporate tax rates and the many companies that operate in price-competitive or regulated industries may not benefit much, if at all, from lower tax rates. In the former case, the effective rate is already low due to tax breaks or global tax planning, and in the latter case, any tax savings will probably be passed on to consumers in the form of lower prices. But U.S. companies that pay a full corporate tax rate and possess strong demand-based business franchises – as evidenced by pricing power – could realize increased profits if corporate tax reform is enacted. Of course the stock market is no dumby, and some of this has already been reflected in stock prices.

As always, we thank you for your continued confidence.

Sincerely,

Michael D. Axel, CFA
Jacob D. Benedict, CFA
Ryan A. Kay, CFP®

Past performance is no guarantee of future performance. All investments contain risk and may lose value. Any views expressed within this document are the views of AMI Investment Management and/or the authors. They are subject to change at any time without notice. Any graphs, charts or formulas included within this document that depict historical relationships may not be valid during future periods and should not be relied upon to make investment decisions. This material is distributed for informational purposes only and should not be considered as investment advice or as a recommendation of any particular investment security, strategy or investment product.

[5] Available at: https://www.jpmorganchase.com/corporate/investor-relations/annual-report-proxy.htm.