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The Biggest Issue Facing Investors is Not Tax Reform

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US equity investors have been laser-focused on the tax reform debate occurring in Washington over the last few weeks. With economic data remaining firm and few economists forecasting a downturn in coming quarters, investor attention has been centered on the potential for meaningful earnings improvement as a result of lower corporate taxes. Depending in part on the composition of a company's earnings, a reduction in the corporate tax rate from 35% to 20% could boost earnings by anywhere from 7% to 27%, according to forecasts[1].

Although important, the passage of meaningful tax reform and its ultimate form remain highly uncertain at this point. Instead, investors may be overlooking a much more important issue: **the transition away from the easy-money policies that have underpinned the market's dramatic rise since mid-2009.**

Since the financial crisis of 2008-09, global central banks have kept interest rates near zero and have bought billions of dollars in corporate and government bonds. The goal was to stimulate spending among consumers and businesses and restore confidence in the global economy.

The effectiveness of these policies in stimulating economic growth remains a source of debate, but most experts agree that the flood of liquidity brought about by aggressive monetary easing was critical to the sharp rise in asset prices over the last seven years. With the global economy now on an upswing, central banks are beginning to rein in their prior policy positions in order to stave off future inflation and provide some "dry powder" in advance of the next downturn, whenever that may be.

The US Federal Reserve is out in front of other central banks in this effort. Beginning in October, the Fed started allowing a portion of the bonds held on its $4.5 trillion balance sheet to mature without replacing them. As the bonds mature, cash is returned to the Fed and drained from the economy. The Fed has announced plans to continue this activity, accelerating its maturities to about $50 billion per month a year from now. Beyond the balance sheet adjustment, expectations are high for a further interest rate hike in December followed by several more in 2018. Currently at just over 1%, the Fed projects the Fed Funds rate to be approaching 3% in the next two years.

Outside the US, other central banks are beginning to tap the brakes. The European Central Bank is still buying bonds, although it recently announced that it will begin tapering its purchases beginning in January. In China, policymakers are expected to tamp down on credit growth next year. Japan remains in an aggressive easing posture, but its actions are unlikely to sway the global trend of tighter policy.

History shows that a shift to monetary tightening can be problematic for asset prices. By definition, higher interest rates caused by tighter monetary policy increase the cost of money, making it more expensive for corporations and consumers to borrow, spend, and invest. That in turn tends to slow economic growth and depress corporate earnings, a dangerous environment for stock prices. Indeed, when the Fed started boosting rates in 1994, it set off the worst corporate bond slide in two decades and

[1] Source: Ned Davis Research, Inc.

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triggered a sudden devaluation of the Mexican peso. Admittedly, the Fed was moving much more quickly back then, raising rates by 2.25% in the space of nine months. A more recent example is the rate hike cycle of 2004-06, when the Fed raised the funds rate from 1.25% to 5.25% to slow the growing housing bubble. The stock market continued to rise during that period until, of course, the collapse of 2008-09.

Because we are starting from such low levels of interest rates, bullish investors argue that this time is different. In their view, the slow and predictable tightening of monetary policy around the world will be easily digestible by financial markets, and solid economic growth will be unimpeded by a gradual tightening of interest rates. Maybe so, but investors would be wise to pay attention to the changing posture of central banks, with particular emphasis on the US Fed. As the buildup of the Fed's balance sheet during quantitative easing was viewed by many economists as "unchartered territory", so will its unwinding.

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Bruce is a Managing Director and Director of Portfolio Research at the firm. Bruce rejoined Ballentine Partners in June 2016 after more than 5 years as Chief Investment Officer of City National Rochdale, LLC, in Los Angeles. City National Rochdale, a wholly owned subsidiary of City National Bank, serves family clients across the United States with a staff of nearly 100 investment professionals. Before moving to Los Angeles, Bruce served as Chief Investment Officer of Ballentine in our Waltham office for three years. Prior to that, Bruce spent four years with Morgan Stanley Private Wealth Management in New York and eight years with Glenmede in Philadelphia as Chief Investment Officer and Portfolio Manager. In addition to working directly with a number of family clients, Bruce serves on Ballentine's Investment Management Committee, which is responsible for the oversight of all of the investment activities for the firm. Bruce received an MBA with a concentration in Applied Economics from George Washington University and a BS degree in Business Administration from Penn State University. Bruce holds the Chartered Financial Analyst (CFA) and the Certified Private Wealth Advisor (CPWA®) designations. He lives with his wife in Palm Beach Gardens, Florida.

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