Manager's Report
November 2016

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Republicans Sweep

Similar to the "Brexit" referendum, the pollsters, in aggregate, got it wrong. Donald J. Trump will be the next President of the United States of America. Further, his party maintained majority in both chambers of Congress. Much has changed in a very short period of time.

One of our responsibilities is to evaluate the constant flow of information and determine whether it is interesting, relevant, or some combination of both. Much of the day-to-day headline news, particularly in regards to politics, is often more interesting than relevant to investment management; however, three unified branches of government with an agenda certainly falls into the relevant camp. At the same time, the fact that our President – elect was not exactly a "traditional" candidate increases the degree to which this election is relevant.

To preface, before discussing some of the things we see possibly changing, I want to address two things.

First, while some aspects of the recent election may call for modifications to an investment portfolio, it does not mean that investors should make wholesale changes to their overall strategy. For example, unless something significant changes within your life, it is unlikely that moving from a conservative to aggressive (or vice versa) strategy is a prudent reaction for a long-term investor. Per the recent *Special Alert* penned by Josh Pierce, our Director of Research, emotionally charged decisions should not have a role within a financial plan. Indeed, one of the many benefits of a good Financial Advisor is the guidance they provide their clients through decisions regarding strategy and risk.

Second, in writing this report I, and all of us at Baystate Wealth, recognize the divisive nature of the election season; indeed, some people reading this are delighted by the outcome, some are horrified, and some just do not know how to feel or what to think. The goal of this month's report is to review some of the likely changes this new administration will bring and whether or not it is favorable, or unfavorable, for certain types of investments. We are not endorsing any candidate, politician, or political party. That's not what we do here – we focus on facts and probabilities, specifically regarding how new facts change certain probabilities. That said; let's jump into taxes and trade.

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Corporate Taxes

In general, Republicans tend to favor a lower corporate tax rate. During his campaign, President – elect Trump has expressed a desire to reduce this rate from the current 35% to 15% or 20%.

In our opinion, this would be a tailwind for U.S. stock prices. The reason is very straightforward. The market value (price) of a corporate stock is a function of future earnings and dividends. All else being equal, higher dividends and earnings-per-share (EPS) command a higher price for the stock. A 20% reduction in taxes has the mathematical result of increasing earnings by a roughly equivalent amount (less tax-drag on earnings). In theory, and assuming that investors are willing to pay a constant multiple (P/E ratio), stock prices would adjust upwards by roughly 20%. To be clear, this intentionally simple example doesn't work with all companies and disregards several other factors which impact future earnings and equity valuation. Some companies don't have earnings and others are valued with pre-tax metrics like EBITA (earnings before interest, taxes and amortization). Actually, many biotech companies in early phases of a trial period have value simply due to the hope/anticipation of future drugs/therapies being approved for market dissemination. Nonetheless, most publically traded companies do have earnings and trade at a multiple to EPS.

As an addition to the theoretical boost to stock prices, higher EPS provides additional capital for businesses to invest in research and development, hire additional employees or buyback their own stock. Some of these dynamics could very well increase the velocity of money and have a positive impact across the aggregate economy.

Personal Taxes

From our vantage point, the probability of personal tax rates decreasing has increased. As with corporate tax rates, the Republican Party tends to believe personal tax rates should be simplified and lowered across the board. If this type of policy change is passed it is likely to boost consumer spending. This has the obvious benefit to companies that sell goods and provide services to the consumer and the obvious detriment of increasing the budget deficit, all else being equal. Yet, some might be surprised by exactly how important the consumer is to the overall health of the economy. Gross Domestic Product (GDP) is the hallmark, high-level metric for the health of an economy. In the U.S., approximately 70% of GDP is personal consumption. The remaining components are mostly made up of government spending and investment which are about 20% and 10%, respectively. Housing adds a few percentages points while imports subtract a few.

The bottom line is that a healthy consumer is critical to the overall economy. Real GDP, meaning GDP adjusted for inflation, has grown at about 2% since the Great Recession almost 8 years ago. The average since the mid-60's has been closer to 3%. There is a good argument that an economic growth rate more in-line with historical averages could be a rising tide that lifts all market participants.

Trade

This is an area that concerns us given the President–elect's comments. One source of concern is that we have heard comments that seem protectionist and others that are tamer and focus on fairer trade. We need a little more clarity at this point. Renegotiating trade deals to benefit all parties is very different than "slapping a 45% tariff on China." Additionally, the renegotiation of trade agreements can come directly from the Oval Office and does not require congressional approval, which also raises the level of uncertainty surrounding this issue, for

obvious reasons. Consequently, trade agreements are not as clear-cut as deals made in the business-word; they often require concessions that would seem absurd to the business-savvy but such concessions are often considered the norm for those familiar with geopolitics.

At the risk of being controversial and understanding not everyone benefits equally, we do believe open global trade helps more than it hurts. Protectionist policies could very well save, and even bring back, some jobs to the United States but that could be at a greater expense than the perceived benefit. However, advocates of free trade, which include us, fear that this strategy will lead to elevated levels of inflation. Imagine the cost of automobiles and cell phones if they were all made here at home. Imagine the cost of products made overseas with a 45% tariff attached to them. We currently enjoy attractively priced electronics, such as mobile phones, which benefit from lower-cost overseas manufacturing. If the flow of goods and capital is restricted, it could cause the cost of such goods to increase in price.

According to the Mercatus Center, a university based research center dedicated to bridging the gap between academic research and public policy problems, *"However well intended, restrictions on foreign trade harm the very people they aim to protect: American consumers and producers. Trade restrictions limit the choices of what Americans can buy; they also drive up the prices of everything from clothing and groceries to the materials manufacturers use to make everyday products. Moreover, it is lower-income Americans who generally bear a disproportionate share of these costs."*

Going forward, given how relevant trade policy is to corporate earnings, these potential negotiations are something we will be monitoring very closely on behalf of our clients.

Summary

The intent of this month's report is to briefly highlight potential changes that have direct relevance to how we manage assets for our clients. Although there have been other proposed policy changes (Supreme Court, social policies, immigration, regulation, health care, etc.) during the campaign process that are important, they are not necessarily relevant to the investment decision making process or we simply do not have enough information to provide a meaningful perspective.

In short, while we do have concerns about dramatic changes to trade policy, lower taxes could be a strong tailwind for risk assets.

While we believe there could be some benefit to stocks with a lower tax rate environment, it's a different story for bonds. In fact, these same variables could cause stress in fixed income markets, and already has. If the consequence of policy changes causes the closely watched metrics which guide Fed policy decisions to change, this could very well lead to more hawkish behavior from the Fed. If more accommodate tax rates help both corporations and individuals, the Fed would have reason to be hawkish. Said differently, a more robust economy warrants higher interest rates. In addition, if our President-elect is successful at increasing infrastructure spending, a rare bipartisan mandate, without offsetting that spending on the other side of the ledger (deficit spending), it is logical to assume higher levels of interest rates will follow. In theory, investors should require for a higher interest rate to compensate them for this type of capital spending and the inherent risks associated with higher debt levels.

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Submission# 1199462