

## Will Wonders Never Cease?

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*“Almost all quality improvement comes from simplification of...processes and procedures.”*

-Best-selling business author TOM PETERS

*“The central issue is that the degree of government expenditure growth, largely entitlements, is destabilizing the financial system.”*

-Former Fed Chairman ALAN GREENSPAN, from a February 2017 interview

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Well, they did it. The gang that couldn't shoot legislate straight managed to get their tax bill passed before year-end. Despite the GOP controlling all three elected arms of government, it wasn't pretty to watch. In fact, by comparison, sausage-making looks like a pristine process.

In future EVAs, we plan to address the changes and ramifications after more time for examination and reflection. Right now, we are still scratching our heads about the pros and cons and I suspect many of you are, as well. If so, you are far from alone. The *Wall Street Journal* reported this week that the new tax bill even perplexes the experts.

What is clear, though, is that many US corporations will benefit from the dramatic reduction in the highest income tax rate from 35% to 21% (though individuals will actually receive a larger reduction in terms of dollars). There should also be a boost from those handful of entities with massive sums of overseas profits (though, as noted in [our December 8 EVA](#), much of this trove is already held in domestic securities, mostly US treasuries). The reality is that the bulk of the \$2 trillion or so that is pending repatriation at the new 15% rate is held by a few mega-cap tech and Big Pharma companies.

On the other hand, it's important to realize that a large number of America's most important businesses are already paying an effective tax rate close to the new levy. This is due to all the games they have played to reduce their taxes using the copious quantity of corporate loopholes. Yet, many corporations, such as the big telcos and a wide array of financial entities, will see significant relief. And, as also mentioned before in these pages, small caps are supposedly big winners despite that about one-third of them are unprofitable. Overall, we've seen estimates of an earnings boost next year of 5% to 10%, at least for the S&P 500.

Consequently, there is no doubt this is positive for the US stock market. What is uncertain is how much this will drive share prices from here considering the number of times rumors of the bill's passage caused stocks to rally since Mr. Trump was elected.

Another clear benefit is the 100% deductibility for capital spending over the next five years. This is a considerable amping up of the previous 50% rate. Logically, this should spur cap ex which was already showing signs of life after a multi-year downward trend. Long-term, it's reasonable to expect this to improve productivity which has been in a coincident bear market (there's a tight linkage, over time, between higher investments and rising productivity).

So, all in all, the new bill appears to be a bullish development for US companies. This is despite its well-publicized flaws (the biggest being what it does to future deficits which were already poised to surge).

The impact on individuals is more of a mixed bag from what we can tell at this point. Lots of deductions are being reduced or eliminated (thus, it may make sense to prepay some items, if possible, before year-end). Offsetting that negative, the highest rate is being reduced and the level at which it kicks in is being raised as well, from \$471,000 to \$600,000 for married couples filing jointly. Middle- to lower-income taxpayers will also see a reduction in their tax rates in most instances. However, in the case of certain high-income individuals, especially those who are subject to lofty state income taxes, they may actually see an increase in how much of their income they are privileged to share with the IRS (see item 2 below).

The below is our best effort to summarize some of the key aspects as far as individuals are concerned, besides those mentioned above:

*(Disclosure: While we do our best to understand the implications of the tax bill from an investment standpoint, we are in no way tax professionals. Any questions related to the tax bill, or how it may impact you, should be directed to your CPA.)*

Personal:

1. New income tax rates are slated to be 10%, 12%, 22%, 24%, 32%, 35%, and 37%. Apparently, however, the Obamacare surtax will still be added to high income earners.
2. There will now be a \$10,000 cap on state and local taxes, including income- and property-based.
3. The dreaded Alternative Minimum Tax (AMT) should be greatly minimized. For couples, the AMT exemption rises from \$84,500 to \$109,400. Additionally, the point at which the AMT exemption gets phased out rises drastically: from \$160,900 to \$1 million and from \$120,700 to \$500,000 for individuals.
4. The estate tax exemption will soar to \$11 million for individuals and \$22 million for couples.
5. The standard deduction is poised to jump from \$12,700 to \$24,000 for joint filers and from \$6,350 to \$12,000 for solos. However, the personal exemption of \$4,050 per family member is being eliminated. This could amount to an effective tax increase for large families.
6. Owners of pass-through entities like Sub-S corporations and LLCs may see a significant reduction in their tax rate. Sadly, for those of us who are shareholders of Evergreen, personal service entities appear to be excluded! On the other hand, it looks like mid-stream energy pass-throughs (the MLPs so often recommended in these pages) will benefit from this and also the aforementioned 100% expensing of capital projects.

(It is important to note that most of the personal “perks” sunset at the end of 2025. Any bets that the deductions stay eliminated and the rates eventually rise?)

In our minds, besides the budget blow-out this reform renders likely, it is also disappointing that the much-advertised benefit of simplification somehow wound up on the cutting room floor. This baby certainly is no threat to the job security of CPAs!

Further, per a most impressive overview from J.P. Morgan, prior tax cuts did not “pay for themselves.” It’s highly unusual to have a tax cut of this magnitude when Federal debt levels are

this elevated (they are literally double, as a percentage of GDP, of what they were when prior tax reductions occurred). Moreover, the deficit is already increasing, which is also extremely odd when the economy is supposedly humming along. Finally, even on a percentage basis (i.e., not dollar-based), the top 5% of taxpayers are getting the greatest benefits. Somehow, we think this is likely to be a major issue in the mid-term election campaigns that will be cranking up soon.

Ok, enough on taxes (I never did like those things, anyways). We're now going to offer a holiday treat to our loyal readers, thanks to my close friend Grant Williams who has, on several occasions, punished himself by interviewing me on his wildly popular Real Vision TV (RVTV). Despite that, he still likes me.

This week, he was kind enough to let us run one of his most recent TTMYPGH newsletters (which are also very popular, particularly with investment professionals around the world). Grant's letter is meant to be a companion piece to last week's maiden voyage of our new *Bubble Watch EVA* series. As you will soon read, it's not just your aging EVA scribe who believes there is definitely something rotten in Denmark—where they have negative interest rates despite a healthy economy and ripping real estate prices—but in a lot of other countries, as well.

Please find a link to Grant's full article [here](#).\*

*\* Editor's Note: While we are linking to Grant's full 49-page missive for your reading pleasure, we recognize that the full article might be overwhelming for many of our readers. As such, please focus on pages 3-16 for a continuation of last week's Bubble Watch EVA theme.*

### **Correction/Amplification:**

One eagle-eyed EVA reader correctly pointed out that I erroneously referred to the below chart as relating to the S&P 500. As was--and is--footnoted, it's actually a monthly return chart for the MSCI All-World Index. In other words, it shows that global markets rose each month during 2017 (with December being a lock for another up month at this point). When you think about it, that's even more extraordinary. However, the S&P 500 also rose each and every month this year which, as never done in the past.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec
2017	2.7%	2.6%	1.0%	1.4%	1.9%	0.3%	2.7%	0.2%	1.8%	2.0%	1.8%	
2016	-6.1%	-0.9%	7.2%	1.3%	-0.2%	-0.8%	4.2%	0.1%	0.4%	-1.8%	0.6%	2.0%
2015	-1.6%	5.4%	-1.8%	2.7%	-0.4%	-2.5%	0.8%	-7.0%	-3.8%	7.8%	-1.0%	-1.9%
2014	-4.1%	4.6%	0.2%	0.7%	1.8%	1.7%	-1.3%	2.0%	-3.4%	0.6%	1.5%	-2.0%
2013	4.5%	-0.2%	1.6%	2.6%	-0.6%	-3.1%	4.7%	-2.3%	5.0%	3.9%	1.2%	1.6%
2012	5.7%	4.8%	0.4%	-1.4%	-9.3%	4.7%	1.3%	1.9%	2.9%	-0.8%	1.1%	2.1%
2011	1.5%	2.8%	-0.3%	3.9%	-2.5%	-1.7%	-1.7%	-7.5%	-9.7%	10.6%	-3.2%	-0.3%
2010	-4.4%	1.1%	6.2%	0.0%	-9.9%	-3.1%	8.0%	-3.7%	9.4%	3.5%	-2.4%	7.2%
2009	-8.6%	-10.0%	7.9%	11.5%	9.5%	-0.7%	8.7%	3.4%	4.4%	-1.6%	3.9%	2.0%
2008	-8.3%	0.1%	-1.7%	5.3%	1.2%	-8.3%	-2.7%	-2.4%	-12.7%	-19.9%	-6.8%	3.5%
2007	0.9%	-0.7%	1.8%	4.2%	2.7%	-0.4%	-1.6%	-0.5%	5.2%	3.8%	-4.6%	-1.2%
2006	4.9%	-0.3%	1.9%	3.2%	-4.2%	-0.2%	0.6%	2.4%	1.0%	3.7%	2.6%	2.1%
2005	-2.2%	3.3%	-2.4%	-2.4%	1.6%	0.9%	3.6%	0.6%	2.9%	-2.8%	3.5%	2.4%
2004	1.6%	1.7%	-0.8%	-2.5%	0.5%	1.9%	-3.3%	0.4%	1.9%	2.4%	5.3%	3.8%
2003	-3.0%	-2.0%	-0.7%	8.6%	5.5%	1.7%	2.1%	2.2%	0.5%	5.9%	1.4%	6.2%
2002	-2.8%	-0.9%	4.5%	-3.5%	-0.1%	-6.3%	-8.5%	0.1%	-11.1%	7.2%	5.3%	-4.9%
2001	2.5%	-8.5%	-6.9%	7.1%	-1.4%	-3.2%	-1.7%	-4.8%	-9.3%	2.1%	6.0%	0.9%
2000	-5.5%	0.2%	6.5%	-4.6%	-2.7%	3.3%	-3.0%	3.0%	-5.6%	-2.1%	-6.3%	1.6%
1999	1.9%	-2.6%	4.4%	4.2%	-3.7%	4.9%	-0.5%	-0.2%	-1.2%	4.9%	3.0%	8.2%
1998	2.1%	6.7%	4.1%	0.8%	-2.0%	1.7%	-0.1%	-14.2%	1.8%	9.0%	5.9%	4.5%
1997	1.5%	1.2%	-2.2%	3.0%	5.8%	5.0%	4.4%	-7.1%	5.2%	-6.1%	1.4%	1.2%
1996	2.1%	0.2%	1.4%	2.3%	-0.1%	0.4%	-3.9%	1.1%	3.5%	0.2%	5.2%	-1.6%
1995	-2.2%	0.9%	4.4%	3.4%	0.9%	-0.2%	4.7%	-2.4%	2.6%	-1.8%	3.0%	2.8%
1994	6.5%	-1.6%	-4.7%	2.5%	0.4%	-0.7%	2.0%	3.4%	-2.5%	2.4%	-4.5%	0.2%
1993	0.1%	2.2%	5.5%	4.3%	2.5%	-1.2%	1.9%	4.6%	-1.8%	2.8%	-5.4%	5.2%
1992	-1.7%	-1.7%	-4.7%	1.1%	3.6%	-3.8%	0.1%	2.0%	-1.1%	-2.7%	1.5%	0.7%
1991	3.5%	9.2%	-3.5%	1.1%	2.2%	-6.3%	4.6%	-0.4%	2.3%	1.5%	-4.5%	7.2%
1990	-4.8%	-4.4%	-6.4%	-1.5%	10.2%	-0.9%	0.8%	-9.6%	-10.7%	8.9%	-1.9%	1.9%
1989	3.4%	-0.8%	-0.7%	2.3%	-2.5%	-1.6%	11.1%	-2.5%	2.8%	-3.4%	3.8%	3.1%
1988	2.3%	5.6%	2.9%	1.1%	-2.1%	-0.3%	1.7%	-5.7%	4.1%	6.4%	3.2%	0.7%

Table displays monthly change in MSCI AC World Index since inception of index.  
Past Performance is no guarantee of future results.  
Source: Charles Schwab, Factset data as of 12/1/2017.



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## OUR CURRENT LIKES AND DISLIKES

No changes this week.

### LIKE

- Large-cap growth (during a correction)
- International developed markets (during a correction)
- Cash
- Publicly-traded pipeline partnerships (MLPs) yielding 7%-12% (we like them even more after their recent correction)
- Intermediate-term investment-grade corporate bonds, yielding approximately 4%

- Gold-mining stocks
- Gold
- Select blue chip oil stocks (wait for a pull-back after their recent strong run)
- Mexican stocks (at lower prices after this year's robust rally)
- Bonds denominated in renminbi trading in Hong Kong (dim sum bonds)
- Short euro ETF (due to the euro's weakness of late, refrain from initiating or adding to this short)
- Intermediate municipal bonds with strong credit ratings

## NEUTRAL

- Most cyclical resource-based stocks
- Short-term investment grade corporate bonds
- High-quality preferred stocks yielding 6%
- Mid-cap growth
- Emerging stock markets, however a number of Asian developing markets, ex-India, appear undervalued
- Select European banks
- BB-rated corporate bonds (i.e., high-quality, high yield)
- Investment-grade floating rate corporate bonds
- Long-term Treasury bonds
- Long-term investment grade corporate bonds
- Intermediate-term Treasury bonds
- Long-term municipal bonds
- Emerging bond markets (dollar-based or hedged); local currency in a few select cases
- Solar Yield Cos (taking partial profits on these)
- Large-cap value
- Canadian REITs (on a pull-back after a healthy recent run-up)

## DISLIKE

- US-based Real Estate Investment Trusts (REITs) (once again, some small-and mid-cap issues appear attractive; also, some retail-exposed REITs look deeply undervalued)
- Small-cap value
- Mid-cap value
- Small-cap growth
- Lower-rated junk bonds
- Canadian dollar-denominated bonds (the loonie is currently overbought)
- Short yen ETF (in fact, the yen looks poised to rally)
- Emerging market bonds (local currency)
- Emerging market bonds (local currency)
- Floating-rate bank debt (junk)
- US industrial machinery stocks (such as one that runs like a certain forest animal, and another famous for its yellow-colored equipment)

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