Marble Harbor Investment Counsel, LLC
Excerpt from
Fourth Quarter, 2017 Letter

We are pleased to send an excerpt from our fourth quarter client letter that discusses our current thinking. We welcome your thoughts.

Sincerely,

Paul Davis, L.J. Harrington, Eric Robb and Daniel Rosenblatt

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Dear Client:

Like an excited kid awaiting Santa's arrival, investors celebrated the new tax plan that was left under the tree, driving the market to a 21.8% gain in 2017. There will be many ramifications and numerous unanticipated consequences, but the bottom line for your companies is that their taxes are going down. Not all firms will experience the same impact, but in general, the more US-centric the company, the more its annual profits will be boosted. For example, an organization like ADP, that gets the vast majority of its revenues from domestic sources, currently has a tax rate of 32%. This should fall to about 26%, which translates into $140 million more in net income each year – an 8% increase in value.

Firms that derive more revenues from outside the U.S. will experience a more muted impact. They already have lower global tax rates, so they will reap less value from this tax bill. One exception is those with stranded overseas profits. The poster child for this scenario is Apple, with $250 billion overseas that has not been repatriated because management was not keen on paying 35% taxes. The new tax bill allows them to bring the cash back at a 15.5% rate. We expect them, and many other large, profitable global companies to bring back much of the $2.6 trillion held beyond our borders and use the funds to buy back stock, pay down debt and increase capital expenditures. Stock buy backs of this magnitude could certainly support investment returns over the next few quarters, especially for large technology and healthcare companies that own the majority of the overseas cash.

It's clear that the tax plan is supportive of equity valuations in the short term. When a company is able to keep more of its cash flow, its value goes up. The S&P is expected to grow earnings 12% in 2018, and about half of that can be attributed to changes in the tax code. The economy is also likely to be spurred on for a spell, as individuals spend some of the money they've saved in taxes. Given the current low rate of unemployment, we're not sure that stimulating the economy is ideal in the long term, but in the short term, it should give us an economic boost.

We've just touched on one tiny bit of the tax plan - the corporate rate - which is most impactful to your companies. However, the plan has substantial implications for your own personal tax and estate situations, and a checkup with your tax advisors is essential.

What were the other drivers behind the strong market performance this past year? Inflation remained muted, and global economic growth was relatively strong around the world for the first time since the great recession. Companies started to spend, especially in Europe where capital spending had been subdued for the past decade. Consumer confidence was (and continues to be) strong, and the U.S. consumer also began spending, especially as lower income earners saw wages gradually increase after years of stagnation.

In general, conditions remain favorable for stocks, which continue to trade at slightly above average valuations, but not at extremes. While this exuberance can be heady stuff, history reminds us that pendulums swing both ways. There are plenty of geopolitical events that could tamp things down – North Korea, Iran and Brexit come to mind. If the economy slows or stocks go to excessive valuations, that could also play a role in slowing market momentum. We also need to be wary of inflation and rising interest rates.

Of course, the shiny new toy can be captivating on Christmas day. Longer term, we take greater comfort in the gifts that keep on giving: great businesses, attractive industries and sustainable earnings growth.

We'd like to introduce you to the newest member of our team – Mirely Garcia. Mirely comes to us with extensive money management experience and joins us after spending nearly 3 years at Fiduciary Trust in Boston, where she had a broad range of administrative and client service responsibilities in that firm's investment advisory operation. We are excited to have Mirely working with us to serve you. She will work most closely with Laura Goon and Charlotte DeYesso on all of the client service, administrative and operational matters that ease things for you and that keep our firm humming along. Please join us in welcoming Mirely.

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