*Marble Harbor Investment Counsel, LLC*
*Excerpt from*
*First Quarter, 2017 Letter*

*We are pleased to send an excerpt from our first 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:

Have you ever noticed how quickly home renovations get completed on HGTV? Jonathan and Drew promise entire gut jobs in 5 to 7 weeks. Not a word is ever said about pulling a building permit, and walls are knocked down without the slightest concern for whether they are load bearing. Carpenters, plumbers, plasterers, installers, painters and countless other trades people coordinate their schedules like a perfectly choreographed ballet. Anyone who's actually undergone a major renovation knows all too well that these small screen wonders bear little resemblance to the true life experience. Alas, as on TV, the chasm between campaign rhetoric and the realities of governing are vast.

We've witnessed a 13% rise in the stock market since the election. We would argue that during this run different constituencies have read into the administration's pronouncements what they wanted to hear. This inevitably will lead to disappointment as reality runs into dreams. Amongst the three key policies that are driving the stock market are (1) tax reform, (2) fiscal stimulus, and (3) deregulation resulting in higher real growth and higher inflation. We will discuss each one in turn.

The kitchen remodel is the showplace of every renovation show. The Formica countertops are swapped for marble and the avocado appliances are replaced with a sparkling Viking and a Sub-Zero. In Washington, the equivalent of the kitchen renovation is the reconstruction of the U.S. tax code. Some options that have been discussed are reducing the statutory corporate tax rate down from 35% to 20% or even 15%. In theory, this is very straight forward. If a company earns $1 billion in pre-tax profits, and its tax burden falls from $350 million to $200 million, then after-tax earnings rise 23%. Smaller companies tend to have more U.S. domiciled business with higher tax rates, and so not surprisingly, small cap stocks have raced ahead 15% since the election on the promise of tax reform. This leaves plenty of after-tax profits to buy a new Sub-Z.

In practice, nothing about taxes is straight forward. Most large companies have significant non-U.S. earnings that are taxed at lower rates, so the reduction in U.S. taxes would be less impactful. Yet another proposal has been to eliminate the deductibility of interest on corporate debt. This would *boost* the tax paid by many companies and potentially reshape corporate America in an enormous way. So now the Sub-Zero is at best a Kenmore.

Of course, in any tax reform there will be winners and losers. In policy papers, these constituents don't have a voice – everyone gets an eight burner Viking. But in Washington there will be vicious fights between lobbyists on both sides. Notice the outcry over the potential border adjustment tax by the retail industry. Despite many calls over the years to simplify the tax code, it only becomes more and more Byzantine. We've all been through renovations: Recasting the tax code faster than you can do redo your kitchen is unrealistic.

As the administration is learning with healthcare, it is much easier to talk about changing legislation than to actually change it. The market is coming to that conclusion as high tax rate stocks have underperformed low tax rate stocks over the last month.

The President has promised a trillion dollar stimulus to reinvigorate the U.S. economy. Think building your dream house, only on steroids. The market is intuiting that such fiscal spending will drive industrial company earnings.

In state-controlled China, it's relatively easy to push forward massive projects. You may have seen the YouTube video of a 30-story building being built in two weeks (www.youtube.com/watch?v=rwvmru5JmXk ). But in the U.S., as we learned in the aftermath of the financial crisis, there is no such thing as a "shovel-ready," large-scale infrastructure project. Undertakings of this nature take years to plan, permit, design and fund. Permissions are needed not just at the federal level, but also at the state and local levels. There certainly may be some stimulus, but we doubt it can achieve the scope or speed promised. That may be disappointing to those who have rushed into infrastructure companies since the election. You just can't build your dream house in 14 days. Just ask Mr. Blandings.

Speaking of interest rates, we recently attended a lunch with Eric Rosengren, the president of the Federal Reserve Bank of Boston. If President Trump is the builder, the Fed is the nit-picking building inspector. While the president wants to initiate fiscal spending to stimulate the economy, the Fed seems to be looking to moderate economic growth through monetary policy. President Rosengren described a healthy U.S. economy, near full employment, that no longer needs loose fiscal policy. He thinks the Fed should "normalize" interest rates, so that they are no longer below the rate of inflation. This policy approach could certainly be a headwind to economic expansion and the continuation of the run in the stock market.

The third tent pole supporting the market is deregulation. Removing "Red Tape" sounds like a great idea. Here again, in practice it can be a thicket of conflicting forces that don't necessarily hew to clear boundaries. Most regulations arise from Congressional statute. Consequently, changing or removing regulations is a slow, labyrinthine process. As we have seen over the past decade, Congress can't seem to agree on much of anything. It took them years to approve the funds to repair more than 1,000 holes in the Capitol's dome. Revamping the regulatory structure of the entire government is likely to take longer.

The economy has been, and continues to be relatively healthy. However, the market has rushed ahead based on campaign rhetoric. We anticipate renewed volatility as investors realize it's far easier to speak of tax reform, fiscal stimulus and deregulation than it is to deliver it. Your companies haven't jumped ahead as much as some in this rally, but we believe they will hold their value better as economic reality reasserts itself and reveals the unlikelihood of our nation experiencing anything akin to a *Property Brothers* miracle.

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