Our December 2016 Newsletter concluded with:

> **"CONCLUSION: We believe that the markets are currently overvalued and operating on greed. It still has to be seen how the new administration will operate and the impact of new policies on markets. We would encourage investors to be cautious and prepare for an interim (5-10%) correction. We also believe that this rally can continue into the first quarter of 2017. We would start to gradually trim investments that have gained unusual returns and be ready to invest during the next correction."** ***December 2016.***

The US stock market (S&P 500 index) has gained almost 3-4% for the year 2017. We obviously underestimated the resilience of the markets. Most investors inferred the market direction incorrectly since the Presidential Election in November 2016. Describing the past is of little value, but the main question is, "What about the future?".

The major factors for this rally have been the expectations of significant infrastructure spending and favorable tax reform from the Trump administration. It is expected that approximately $1 trillion will be invested to enhance and improve the US infrastructure. The US economy is primarily fueled by retail consumption which is directly affected by the job market. The major endeavor of the Trump administration with regards to infrastructure spending is expected to create umpteen number of jobs that would bolster the US economy.

In addition, the US hasn't experienced a meaningful tax reform since the mid-1980s, the Reagan Era. It is expected that the Tax reform will provide deeper and wider tax cuts which would be implemented sooner rather than later.

Potential impact of select proposed corporate tax reforms on S&P 500 earnings

Federal tax rate	[A] New statutory federal tax rate on domestic income	[B] Repeal of net interest deductibility	[A] + [B] Combined rate cut and repeal of net interest deductibility	[C] Territorial system (no tax on foreign income)	[A] + [B] + [C] Combined rate cut, territorial system, and repeal of net interest deductibility
35%	0%	-6%	-6%	+2%	-5%
30%	+4	-5	-1	+2	+0
25%	+8	-5	+4	+2	+5
20%	+12	-4	+9	+2	+10
15%	+16	-3	+13	+2	+15

Notes: Sensitivities based on FY2015 reported company data. Numbers may not add due to rounding.
Assumes effective rate 4 percentage points above federal rate including state and local taxes.
Net interest deductibility sensitivity excludes Financials and implies no grandfathering of existing debt.

Source: Goldman Sachs Global Investment Research

Goldman Sachs, performed a study[1] at the beginning of the year which reviewed among other variables, the

[1] Source: https://www.bloomberg.com/

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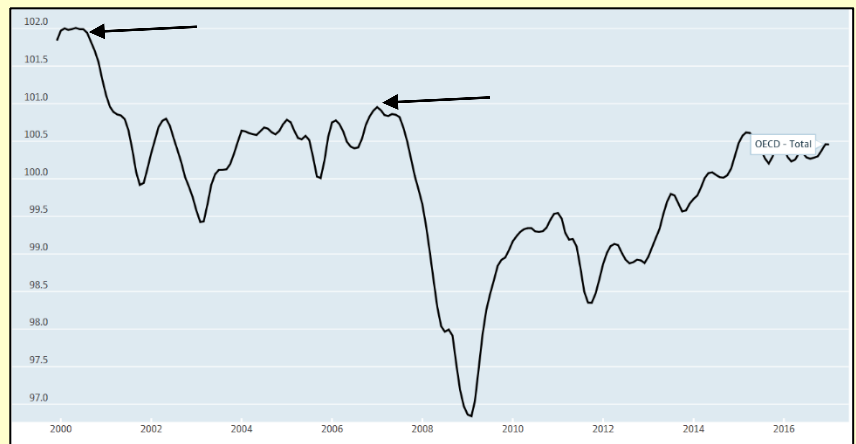
impact of lower corporate taxes on the broader capital markets. It was inferred (see table on Page 1) that the correlation between taxes and the S&P 500 earnings was approximately 1:1. In other words, for each percentage drop in corporate taxes, there would be approximately 1 percent gain in earnings.

Since the Presidential election, which took place on November 3rd, 2016, US markets have gained approximately 11-12%, on an average for respective indexes. It is obvious that the markets have been bullish and expect positive changes from the new administration. Having said that, we cannot forget that investor psychology as fickle as it is, can change quickly in case there is a change in the political rhetoric or delays on the execution of the policies from the Trump administration.

Markets are a leading economic indicator. In other words, markets tend to factor in expectations of future events. We believe that markets have already factored in most of the earnings growth expected from tax reforms. We further believe that markets are currently deficient in making allowances for an unfavorable tax scenario.

Consumer Confidence[2]: "The consumer confidence index (CCI) is based on households' plans for major purchases and their economic situation, both currently and their expectations for the immediate future. Opinions compared to a "normal" state are collected and the difference between positive and negative answers provides a qualitative index on economic conditions", based on The Organization for Economic Cooperation and Development (OECD)[3].



It can be observed from the adjacent chart that the consumer confidence is at an extremely high level. The current level of 100 is almost as high as it was in 2000 (CCI of 102) and 2006 (CCI of 101). Both levels were followed by major market and economic declines.

We have discussed other unfavorable market variables like the Volatility Index and the Margin Levels on the NYSE in previous issues. We will not expound on these variables but will provide a link for reference.

Volatility Index (VIX) and the US Markets was explained in the November 2016 Newsletter.

[2] Source: https://data.oecd.org
[3] Source: Definition of CCI from OECD

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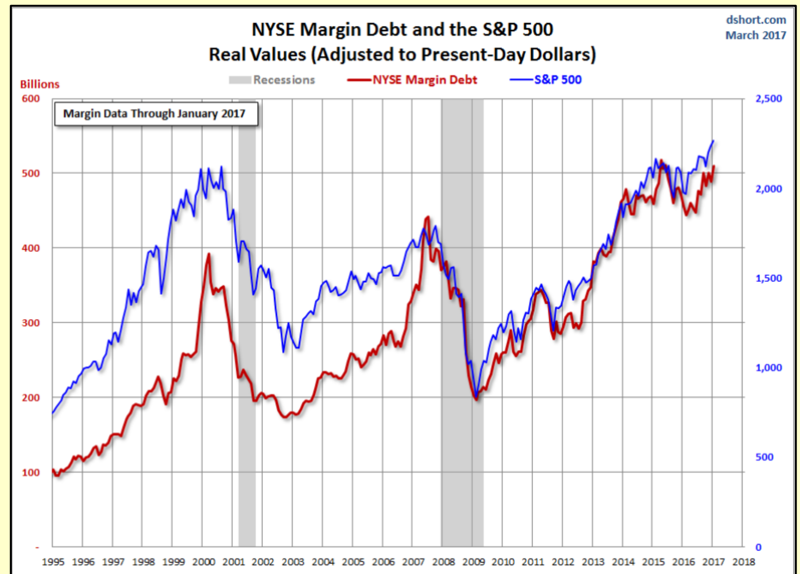
Margin Debt: Margin debt[4] balance on the NYSE is the margin debt investors avail of by pledging assets in their respective brokerage accounts. In other words, investors borrow based on the securities they own and reinvest this money into the market. The idea is to gauge investor bullishness / euphoria by observing the margin debt as a percentage of the total assets in investor accounts.



The adjacent chart shows the correlation between the margin debt and the S&P 500. It can be observed that preceding both major market corrections in 2000-02 and 2008-09, margin debt was at elevated levels. We believe that the current level of margin debt is reminiscent of the past? "History doesn't always repeat itself but it rhymes", Mark Twain.

We believe that the amalgam of the variables stated above paint a worrisome picture of the markets in the near and intermediate term from a technical perspective.

CGAM's Proprietary Market Model:

We now turn our attention to our Proprietary Market Direction Model to gauge how much of the S&P 500's earnings growth expected from the tax reform have already been factored into the markets. As always, we believe that expected earnings along with a few other fundamental and technical variables are critical to predict the market valuation over a period of 12 to 18 months.

We have used the market expectations of the S&P 500 companies' earnings based on the favorable tax reform that most investors are banking upon. Our endeavor is to get an idea of how much of this expectation has already been factored into the market valuation and the risk involved in being euphoric at current market levels.

Our proprietary model was developed on the concept that investor behavior repeats itself based on a combination of fundamental parameters of the economy and human psychology. The model constantly reviews the change in the index based on the changes in statistically significant economic variables.

[4] Source: https://www.advisorperspectives.com

The objective of the model is to quantify these variables into a regression equation using four decades of historical data. The combination of these variables statistically explains 93-94% movement in the S&P 500 index.

Fundamental Variables (12 month Projections)		**Market Projections**	***As of:*** ***March 9th, 2017***
S&P 500 Earnings	$140.00	S&P 500 (12 Month Projection) =	2,326.00
S&P 500 Expected PE Ratio	17.00	S&P 500 (March 9th, 2017) =	2,365.00
10 Treasury Bond Rate (%)	3.0%	***S&P 500 Estimated (Gain/Loss) =***	***-1.67%***
Inflation Rate (%)	1.70%	*Standard Error*	**+/- 5.50%**
Volatility (VIX) Index	12.00		
Unemployment (%)	4.80%		

Markets have gained almost 12% since the elections in November 3rd, 2016. As mentioned, the major impact of the tax reform would enhance US corporate earnings. We have incorporated the best possible scenario of corporate tax reduction and therefore increased the earnings projections of the S&P 500 companies from $130 to $140 (7-8% growth) in our model. In addition to earnings projections, we are using a PE ratio of 17 which is approximately 15% above the average PE for the last three decades. The rest of the variables haven't changed.

It can be observed from our Market Direction Model, that the S&P 500 seems to be fairly valued. The markets seems to have factored in higher corporate earnings and an optimistic investor sentiment for the near future. Again, as Charlie Munger (Warren Buffet's Partner) says, "Just because you put something on an excel worksheet, it doesn't make it true. We do not take the inferences from the model as gospel but a guidance tool which we believe has significant pertenence. Considering the various possible outcomes on the political and economic front, we conclude:

We still believe that the markets are currently overvalued and euphoric. Despite strong economic fundamentals and high consumer confidence, markets could correct in the short and intermediate term by 5-7% on a technical basis. We would reiterate by recommending that investors prepare for a correction by raising cash. We are not recommending selling everything and bury our heads in the ground but be aware of risk return that the markets currently offer. The downside of having a reasonable level of cash in a portfolio will prohibit from capturing 100% of the upside but it will definitely provide investors with a better opportunity to invest during a correction.

PLEASE REMEMBER: Each investor is unique and should invest to compliment their respective financial conditions and objectives.

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