CLEAR CREEK ADVISORS

IS "A BETTER WAY" BETTER?

Market Review **MARCH 2017**

A Better Way. That is the name of the tax proposal made by the Republican Congress. Their intention, make the IRS code simpler and fairer, and put American taxpayers first. That sounds like a better way. Still, major tax reform is a powerful tool that will determine new winners and losers.

Take the proposal for an immediate tax deduction on all capital spending. This proposal derives an instantaneous benefit to industries that buy heavy machinery. However, industries that operate without durable assets obtain no benefit. Furthermore, heavy capital industries may become liable for heftier future tax bills under an invest now policy. Essentially, deferred tax liabilities would snowball on balance sheets, thus deferring settlement throughout the depreciable life of an asset.

Another proposal is to eliminate tax deductions on interest for all future borrowings. Historically, government has subsidized capital investment with this exemption. All else equal, an enactment of this proposal raises the cost of capital and could discourage investment. No wonder why investment grade and high-yield borrowers recently rushed to issue debt. Relative to the full-year of 2016, high and low quality borrowings increased 4% and 200%, respectively, in the first two months of 2017.

Elimination of the interest deduction may adversely impact businesses that require leverage for operations. Think real estate investment trusts and hedge funds. The interest expense deduction has been important cash flow component for shareholder distributions.

Other significant changes include a reduction in marginal tax rates and greater standard deductions for households. Private citizens could also get a 50% deduction for investment gains and income, and a repeal of estate and gift taxes. Corporations and possibly partnerships and limited liability companies could see a reduced tax rate. Preferential treatment for foreign-subsidiary dividends and repatriation of foreign cash could be extended to multi-nationals. Now, the recent record breaking stock market prices seem more fundamentally sound. Republicans say domestic tax reform is possible

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without increasing the deficit. A principle component for paying for tax cuts is a boarder adjustment tax (BAT). BAT will ultimately raise the tax bill on companies that import unfinished and finished goods. On the other hand, BAT lowers taxes for exporting industries. Clearly, US exporters stand ready to benefit from such a law.

A rationale for BAT is it will force industries like manufacturing to bring jobs back into America. However, foreign labor is not the complete reason behind the loss of US manufacturing jobs. Productivity is the main culprit. In fact, real manufacturing output has returned to its pre-recession quantity. A major difference now is it takes less US labor to manufacture the same amount of goods because of technological advancements.

BAT could be a perilous policy. For example, consumer prices on imported goods would likely rise, which might unfavorably affect aggregate demand. Also, the US dollar would presumably rise. That possibility is harmful for the one-trillion-dollar emerging debt market that is denominated in US dollars. A US dollar appreciation makes this debt more expensive to repay.

The US trade deficit is unlikely to be the core of American hardship. After all, foreigners end up exporting their US dollars back into the American economy, because America offers a favorable environment for foreign investment. Correspondingly, foreign direct investment into the American economy has never been higher in history.

US corporate tax policy needs a serious overhaul to keep American businesses competitive. But, it should not come at the expense of higher budget deficits. Politicians will hopefully realize they are working with an economic powder keg when it comes to tax reform. When done correctly the benefits are enormous. If done incorrectly, the costs will carry on to future generations. The stakes are high.

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Market Movers

Security gains were somewhat evenly distributed among asset classes in February, with all major categories adding value. US stocks lead the pack yet again. Our tilts towards stocks made at the beginning of the year in our diversified Core Allocation strategies have already added value in 2017. Although diversified portfolios have performed well in 2017, all of our Core strategies out-performed their primary benchmarks on a risk-adjusted basis. The Core strategies will always remain diversified across the primary asset categories (US Stocks, Foreign Stocks, US Bonds, etc.). However, our selection of individual asset classes was critical in the first two months of the year. The Investment Team remains vigilant by monitoring economic and political developments.

Asset Categories	*Monthly*	*YTD*
US STOCKS	2.51%	3.88%
FOREIGN STOCKS	1.88%	6.29%
US BONDS	0.72%	1.35%
FOREIGN BONDS	1.37%	2.67%
HARD ASSETS	1.91%	1.93%
HYBRIDS	1.54%	3.57%

*DATA USED IS SOURCED FROM MORNINGSTAR®

US STOCKS lead the group again in February. Improving economic activity and labor markets helped push the asset class higher. Plus, US investors are looking for some pro-business tax policy out of D.C. Large-Cap Growth (VUG) posted the strongest gains Large-Cap Value (VTV) and Mid-Cap Value (VOE) held second and third place. Our tilts to Large-Cap Growth and Mid-Cap Value in the diversified Core strategies helped lift overall performance in the US equity space.

FOREIGN STOCKS Despite upcoming election worries in France, Developed Large-Cap Blend (VEA) held its ground and eked out a small gain. Emerging Large-Cap Blend (VWO) stocks and International SMids (VSS) did best last month. So far for the year, Emerging Large-Cap Blend stocks have been the dominate asset-class. Our increased allocation to this market at the beginning of the year was well-timed.

US BONDS traded pretty much flat in February. Among investor favorites were high quality corporates (VCIT) and low quality corporates (JNK). Spreads over treasuries on these two asset classes continue to compress as investors find promise in the recovering American economy and possible tax reforms. Our allocations to both sectors have paid off well.

FOREIGN BONDS made modest gains in February. Emerging Market debt (PCY) led the foreign category. New emerging debt coming to market continues to provide the price confirmation investors seek on the securities. Emerging market debt is still the last resort for investors seeking international yield. Likewise, our diversified Core strategies have benefited from our positioning to this asset class. This allocation decision has been extremely beneficial in 2016 and already in 2017.

HARD ASSETS edged out another positive month despite another month of losses by energy. Precious Metals (IAU) put up another good month and Real Estate (RWO) made its first gain this year. Our position to Master Limited Partnerships (AMJ) helped mitigate the losses to energy. Even though energy as a sector was down on the month, our MLP position posted a small gain.

HYBRIDS were once again correlated to US stocks returns in February. Convertible Debt (CWB) and Variable Preferred Stock (VRP) together finished the month up. Performance remains in-line with equity markets but at a lower risk profile, which we feel is extremely helpful in the current market environment.