LIBERTY CAPITAL MANAGEMENT

QUARTERLY OUTLOOK

Vol. XXVI - Number 1 First Quarter 2018

THE ECONOMY

How Do Tax Cuts Affect The Economy?

How do we sum up 2017? On the economic front, 2017 ended on a high note. GDP continued to accelerate across much of the world in the broadest, cyclical upswing since the start of the decade. Also, the government handed individuals and corporations a big tax cut. Let's explore some of these tax cuts and their effects.

Income Tax Cuts

In 2018, individuals are getting new tax brackets ranging from 12% up to 37%. An income tax cut reduces the amount individuals and families pay on wages earned. In theory, when people take home more money, they spend it, resulting in an increase in consumer consumption (spending). This is important because consumer spending is one of the four components of GDP. Consumer spending is almost 70% of the economy (GDP). Starting in February 2018, most individuals will immediately notice the impact, while others will feel the greatest impact when they do their taxes in 2019. This is due to increasing the standard deduction level that expands the child tax credit and a few others.

Business Tax Cuts

Business tax cuts reduce taxes on profit. When businesses have more money, they tend to invest and hire workers. Trump's plan incorporates two business tax cuts—one for the small business and another for the corporation.

Small Business Tax Cuts

Small business tax cuts help entrepreneurs who employ 50 or fewer workers. As we all know, the Trump tax plan will allow small businesses to deduct 20% of income. (I will spare you the details of how the deduction works, because it's wildly confusing and no one knows exactly how it even works yet.) What this lower tax rate does is return the entrepreneur's role to the center of economic theory. The entrepreneur must take center stage as he is the agent of innovation and creativity that increases economic output. Taxes inevitably affect the actions and incentive of those from which they are taken. With lower taxes, economic theory believes entrepreneurs are incentivized to hire more workers, improve machinery, and/or better equip factories. The tax cut for small business is important because small businesses create almost 65% of all new jobs.

Lower taxes will also increase the capital available for risk-taking, such as opening a new business. Lower taxes and regulations encourage risk-taking—crucial to economic growth. If taxes are too high, capital to provide new private jobs is unavailable and then this type of growth is prevented. That which does come into existence is discouraged from starting new enterprises.

Corporate Tax Cuts

In case you haven't heard, the newly approved tax legislation aims to create a more attractive environment for business investment through a number of policies. These policies include corporate tax rate reduction by 14 percentage points, allowing businesses to immediately write off new capital investments and switch to a national system of taxation.

“The Goldilocks Economy is alive and well.”

Corporate tax cuts lower corporate income taxes. This gives corporations more money to invest back into their businesses, boosting spending on durable goods orders, including capital goods. This tax cut also creates jobs. Corporate payroll tax obligations made to Social Security, Medicare, and unemployment taxes will be lower. Businesses and employees share this cost, so a payroll tax cut benefits both parties.

At this point, you may wonder: What will corporations do with this money? We have already seen a couple corporations announce one-time bonuses and another announce they are raising minimum wage for their hourly employees. The theory is these measures will encourage companies to bring a larger share of their profits they have previously held offshore for tax purposes, back onshore to reinvest in the domestic economy, thereby spurring growth. The White House forecasts that U.S. growth could reach 4% as soon as the economy experiences the full effects of the tax reform law. Any materialized gain in GDP would be building upon an already solid foundation. In the third quarter of 2017, the U.S. economy grew at 3.2%, the fastest rate since the first quarter of 2015 and also the first time since 2014 the economy expanded at a rate of 3% or more for two consecutive quarters.

The U.S. economic outlook is healthy according to some of the key economic indicators. GDP growth is expected to remain between 2% to 3%. Unemployment is forecasted to continue at the expected rate. Inflation should remain in check. Oil prices are predicted to remain relatively stable. And interest rates are expected to remain historically low. The bottom line, The Goldilocks Economy is alive and well.

Fixed Income

Tax Law Change Brings Some Good News Some Bad for Bonds

The yields on fixed income investments didn’t change much during 2017. The 10-year Treasury note ended at 2.41%--which is just about where it started. One figure to consider is the yield spread between the 2-year Treasury notes and the 10-year Treasury notes. That spread narrowed significantly to 0.53% at year end from 1.24% in January. This clearly shows a much flatter yield curve from the Federal Reserve’s three-rate increases but not much concern for longer-term inflation.

The effects of the Tax Law changes on fixed income investments are both good and bad. Let’s first talk about the bad news for municipal bonds: Lower income tax rates will usually make municipal securities less valuable to investors. The largest investors in municipal bonds are corporations, such as banks and insurance companies. The reduction in tax rates for individuals is minor, roughly 2-3%, but for corporations it is significantly dropping from 35% to 21%. If investors don’t get the previous higher after-tax value from the tax exempt feature of the bonds, they will look to other competing asset groups, such as taxable bonds or equities. This will cause the yields on tax exempt bonds to increase in order to attract investors.

The new law also reduces issuance of tax-exempt bonds. Previously, issuers could advance refund their bond issues prior to call dates on their bonds in the market. This often was a method to reduce the interest expense of an issuer in a falling interest rate environment. The elimination of many advance-refunding issues will decrease supply of tax-exempt bonds. Fewer bonds will usually lead to lower yields as

> *“Issuance of tax exempt bonds was also reduced with this new law.”*

investors are willing to accept reduced rates in order to get bonds. Private Activity Bonds (PAB’s), which are tax-exempt bonds issued by entities not considered traditional municipalities, survived under the new law. The PAB market has become an important source of new issues over the last ten years; without those bonds the available supply would have been greatly reduced.

One of the more talked about changes in the new law is capping the deduction of state and local income taxes. Individuals will be capped at $10,000 on their Federal returns. For individuals in high-tax states the Federal deduction had been a nice offset to their above-average tax burdens. This change should be good news for municipal bonds because demand should increase as investors look for other ways to save on taxes. We must wait and see what happens in these higher tax states. Will there be a migration to lower tax states or will states adopt to lower rates to stay competitive?

Although there are many things to consider with the new tax law changes, a balanced allocation of equities and fixed income is the bottom line. It will take a little time for the fixed income markets (specifically the municipal bond market) to digest these changes but overall it probably won’t hurt your fixed income holdings.

Equity Markets

Moving On Up

Moving on up! 2017 is in the rear view mirror. The markets in 2018 should show continued growth. Last year, the DJIA, S&P 500, and NASDAQ indices were up 24.39%, 21.83%, and 27.24%. This is the best annual return since 2013, provided by further strengthening of the economy, a sweeping tax reform package, and frankly a lack of investment alternatives.

While we’ve sounded like a skipping record about the looming correction, the markets continue to show surprising resilience to any substantial drop in market averages. The last market correction of 15% was two years ago in Q1 of 2016. A noticeable drop is overdue; however, there are compelling reasons to stay the course as this market advances.

Various data shows this economy is strong and still accelerating. Unemployment levels are at historic lows. Prior occasions where we have been at near-full employment indicate economic growth can continue for two more years without recessionary implications. Inflation is virtually nonexistent. Even the Federal Reserve, which has been raising short-term interest rates, is beginning to lean to a more moderate pace of only two rate hikes in 2018. Consumer sentiment, consumption, and overall business activity are all accelerating.

And then there is the GOP Tax Package. Without digging into details, this is undoubtedly a business friendly tax reform. That in turn adds to an already positive stock market.

The top corporate tax rate is now 21%. For companies paying substantially more in taxes, this is an overnight windfall. Recent studies indicate the overall impact of the reduction in corporate federal taxes for S&P 500 companies will add 7% to 10% in earning growth. More importantly, since Congress and the President passed the new tax law, the market has not yet increased enough to adjust for the tax savings. On this basis alone, the market appears undervalued.

"We should continue to see further advances in the equity markets."

Corporate profits earned overseas and remaining offshore have now been repatriated. Basically Washington has told those companies they will now be directed to pay a moderate percentage of tax on those funds to encourage the monies to return to the US for capital uses. As an example, Microsoft (MSFT) has roughly $132B in assets (cash) offshore. They will pay a lump sum of approximately $20B in tax at a rate around 15%. This frees up the remaining $112B to utilize in the U.S. There are many companies in similar situations, meaning billions of dollars will find their way back to the country. Companies are indicating the repatriated funds will be used to 1) pay down debt and improve the balance sheet, 2) repurchase shares, 3) increase mergers and acquisitions, and 4) increase capital spending. All of these further indicate an undervalued market.

Some market sectors will fare better than others in this new environment. With rising short-term interest rates and the tax changes, the financial sector should reap the advantages. Also include industrials (balance sheet improvements) and technology (lower tax rates). On the other hand, consumer staples (less impact from tax rate changes), utilities, and REITs (rising interest rates) may not enjoy the changes as much as the other sectors.

While this market cycle is getting long in the tooth and last year was a banner year for stocks, it appears we should continue to see further advances in the equity markets. As I noted, a correction is still expected but longer term this market should provide 10+% returns over the next few quarters.

By the Way…Compliance Issues

Asset Mix

The asset mix decision, or the ratio of a portfolio's balance between stocks and bonds is extremely important to the effective management of a portfolio and the client relationship. It is something discussed and agreed upon at the beginning of the relationship and should be reviewed periodically. Situations change: clients age, income becomes more important, time horizons change, etc. Have there been changes in your outlook of situation that should be reflected in your portfolio? Please contact us.

CELEBRATING 25 YEARS IN BUSINESS

This marks the 25th year anniversary for Liberty Capital Management. We could not have done it without all the support of our clients! Thank you ALL from the bottom of our hearts for being part of the Liberty Capital family!

Kenneth J. Carbaugh ~ Charles L. Dettloff ~ Robert D. Foster

FOCUS ON . . .

PACKAGING CORP OF AMERICA (PKG)

Packaging Corporation of America (PCA) is a producer of containerboard products and uncoated freesheet. The Company operates through three segments: Packaging, Paper, and Corporate and Other. The Packaging segment produces a range of corrugated packaging products. The Paper segment manufactures and sells a range of papers, including communication-based papers and pressure sensitive papers. The Company's containerboard mills produces linerboard and semi-chemical corrugating medium, which are papers primarily used in the production of corrugated products. The Company's corrugated products manufacturing plants produce a range of corrugated packaging products, including conventional shipping containers used to protect and transport manufactured goods, multi-color boxes and displays. The Company also produces packaging for meat, fresh fruit and vegetables, processed food, beverages, and other industrial and consumer products

The company (PKG) has attained a growth rate of 23% over the past 5 years and is expected to continue to grow by 8% over the next 3-5 years. It boasts a solid ROE of 27% despite a low debt to capital ratio. This stock provides the long-term stability and quality that Liberty Capital Management looks for.

Packaging Corp of America (PKG)

PACKAGING CORP OF AMERICA
1955 W FIELD CT
LAKE FOREST IL 60045
PHONE: 1(847)482-3000
www.packagingcorp.com

Jan 13, 2018...........	$128.32
Total Return - YTD	6.45%
Dividend Yld	1.96%
P/E..................................	23.76

Packaging Corp of America
(01/14/2013 to 01/12/2018)

Capitalization

% LT Debt to Total Cap	55.38%
Owned by Institutions	90.80%
Market Capitalization	$12,107
Avg Daily Vol (Last 30 Days)	696,012

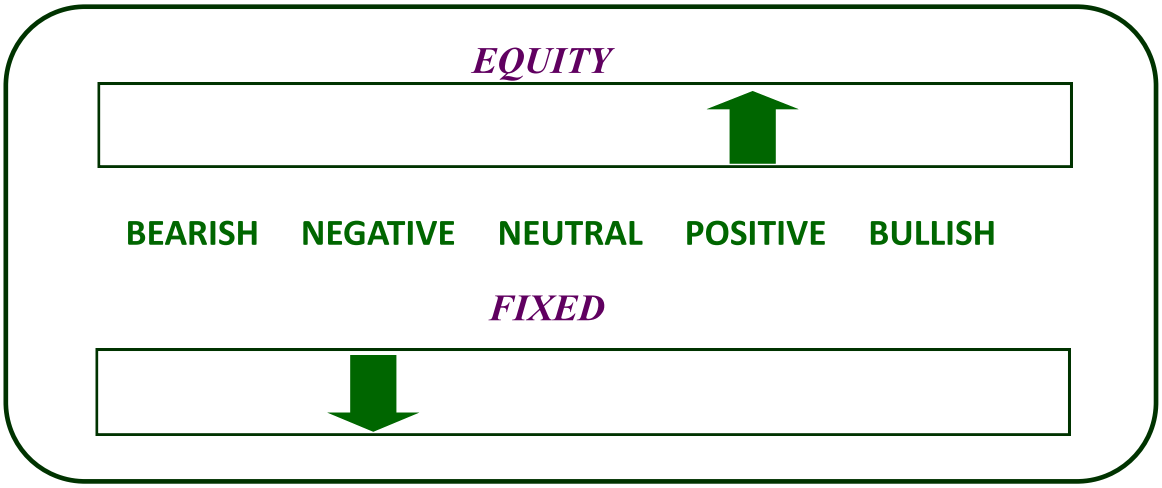
Business Overview

BRIEF: Packaging Corporation of America is the fourth largest producer of containerboard and corrugated products in the United States in terms of production capacity. Recently they produced 2.5 million tons of containerboard at their mills, of which about 80% was consumed in PCA's corrugated products manufacturing plants, 10% was sold to domestic customers and 10% was sold in the export market. Their corrugated products manufacturing plants produce a wide variety of corrugated packaging products, including conventional shipping containers used to protect and transport manufactured goods, multi-color boxes and displays with strong visual appeal that help to merchandise the packaged product in retail locations. In addition, they are a large producer of meat boxes and wax-coated boxes for the agricultural industry.

Earnings	$	%	Growth Rates
Latest Quarter	1.47 up	16.67%	5 Yr Historical
Latest 12 Months	5.40 up	16.13%	%
Zacks Concensus			LT Future
Current Quarter	1.51 up	29.06%	
Current Fiscal Year	5.99 up	26.11%	
Next Fiscal Year	6.73 up	12.35%	8.33%
Revenues			5 Yr Historical
Latest Quarter	1,640 Mil up	10.52%	
Latest 12 Months	6,237 Mil up	9.55%	18.29%
Dividends			5 Yr Historical
Indicated Rate & Yield	$2.52	1.96%	
Increases Last 5 Years	3.00		15.00%

Key Ratios & Measures	Current
P/E	23.76
Price to Book	6.04
Price to Cash flow	15.12
Price to Sales	1.93
Return on Equity	27.27%
BETA S&P 500	1.12

MARKET BAROMETER



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~ Closing Figures as of December 31, 2017 ~

DJIA	**24719**	**10 yr. Treas.**	**2.41%**	**Funds Target**	**1.25% - 1.50%**
S&P 500	**2673**	**3 mo. T-Bill**	**1.39%**	**Prime Rate**	**4.50%**

Liberty Capital Management, Inc.
401 S. Old Woodward Avenue ~ Suite 430
Birmingham, MI 48009
Tel: (248) 258-9290
Fax: (248) 258-9292
Toll Free: (800) 496-9166