

## Economic and Financial Market Commentary

*This article by Michael Melby is excerpted from a letter of [Gate City Capital Management](#).*

During the quarter, the Federal Reserve announced its plan for reducing its \$4.5 trillion balance sheet. Rather than selling any assets, the Fed elected to only reinvest a portion of the principal that matures each month from its fixed income portfolio. The slower pace of reinvestment is expected to gradually reduce the size of the Fed's balance sheet over several years.

To the best of our understanding, the maturing principal that is not reinvested will be returned to the U.S. Treasury. As predicted in prior letters, the Fed's proposed mechanism ensures that the U.S. Treasury will never have to repay any principal or interest associated with the Fed's asset purchases, effectively monetizing approximately \$1.7 trillion of the U.S. national debt.

In September, the Trump administration announced plans to reduce the corporate tax rate from 35% to 20% as part of a broader overhaul of the tax code. The announcement helped spur stock prices and proved especially beneficial to small-cap value stocks as these companies tend to pay higher tax rates as a greater percentage of their earnings are generated in the United States. The announcement led to renewed enthusiasm surrounding the so-called "Trump Trade" as these small-cap value companies were also strong outperformers following the presidential election in November of 2016.

The proposed reduction of the corporate tax rate would increase the after-tax cash flows of a company by 23% (assuming the company was previously taxed at the full corporate rate). This potential increase in after-tax free cash flows serves as a possible offset to historically-high stock market valuations. We note that the legislative process is difficult to predict and the timing and size of any potential future cash flow remains highly uncertain. We have not yet changed any tax rate assumptions for our modelling purposes, but remain cognizant that a reduction to the corporate tax rate would meaningfully increase the free cash flows of our portfolio companies.

U.S. equity markets rose in the third quarter, and many equity indices reached record highs. The third quarter also marked the 8th consecutive quarter of positive performance for the S&P 500. Small-cap companies outperformed large-cap companies, partially reversing the outperformance of large-cap companies seen earlier in 2017. Similarly, value companies were notable outperformers of growth companies, reversing the trend seen earlier in the year. Technology, energy, and materials were the top performing sectors while consumer stocks lagged.

The widely-followed VIX Index which tracks the implied volatility in stock options also declined to near record lows, potentially indicating growing complacency from equity market investors. In fixed income, interest rates were largely unchanged as the Fed held short-term rates steady and inflation expectations remained muted. In commodities, gold prices ended the quarter higher on increased geopolitical concerns and oil prices also advanced.