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September and a Tale of Two Cities

With August winding down, the S&P 500 is lower by about 1% for the month. Investors are hoping to hold off worse damage as stocks enter the worst performance month of the year. The September calendar is complicated by two cities that share the national spotlight at present.

Across America, all hearts are heavy with the suffering in South Texas related to the hurricane and flooding. Many residents in and around Houston have lost a lifetime of memories, and in some cases much more. The still-unfolding tragedy in Houston came on suddenly, as storms often do. It now appears likely to impact the region for years, much as Katrina did in New Orleans and Sandy did on the East Coast.

The next few months in Washington, by contrast, represent the culmination of dramatic events at least a year in the making and in many cases several years in the making. The GOP-led Congress must structure a range of spending bills, prepare and pass a federal budget for fiscal 2018, and raise the debt ceiling in order to preserve the nation's credit rating, all within the next month.

Simultaneously, the administration has begun its pitch on tax reform. Achieving a new tax system or even enacting modest tax reform is predicated on cooperation with the Congress; but relations between the White House and Congressional leaders are strained. Attaining revenue-neutral tax reform would entail eliminating certain breaks and exemptions that will be fiercely defended by beneficiaries. And before it can get to tax reform, Congress has its hands full with aforementioned items.

SEPTEMBER: NOT THE FRIENDLIEST STOCK MONTH

September has a well-deserved poor reputation among stock investors. Since 1980 on the S&P 500, September has averaged a decline of -0.77% (all monthly performance figures exclude dividend contribution). That is the worst single-month performance average among the 12 months. With June having recently swung to positive, only one other month, August, has averaged negative capital appreciation since 1980; and the August average decline of -0.16% is much more moderate than that for September.

September is not only bad on average; it is bad more frequently, compared with all other months. September's "winning percentage" – the percentage of years in which it has been positive on the S&P 500 – is a meager 46%. That is, for the 37 years between 1980 and 2016, September has been up 17 times, or 46% of the time, and down 20 times, or 54% of the time. The next-worst percentage month is July, with just a 47% win rate through 2017. July, however, tends to win big and lose small. Accordingly, July has averaged 0.91% appreciation since 1980.

September has been horrendous since the millennial turn, which included three really bad Septembers in a row. September 2000, which declined 5%, captured the internet implosion. Stocks fell 8% in September 2011, mainly after 9/11. And September 2002, in which stocks declined 11%, marked the final month before the invasion of Iraq kicked off the 2003-07 bull market. All in all, September averaged a decline of -1.52% on the S&P 500 between 2000 and 2016.

HOUSTON & WASHINGTON

Past calendar month performance should not be seen as an indicator of future performance. But all investors would do well to remember that experienced investors are aware of seasonal patterns in the market. These market veterans are not likely to "fight the tape" should a seasonal pattern begin to prevail. Adding to the normal stock headwinds in September are events and circumstances in two cities.

We do not doubt that Houston will eventually emerge from this storm and its aftermath stronger than it went in. No nation on earth is better at disaster relief and rebuilding than the U.S., based on the generosity of our people and the strength and resilience of our private-sector-based capitalist economy. History has shown, however, that Houston and surrounding counties

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will go through lots of pain and loss of economic power before the rebuilding process can even begin.

Katrina devastated a large city, New Orleans, while causing $100 billion in damage and costing over 2,000 lives. Super storm Sandy devastated coastal communities in three states (New York, New Jersey, and Connecticut), killing more than 70 people while causing $65 billion in damage. Hurricane Harvey, unfortunately, has elements of both.

Houston is flat and paved, and the storm has sent the overflow of water into basements and first floors citywide. Surrounding areas have suffered road and other damage and will be cut off for weeks if not months. Houston is not only the epi-center of U.S. refining operations; the Port of Houston is the busiest port in the U.S. in foreign tonnage and the second busiest for overall tonnage (source: Houston Chronicle). Fortunately, refining and port operations do not appear to have suffered much structural damage related to hurricane winds. Assessment of flood damage to low-lying port or refining facilities is still some time off.

Though regionally contained, Katrina and Sandy caused such severe regional dislocation that they were impactful to national economic data. Both storms registered in weekly unemployment claims, monthly nonfarm payrolls, and quarterly GDP reports. For instance, Super Storm Sandy hit in October 2012. Real GDP for 4Q12 was just 1.28%, even though 4Q is often one of the stronger quarters of the year. With Sandy rebuilding slow to get off the ground in winter 2013, first-quarter 2013 real GDP grew an equally weak 1.31%.

While the nation reaches out to Houston, the market is showing its usual dispassionate response. Hurricane Harvey will trigger enormous claims that will impact the Property-Casualty and Auto Insurance markets meaningfully in 2017 and likely well into 2018. These stocks were immediately sent lower as trading opened on 8/28/17 and conditions continued to worsen.

We expect Houston-based Waste Management, the nation's largest environmental company, to be prominent in the clean-up effort. Katrina and Sandy demonstrated that any room that filled with floodwaters will need new wallboard and paint, and potentially re-framing, new electrical wiring, fixtures and plumbing.

Even with an expected influx of carpenters, wallboard installers, painters, electricians, plumbers and masons from around the Southwest, homes and businesses in Houston and environs will likely require years of repair and renovation work. That in turn will spawn ancillary activities including housing, fast food and grocery, auto repairs, tavern traffic, and everything else that accompanies a surge in workers. Through a long and difficult process, Houston will in time transform from waterlogged, to early recovery, to boomtown, and finally to normalcy.

Washington is bracing for a different kind of surge, as the Congress and President work to pass needed spending bills, prepare the fiscal 2018 budget, and raise the debt ceiling, all in the next two months. Both the new administration and Congress are anxious to end the year on a high note, but finding accord won't be easy. The Republican Party has struggled to translate its hegemony into policy. This likely reflects the differing perspectives and agendas of populist Republicans, led by the White House, and establishment Republicans, exemplified by the House and Senate leadership.

While Congress has its hands full with the budget and debt ceiling, the administration has begun its pitch on tax reform. Achieving a new tax system or even enacting modest tax reform is predicated on cooperation with the Congress; but relations between the White House and Congressional leaders are strained. Lacking 60 votes in the Senate, the GOP will likely try and pass any tax reform bill using the procedure known as Reconciliation. Unless the tax bill is revenue-neutral (i.e., tax revenue reductions from lower rates are matched by domestic spending cuts), any tax reform will be deemed temporary, although this can extend for years.

Even without getting to fully revenue-neutral tax reform, paying for some portion of tax cuts would entail eliminating certain breaks and exemptions that will be fiercely defended by industry players and consumer beneficiaries. For example, early indications are that while the GOP's tax reform will preserve mortgage interest deduction, it may well eliminate deduction of state and local taxes. Compared to loss of mortgage interest deduction, loss of state and local tax deduction would impact a much larger set of taxpayers, and particularly older taxpayers whose homes are paid off. There is sure to be pushback on this proposal from a broad range of interests, including home builders, realtors, mortgage bankers and even AARP.

CONCLUSION

The challenge this time around is that the huge post-election rally likely built in not just hope but promise of fiscally stimulative policy, including infrastructure investment, tax reform, and de-regulation. Of the three, the latter is easiest. Deregulation often flows from the President's pen and requires little cooperation; however, its stimulative effects are unproven.

In a Congress that can't pass healthcare reform and has yet to tackle tax reform, and given reluctance to spend money that isn't there, infrastructure investment has slid well down the list of Congressional priorities.

That leaves tax reform. If the Congress does not at least make a run at tax reform by calendar year-end, fragile stock-market gains from the first half could be trimmed or even reversed. Should tax reform fizzle, however, a pullback in stocks is not a given.

The stock market, in our view, has already begun to discount the likelihood of major legislative action this year. That is usually okay; the old wisdom holds that Wall Street likes Washington gridlock. And the market has held up, again in our view, because global economic fundamentals are sound. U.S. corporate earnings are strong and potentially getting stronger, as dollar weakness improves global competitive positioning while commodity strength signals emerging-economy acceleration.

This September combines the usual seasonal fatigue with challenges – one heart-breaking, one maddening – from two major American cities. So far, we see nothing in coming months that this long-running bull cannot handle.

Jim Kelleher,
Director of Research

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