Investment Perspective

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BUILDING OR CLIMBING WALLS OF WORRY? **April, 2017**

Despite the tumult both inside and outside the Beltway as the new administration struggles to settle in, stocks have largely stayed in post-election rally mode. And curiously, first quarter returns proved solid in the face of very low volatility. In fact, until late March, 109 days had passed without the S&P 500 Index closing down more than one percent.

In contrast, it is difficult to recall a more *politically* volatile quarter: widespread protests around inauguration day, continued speculation as to Russia's involvement in the election; contentious debates on the qualifications of cabinet nominees; internecine warfare between the White House and Congressional Republicans; staff departures. And of course, the poorly planned and haphazard battle to replace Obamacare.

Leaving the party

Capital markets also shrugged off the Federal Reserve's mid-March decision to increase the target range for the federal funds rate, the second hike since December. Perhaps the policy move had been so well telegraphed that it had already been priced into asset values. The lack of reaction may also reflect confidence that the economy has the momentum to withstand a less accommodative central bank.

After years of obsessing about each economic data point in light of its potential impact on interest rate policy, market participants have shifted from Fed watching to Trump watching. The new narrative seems to be that infrastructure spending, tax reform, and deregulation will take the reins from monetary policy to propel the economy forward.

Ideally, fiscal and monetary authorities work in tandem to support growth. Yet in the years following the financial crisis, the Federal Reserve has been the only game in town. Politicians have not been willing to take meaningful or concerted action to help revitalize growth, despite pleas from central bankers. Ironically, now that the political mood has changed in Washington, the Fed is leaving the party.

So rather than moving together, fiscal and monetary policies may again work at cross purposes. In hindsight, it is clear that monetary policy alone has not been sufficient to normalize the growth rate. Indeed, 2016 marked the 11th consecutive year in which gross domestic product expanded by less than 3%. Therefore, will more aggressive fiscal policy alone shift up the U.S. growth curve?

Hard vs soft data

Stocks' move upward and onward seems a bit at odds with all the uncertainty — even flip-flopping — relating to the nation's domestic, trade, and foreign policies. To justify its sugar high, the market will need the support of an improving economy along with better corporate earnings growth.

Fortunately, that environment may be on deck. The U.S. economy had been gaining traction prior to the election and the ramp up in stock prices. Optimism among consumers and small businesses has surged in recent months presumably on an outlook for growth-boosting policy initiatives. If such a mood swing translates into more spending, borrowing, and risk-taking, economic growth should accelerate.

But on that note, the financial cognoscenti have pointed out that improvements in so-called *soft* data, like sentiment measures, have still not been reflected in *hard* economic data. In other words, although folks are feeling better, we have not really witnessed a pickup in activity yet. Either the hard data will catch up, justifying higher stock valuations, or sentiment will fall back — leading to a market pullback.

Up, up and away

Meanwhile, Wall Street has been raising global profit estimates for 2017. Typically this time of year, analysts are scurrying to *lower* their overly optimistic forecasts. But according to Bloomberg, lately positive earnings revisions have exceeded negative ones, most notably for companies domiciled in Europe and Japan.

Strategist Ed Yardeni points out that analysts' consensus expectation for year-ahead S&P 500 sales growth has moved up from about 3% in early 2016 to 5.5% today. The outlook for corresponding earnings growth has doubled, from 5% to 10%. This could turn out to be the best year for profit growth since 2010. Yardeni attributes much of this anticipated improvement to a recovery by the global commodities complex, particularly oil.

As oil and other commodity prices plunged between mid-2014 and early 2016, producers cut output, axed workers, and severely curtailed capital spending. Many smaller and highly-leveraged companies went out of business. The sector's troubles rippled throughout much of the industrial economy as energy firms canceled orders. Such stress overwhelmed the beneficial impact of lower gas prices on consumers' wallets.

Today, commodity prices remain well below their 2014 highs but are nonetheless up significantly from 2016 levels. And commodity demand appears to be solid. Thanks to cutbacks and efficiency gains, many companies are profitable again with lower break-even prices. Shale oil producers represent one obvious example.

It's complicated

Many observers question the White House's decision to take on the Sisyphean task of reworking the Affordable Care Act (ACA), at least so early in its reign. Apparently, "nobody (in the administration) knew that health care could be so complicated." But House Speaker Paul Ryan advocated this route to pave the way for the tax reform debate.

The overall merits of repealing the ACA may be debatable but viewed narrowly, doing so would have simplified the budget picture. The purported replacement aimed to lower spending while scrapping a dozen or so taxes such as the medical device tax and 3.8% surtax on investment income. Overall, the net impact would have led to lower future budget deficits.

Without the spending cuts from the replacement healthcare legislation, Republicans will have to find other areas of the budget to help offset tax cuts in any potential reform package. And therein lies the challenge: Excluding mandatory spending and interest on the national debt leaves $1.2 trillion of discretionary spending to target. But defense spending accounts for $800 billion of that balance and appears to be off the table. The math therefore, is somewhat cruel, as only 10% of the federal budget, or $400 billion of outlays, resides in the non-defense, discretionary bucket.

So new sources of revenues must be found. A "border adjustment tax" has been proposed that might raise a trillion dollars for the Treasury's coffers. This could offset lost revenues from tax reform. A BAT would be levied against imports, not exports, but the concept is extremely controversial and faces an uphill battle on Capitol Hill.

The Taxman cometh

The White House and Congressional Republicans do agree on a number of core tax reform features. For instance, both groups wish to collapse the number of individual tax brackets, eliminate estate and Alternative Minimum taxes, and lower the corporate tax rate. But the scope of any tax reform package remains unknown while the timing is likely a late 2017 event, at best.

At 35%, the statutory U.S. corporate income tax rate is among the highest in the world. Of course, the *effective* rate that many companies actually pay is lower due to loopholes and offshoring (operating in countries with more preferable tax treatment). Supporters of a corporate tax cut argue that companies will be incented to keep jobs in the United States.

The prospect of a sizable corporate tax cut could help explain part of the stock market rally. Republicans have talked of reducing the marginal rate to 15%-20%. Even a less aggressive reduction would have a meaningful impact on S&P 500 earnings. For instance, Standard & Poor's estimates that a 10-point reduction (to 25%) would boost 2018 net profits by 10%.

Bring it back

Members of both parties have shown some interest in temporarily slashing the tax rate on corporate cash repatriated from overseas. Excluding the financial sector, U.S. companies hold around $1.3 trillion of cash outside the country. Some is earmarked for foreign operations but the main reason for the hoarding is that 35 cents of each dollar brought back would go to Uncle Sam.

Advocates of a tax holiday claim that this cash pile (equal to 7% of GDP) would flow from passive holdings to active use. It would fund new investments and job growth. But in reality, U.S. businesses have not been hamstrung; they have had access to cheap capital for years. An analysis of a 2004 Bush-era temporary tax cut on cash indicated that most of it went towards stock buybacks. Therefore, it is not clear that this reform would have a significant multiplier effect on the economy.

Speaking of multiplier effects, investments in America's crumbling infrastructure may serve as the most substantial catalyst to jumpstart growth. Conceptually, this issue enjoys broad, bipartisan support and will likely provide the biggest bang for the buck. Devoting more resources to the nation's transportation and energy grids would boost job growth while enhancing future productivity.

Ball is in Republicans' court

The recent failed efforts to replace the Affordable Care Act underscore the challenge of passing substantive legislation even with one party "controlling" the Presidency and both houses of Congress. But as the year progresses, consumers, businesses, and investors should all obtain a better sense of the scale of new initiatives out of Washington. The next few rounds should be less contentious. Perhaps such clarity will unleash pent-up economic forces. The potential still exists for a pickup in growth, fueled by aggressive fiscal policies.

Stocks are currently pricing in a fairly optimistic outlook and valuations are not cheap. Higher corporate profits and a benign interest rate backdrop should help support stock prices. Nevertheless, it would be unreasonable to expect them to keep moving up at the pace they have been. And, if politicians fail to enact pro-growth policies that investors are anticipating, stocks will be at risk.

— Christopher J. Singleton, CFA, Managing Director

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