MAR 23, 2018

Balancing the Positives

The first quarter saw volatility return to the United States equity market. At long last, the indexes had their first 10% decline since 2016 and the VIX index of volatility soared to 50 before settling back to around 20. The VIX had been mostly at 10 for the past year. Stock pickers found themselves in an environment where they could demonstrate their ability to add value, but the market remained narrow, with, according to Bianco Research, the ten largest capitalization companies in the Standard & Poor's 500 accounting for 45% of the year-to-date performance of the index. Technology stocks were at the top of the pack, with Amazon, the standout, contributing 16.5 percentage points, followed by Microsoft at 9.3, Google at 6.6 and Apple at 6.3. These companies are indeed impressive, but you have to wonder if their stock market leadership can continue indefinitely.

The current bull market marked its ninth anniversary in March, and last year, with a total return of 22%, was one of its best. You would expect an aging bull to be showing signs of weariness, but 2018 began with a strong performance before the February decline that was triggered by the January employment report and renewed apprehension about inflation and higher interest rates. With the market having done so well for so long, you would think stocks would have reached a point of overvaluation, but that does not seem to be the case. We are estimating S&P 500 earnings at $160 for 2018, so the multiple is about 17. This does not seem unreasonable considering earnings for the index are expected to grow in double digits this year. Although investors are not as dangerously euphoric as they were at the end of January, they are not yet at the level of concern or pessimism that would provide a platform for a significant rise in the market. My current year-end target is 3000, less than 10% above present levels.

Because we are in a rising interest rate period, big returns should not be expected anyway. At the beginning of the year, most observers were expecting the Federal Reserve to raise the funds rate two or three times this year. Many now believe (and I agree) that we may see four increases, as evidence shows that the economy is strengthening, and worries about rising inflation are renewed. Intermediate and longer-term rates have risen as well, making bonds more attractive in comparison with equities. Rising rates alone may not be enough to cause a retest of the February lows. There are many instances of the market rising during periods of Fed tightening, but the yield curve inverting would be a warning signal that trouble is ahead. Even if that occurs, we should have a one-year lead time and we're not at the point of inversion yet.

We have had no shortage of major developments recently, and any one of them could have caused a further market decline. The most notable was the decision by the Trump administration to place tariffs on steel and aluminum. This raised fears among investors that a trade war with China may be starting. The president has always leaned toward a nationalistic stance on trade, so the current policy move is not surprising. My view has always been that free trade is a positive for the world economy, but I also believe in fairness and there is no question that some countries have trade practices that are harmful to American exporters. Unfortunately, however, the countries most hurt by the new tariffs are among those that are fairest in their trade policies with the United States. As a result, the initially announced tariffs are likely to be modified. Canada and Mexico have already been granted exemptions. There are several studies that argue for a softening of the steel and aluminum tariffs. According to one, only 140,000 people are employed in the steel industry in the U.S. today, while 6.5 million are working in steel-consuming industries. Another study, by the Council on Foreign Relations, shows that 45,000 auto workers could lose their jobs because of the tariffs; that is one third of the number of workers in the steel industry. If the principal target were China, that country accounts for only 5% of our steel imports and 10% of our aluminum, according to the Peterson Institute.

The trade issue caused Gary Cohn, the highly respected National Economic Advisor, to resign. Cohn is the former Chief Operating Officer at Goldman Sachs and is considered by most observers to be intelligent, fair, knowledgeable in finance, easy to work with and a balancing factor in the White House. His departure will deprive the White House of a degree of financial expertise which will be essential to the formation of economic policy going forward. Cohn's leaving may not be enough to produce another down leg in the market, but it is not good news. More worrisome, perhaps, is the high turnover of the White House staff and the fact that a number of key departments have had trouble recruiting, leaving many jobs unfilled and important work undone.

Offsetting these developments have been some favorable events. North Korea has expressed a willingness to sit down at the negotiating table and discuss its nuclear program with South Korea and the United States, and President Trump will meet with Kim Jong-un in May. Previous negotiations have resulted in North Korea agreeing to suspend work on nuclear weaponry in exchange for some concessions but then resuming its hostile efforts after a while. As a result, many in the defense establishment are suspicious of Kim's sincerity. Part of the reason for North Korea's willingness to initiate talks was the decision by China to sharply cut back food and fuel shipments to North Korea. I have long believed that China was critical to any attempt to neutralize North Korea's nuclear effort so maybe there will be more progress this time than in the past. A summit initiated from the top down (Trump and Kim) carries dangers because it does not give diplomatic staff enough time to lay the groundwork.

The other good news is on the world economy itself. Data coming in from around the globe indicate moderate growth almost everywhere so the background fundamentals remain sound. Interest rates in the United States continue to be higher than in any other developed countries. Real growth, at about 3%, is more than in Europe as well. The recent cut in corporate taxes makes investment in the United States more attractive. The unemployment report for February showed 313,000 jobs created versus estimates of 200,000, and the unemployment rate stayed flat at 4.1% because 800,000 people entered the work force. The unemployment numbers may not be as good as they look, since U6, which includes part-time workers looking for a full-time job, was 8.2%. The last time the unemployment rate was 4% (2000), U6 was at 6%. There still seems to be slack in the work force.

On the basis of these considerations you would expect the dollar to be strong, but the opposite is true. There may be several reasons for this. We know that chaos in Washington and turbulence in the White House have hurt the President's credibility. The reduced confidence that foreign investors have in America's leadership is reflected in the value of U.S. currency. Second, both the federal budget deficit and the trade deficit are increasing. Higher government deficits mean more borrowing, and higher trade deficits may result in dollar depreciation to stimulate exports. In the end, I believe growth is the determining factor. I expect the dollar to strengthen before year-end, but I anticipated that last year and I was wrong.

There are several other background factors that may be worrying investors. While S&P 500 earnings have been increasing at better than 10% annually in recent years, that pace is likely to decline. For 2019 we are projecting earnings of $170, only $10 or 6.25% more than 2018. That is still an impressive performance for an economic expansion in its tenth year, but it is meaningfully slower than the recent pace of earnings growth. Productivity is another potential problem. During the Internet and smartphone surge, it reached an annual improvement rate of 4%, but it has been hovering at about 1% since then. This factor is critical to profitability increases and a rising standard of living. A Brookings Institution study shows that the impact of technology is reflected not so much in the loss of jobs, but primarily in the lack of income growth. Two possible conditions could improve the outlook. Increased capital expenditures generally result in higher productivity because more efficient equipment is acquired. Second, a technological breakthrough like the driverless car or truck could provide a step-up in productivity, but that is likely to take several years.

The most important factor influencing the financial markets may be central bank liquidity. During 2016 and 2017, the world's central banks (Federal Reserve, Bank of Japan, European Central Bank and Bank of England) were buying assets and therefore injecting liquidity into the economic system at a rate in excess of $150 billion a month. Year-over-year the combined balance sheets of the major central banks increased 15.8% to $14.9 trillion by February 2018. Now that period of monetary stimulus is over. Starting this year, monthly purchases will taper off and, according to Deutsche Bank (as reported by Bianco), they will turn negative in 2020. If that happens, an important driver of equity performance will no longer be present. The Deutsche Bank estimates may be extreme, but there is no question that monetary expansion is diminishing. Not receiving as much attention is how a decrease in central bank bond buying could cause yields across the curve to move higher. The Federal Reserve shrunk its balance sheet by $12 billion in early March, while Japan and China have slowed their purchases of U.S. Treasuries. This is in the face of more debt issuance. Increased government spending and lower tax rates will push up the deficits in the United States. Buyers of our debt will be found, but at a higher yield than today. Another debt problem exists. Up until 2002, U.S. non-financial debt increased at the same rate as nominal GDP. Since then it has been growing at twice the rate of GDP. When this dependence on credit will begin to retard growth is hard to know.

Inflation is another issue that becomes more troubling as expectations continue to move higher. Tighter labor markets could push average hourly earnings increases up to 3.35% from 2.5% according to the National Federation of Independent Business (NFIB). The NFIB index of small business optimism has moved up sharply and has reached the peak it attained in 2005. This is reflected in general business optimism about earnings. While I expect S&P 500 earnings to increase as much as 15% over last year in 2018, partly because of the tax changes, the consensus has moved closer to 20%. Revenue increases are expected to be about 7% this year.

Aside from the reduction in taxes, one of the most favorable aspects of the Trump agenda has been the dismantling of regulation. One measure of this has been the number of pages in the Federal Register. A chart from Bianco Research shows that the number of pages had been rising pretty steadily over the past 80 years except for a period during the Reagan administration. In the past year it dropped from close to 100,000 pages to 54,153 because of the Trump program requiring two regulations to be cut for every one added. The Administration has in fact, exceeded that target. This is a dramatic change that has given American business considerable operating flexibility and enabled profits to improve.

My conclusion from reviewing the total mix of these factors is that investors are too focused on the positives in the outlook and paying insufficient attention to the negatives. We have all accepted the fact that volatility will increase, but investors are not taking into account the downside aspect of the market's progression that produces that increase in volatility. Fundamentally inspired dips may be forgotten if the year ends at 3,000 or above on the S&P 500, but investors should be prepared, for such dips are likely to occur. The event precipitating the decline is often hard to identify before it arrives.

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