Economic Commentary

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"We're Sending You Back to the Future!"

- Dr. Emmett Brown

With the close of 2017, we mark the end of one of the most consistent years in market history. Including dividends, the stock market experienced 14 straight months of positive returns, going back to November of 2016. Equity volatility evaporated and the year passed without experiencing a single daily decline of more than two percent. Credit Suisse notes there were only eight days during the year in which the S&P fell by more than one percent. The Dow-Jones Industrial Average had 70 new closing high days during the year and crossed four 1,000 point thresholds for the first time ever. A key measure of stock market volatility, the VIX, spent much of the year below 10, well below its historic mean, which is closer to 20.

Not only was the market steady, but the returns were surprisingly strong. Indeed, last year's prediction of a positive market was only off by the magnitude of the gains. The S&P 500 Index was up 21.83% (with dividends reinvested), while international equities rose 25.03%, as measured by the MSCI EAFE Index. Defying many predictions to the contrary - including our own – bonds also fared well in 2017, with the Bloomberg Barclays Aggregate Bond Index posting a 3.54% total return for the year. The Bloomberg Barclays Intermediate Aggregate Index came in at 2.27%.

This looks like a classic case of "animal spirits" coming back to the market. Beginning with the 2016 elections, investors were initially buoyed by the prospect of relief from an aggressive regulatory environment. Optimism grew as it became clear businesses could still be viewed in a positive light, not just a negative one. As the economy steadily improved, investors who had been sitting on the sidelines have fed on the optimism and are now flocking back to the stock market, and in many cases are also selling bonds to fund their purchases.

The buying has not been unwarranted. The economy, domestic as well as global, is strong. The economic firm ISI Group notes we are in the middle of a synchronized global expansion, with every major industrialized country experiencing growth. Unemployment remains low, wages are rising and help wanted indices are at the highest level in years. Corporate profits, which had experienced tepid growth for several years, are now surging.

The underlying optimism is showing in many ways. The price-to-earnings (P/E) ratios of the market indices have risen during the year. The P/E of the S&P 500, for example, is now three points higher than at this point last year. Almost every measure of consumer confidence is also sharply higher now than at the end of 2016. Perhaps most importantly, small business optimism is now at the highest level since 1983 and the index now stands at the second highest level in history.

Interestingly, Congress passed a tax reform package at the end of December that includes a large tax cut component. Tax cuts, especially of this magnitude, are usually reserved for periods of economic weakness. The reform tax package, blandly titled the Tax Cuts and Jobs Act, was ostensibly meant to reform a very cumbersome and outdated tax system. However, the rate cuts that came with the package will be highly stimulative when they take effect this year. This stimulus will undoubtedly have a big impact in an already tight economy. It will certainly impact asset prices.

The last time we had such large tax cuts during a period of relative economic strength was the Reagan cuts in 1986. The next three years were all positive for stock market returns, but not without anxiety. After surging higher for the first seven months of 1987, stock prices began to correct in late August; a move that culminated in Black Monday, October 19th. Interest rates also surged, as the Fed acted to cool a strong economy. These higher rates played a significant role in the recalibration of equity prices later that year.

We are not predicting a repeat of 1987 in 2018, but the similarities are strong enough to draw observations about the risks that we might be facing today. Most notably, the yield curve flattened dramatically in the prior year. Like today, the flattening occurred as front-end rates rose as monetary policy was tightening. Long end rates fell on the belief that economic growth and inflationary pressures would be held down by higher rates. This belief did not accurately reflect the pressures of rising budget deficits and the acceleration of economic growth, let alone the added stimulus created by the tax package. Market multiples expanded in the prior year, buyer confidence was rising and the economy was on an upward trajectory. In another interesting coincidence, the Federal Reserve was about to get a new Chairman (Greenspan then, Powell now) and was tightening as the economy gained steam.

Given the lessons of 1987, interest rate changes will clearly be important to the health of the stock market in 2018. The Fed has been moving to normalize interest rates now that the country is no longer in a crisis, but the slow rate of change is maintaining a very accommodative monetary policy. The Fed funds rate and the discount rate are still well below historical norms, relative to short term Treasury yields. Whether this can be maintained if growth picks up is a risk to be closely monitored. Any sign of stronger growth or higher inflation will likely encourage the Fed to move faster than planned. As was the case in 1987, rising interest rates, especially in the long end, may be a serious risk in 2018.

This risk should not be underestimated. Rising rates impact the market and the economy on many levels. As rates rise, spending for both consumer and business product becomes more expensive and consumption falls. Higher finance costs lower profits and allow fewer debt fueled buy-back programs. Those in debt already will see debt service costs rise and will have less ability to spend and default rates may increase. Perhaps most importantly, equity valuation models use interest rates as an input and higher rates will lead to lower price models as an output.

It is impossible to turn on a financial news channel today and not hear someone say "stocks are cheap/fairly valued at current rates," but it is important to remember the phrase is only true if rates remain unchanged.

Strategy and Market Outlook

From a financial perspective, the markets are in fine shape. The world has shaken off the Crisis-induced hangover experienced earlier in the decade. Domestically, the U.S. economy is experiencing the strongest growth in several years and forecasts suggest this will be a multi-year phase of the economic cycle. Unemployment is low, wages are rising (although not as fast as some would like) and companies are expanding. The banking system - the primary driver of the velocity of money - is solidly in recovery and loan growth is finally expected to accelerate. The new tax legislation will add a significant amount of stimulus to the system. Barring an outside event, we see 2018 shaping up to be another good year for stock prices.

Risk levels do remain high in this environment. This is said more from a policy and geo-political perspective than a valuation perspective. Tensions remain elevated in many parts of the world and internal strife in places like Saudi Arabia and Iran can easily spiral out of control to cause global consequences. Domestic political risk has been over-stated, but still exists. We suggest the rally has been more of an endorsement of gridlock, than of domestic policy. Markets love a stable, non-intrusive government much more than a highly interventionist government. Legislative gridlock has been the best stimulus for stock prices in recent years. We saw this in the late 1990's, in 2013 and in 2017. If there is political risk in 2018, it is that gridlock will suddenly end.

We are looking to mitigate some of this risk by gradually moving some money out of stocks and into bonds as the equity markets rise. We still see positive equity returns, but taking some money off the table and legging into a rising rate environment makes sense.

As we look to the year ahead, we see the current cycle favoring larger companies. Those firms with greater scale and efficiencies will better survive an environment where technological innovations are rapidly eroding profit margins. Companies with higher cash flows and a greater level of internal financing can better survive a rising rate environment than companies that are highly reliant on external financing.

The tax legislation will be positive for U.S. companies. Firms with higher U.S. sales will benefit more than multinationals and foreign companies. Multinational firms pay a lower effective tax rate than domestic companies (because they keep foreign earnings off shore, rather than bringing these profits back to the U.S.) and will not see as much of a direct gain. However, the new rules will allow for easier repatriation, which will allow these firms to be more efficient with shareholder capital. We believe many are still underestimating the benefits of the Act for U.S. companies and that U.S. stocks may still offer value relative to international stocks, despite what the pundits say on CNBC. We note that most central banks are also well behind the Federal Reserve in easing monetary policy. This suggests the interest rate risks might be greater overseas than domestically. With stronger balance sheets and better transparency, U.S. stocks still look attractive on a relative basis.

We are less optimistic on bonds, although the asset class still provides stable income and safety and will act as a hedge in the event of a severe correction. We now see the bond market much like a coiled spring. We believe, at some point soon, the spring will have to uncoil. Spread widening can result from short rates falling, long rates rising or a combination of both. However, with the front end of the curve held in place by a tightening Federal Reserve policy, we see any unwinding having to come entirely from the long end moving higher.

The risks to interest rate stability, especially at the long end, are numerous. The perennially large Federal budget deficit is poised to swell, even before taking into account the impact of the new tax plan. Treasury debt issuance is expected to double to $1.3 trillion, according to J.P. Morgan Chase & Co. estimates; the highest level since 2010. Adding to the pressure, the Federal Reserve, the largest buyer of Treasury debt in recent years, is now stepping back and shrinking its bond holdings. The Fed will allow an estimated $300 billion of bonds to roll off its balance sheet next year and these securities will have to be purchased by the public. Monetary policy should continue to normalize in the years ahead, leading to more rate increases and higher yields across the board.

The interaction between stocks and bonds will be an interesting dynamic to watch, but for now, we maintain a positive outlook for the year ahead.

As always, please contact us should you have questions.

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