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AN OLD ADAGE

There's an old adage on Wall Street that says, "Buy the rumor, sell the news." It's a simple synthesis of how the market operates in that it reacts to expectation or forecasts, it doesn't wait for them to be announced. And when there is an announcement, it's often too late for an investor to take advantage of it because it's already priced into the market. And for a trader, it's time to sell.

We saw a good example of "buying the rumor" late last year as it became more apparent that tax reform legislation would be passed in the United States. When it was signed into law on December 22nd, that was the news. Time to sell? Well, we think not. In this case, tax reform is broadly considered positive, but the real impact will be company and industry specific. So, we think the "news" will be revealed in the fourth quarter earnings reports which will start in mid-January.

On balance, these reports could be messy as companies try to bring forward any expenses that can be written off in 2017 given it is a higher taxation year. You're already seeing companies committing to employee bonuses that may qualify as last year's expense.

There are also "deferred tax assets" which are losses from the financial crises that were capitalized and will now have to be written down. Although they aren't included in operating earnings, they are estimated to total $600 billion.

So, the focus of the upcoming earnings reporting season will be on company guidance and what tax reform will mean to them specifically and the economy in general.

Tax Reform and Earnings

Because of the difficulty in knowing the specific impact of tax reform, most analysts have left their 2018 earnings forecasts unadjusted. However, consensus forecasts have been drifting higher, so some positive fallout seems to be creeping into the numbers.

Nevertheless, let's start with current consensus expectations. For 2017, earnings are forecast to be $130.62 and for 2018 they are expected to be $145.20 for an 11.2% improvement.

Tax reform will cut the corporate tax rate from 35% to 21%. The trouble is, not everyone is paying 35%. In fact, the effective tax rate for the S&P 500 companies was only 26.4% in 2016.

Consequently, the impact from tax reform is quite disparate and won't be narrowed until we see company guidance.

Right now, the rule of thumb is that 1% tax reduction is worth $1.83 to S&P 500 earnings. So 5% gets you $9.10 and this would take the 2018 estimate to $154.30.

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However, J.P. Morgan estimates the impact to be close to $12 per share while economist, Ed Yardeni has calculated the benefit closer to $6 per share. Most analysts figure that the tax benefit will add between 7% and 14%. The midpoint of that range would be 11% and equal $14.37 per share. That's quite a range.

Add to this the impact of repatriated earnings from overseas. Tax reform allows for foreign earnings to be brought back at a lower tax rate. There is currently $3.1 trillion sitting offshore. If only $1 trillion is brought back and 35% of that is used to repurchase shares, it amounts to 1.8% of the S&P 500 market capitalization and would add 1-2% to S&P 500 earnings or $1.43 to $2.83.

The value of the dollar also factors into this equation as a 2% change in its value affects the S&P earnings by 1%. Last year, the dollar was down 8% which would equate to $5.80 in incremental earnings.

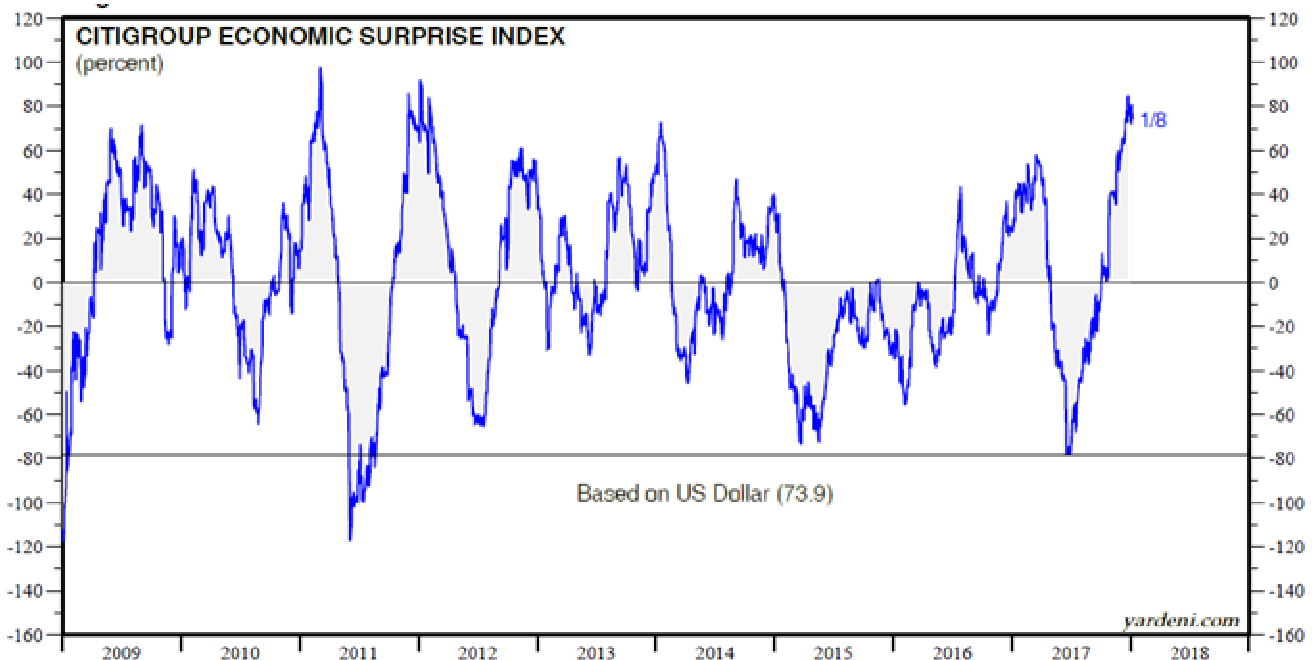
So, as one can see, triangulating to an earnings forecast for 2018 is a very imprecise exercise until we get more specific guidance from each company.

Nevertheless, we do know it is positive, so at least the market has gotten the direction correct and the threat of another legislative failure has been eliminated.

Economy

Not only is tax reform positive for earnings, it is also beneficial for general business conditions. Even without tax benefits, earnings were expected to improve by over 11% this year and another 10% in 2019.

For the United States, the simplest indicator to look at would be the Citigroup Economic Surprise Index.



Source: Yardeni Research, Inc

It fell as low as 78.6 last June when the hard data didn't support soft survey conclusions on consumer and business confidence. It has since risen as high as 84.5 while the GDP has recovered from a weak 1.2% in the first quarter to over 3% in both the second and third quarters.

Moreover, this isn't just a North American phenomenon. It would appear that we are now in a synchronized global expansion. Globally, the purchasing manufacturers index (PMI) has soared from last year's low of 50 in February to 54 at the end of November.

More specifically, advanced economics are leading the way.

	Recent PMI readings
Euro Zone	60.6 – the highest since the survey began
Germany	62.5% (IFO business confidence hit a record high)
Italy	58.3
France	57.7
Spain	56.1
UK	58.2
US	58.2 (Dec. ISM rose to 59.7 – near a 13 year high)
Canada	54.7
Japan	53.6 – a 46 month high

With this kind of economic growth momentum, it isn't likely that a recession is on the horizon.

Monetary Policy

There is no doubt that we have recovered from the crisis conditions that set-off the extraordinary monetary easing.

Nonetheless, central banks are only reluctantly reducing stimulus by either raising interest rates or reducing their balance sheets by selling bonds.

The U.S. Federal Reserve has now raised rates three times and is predicted to raise them an additional three times this year to 1.5%. They are also reducing their balance sheet by $10 billion every month and will increase their sales by $10 billion every three months until they reach $50 billion in sales by September.

The European Central Bank (ECB) has maintained low interest rates and is "tapering" which means they are continuing to buy bonds but at a slower rate. Purchases have declined from $80 billion to $60 billion last April and will be cut to $30 billion in January and continue at that rate through September.

The Bank of Japan (BOJ) has not committed to any policy change yet and continues to hold interest rates near zero. However, they did reduce their balance sheet by $3.96 billion in December.

Even the Bank of Canada has raised interest rates twice, last July and September, and is expected to ratchet them higher by another quarter point to 1.25%.

Given the massive monetary stimulus that we have seen, the transition from accommodative towards tightening seems pretty modest.

<u>So where does this leave us?</u>

On balance the underlying conditions are pretty constructive. The economy is growing, earnings growth will be accelerated by the tax cuts and monetary policy isn't hurting. Our only caution is valuation. The US market ended the year at roughly 20.5 times last year's operating earnings and pick your number, but assuming $154.40, we're trading at 17.3 times this year's forecast. Neither are outrageously expensive but not cheap either.

We've said repeatedly that we don't see a bear market developing until there is either a threat of a recession or you get much tighter monetary policy.

However, we haven't ruled out a pretty good correction. This market has been on a one-way trajectory for quite a while without any kind of a pullback.

Consider the following:

In 2017:

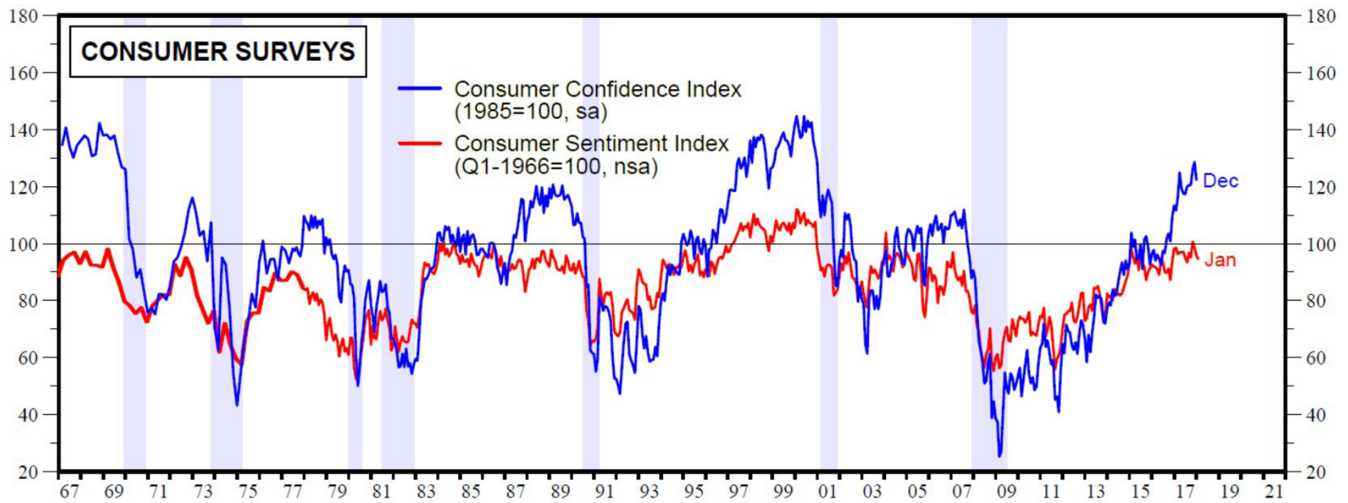
The S&P 500 rose in every month for the first time on record.

The S&P 500 has gone almost 300 trading days without a 3% correction, the longest run on record.

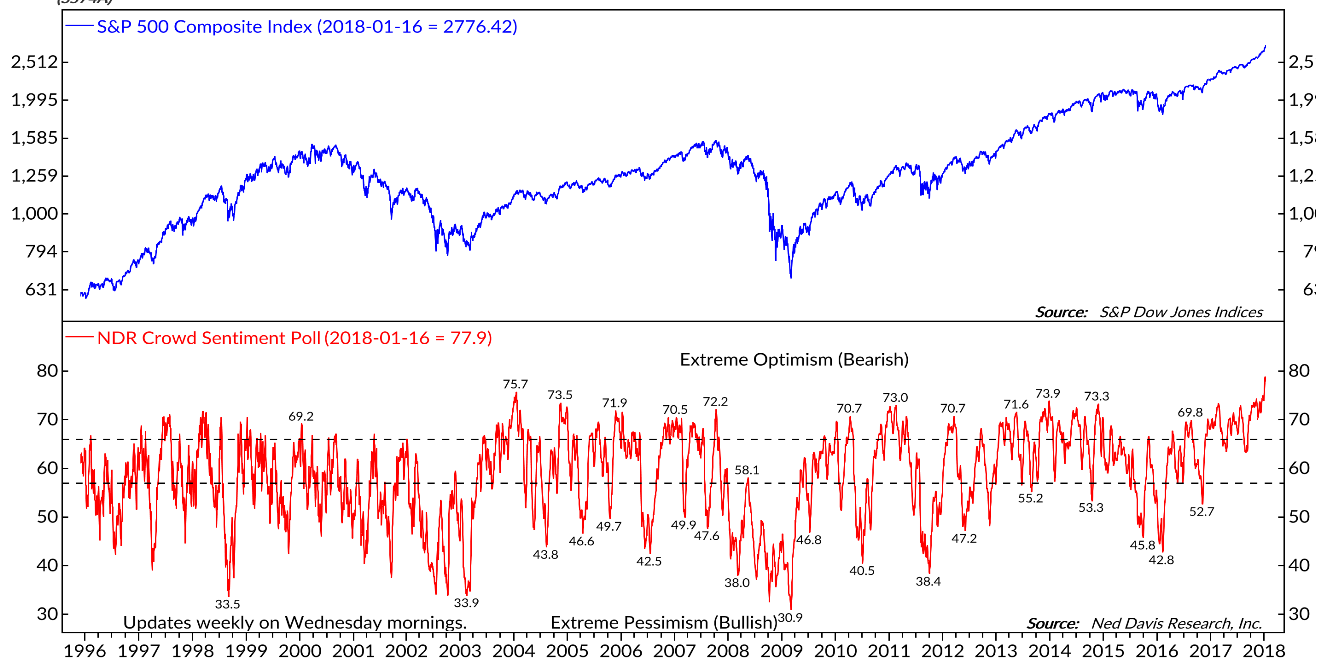
The S&P 500 has never had back to back years with a maximum correction of less than 6%.

The Dow Jones Industrial hit 71 record highs, eclipsing the old record of 69 set in 1995.

Margin debt has hit a record $561 billion which is higher than the peaks seen in 2000 and 2007.



Source: Yardeni Reseach, Inc



S&P 500 Index Performance **Full History:** 1995-12-01 to 2018-01-16		
NDR Crowd Sentiment Poll is	% Gain/ Annum	% of Time
Above 66.0	-2.72	24.54
57.0 - 66.0 From Above	1.66	17.84
57.0 - 66.0 From Below	21.08	18.87
Below 57.0	10.16	38.26
Buy/Hold = 7.11% Gain/Annum		

Source: Ned Davis

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Furthermore, consumer confidence and crowd sentiment are at extremes which are usually associated with short term market tops as seen in the above charts.

So, we're understandably cautious. However, one critical technical indicator for the stock market is breadth. Historically, market tops occur after the broad market has already started to retreat. Leadership gets very narrow and limited. Think of tech stocks in 2000, when they were the only group moving higher.

Today the market is broadly based. Over 66% of the S&P 500 stocks are trading above their 200-day moving average which is very healthy and the advance-decline ratio is also at a record high. We would expect to see this breadth diminish before any serious correction.

On balance, most market forecasts are looking for the averages to finish higher this year by roughly 10%. Given the buoyant underlying conditions, it's hard to argue with this forecast.

Dark Side

However, these predictions come with some caveats. We don't necessarily see them affecting this year's forecasts, but they could be relevant in 2019. It then becomes a question of when the market wants to start discounting them, maybe at the rumor stage if you will.

If you boil down our concerns to one thing, it's interest rates. It's one of the items we cited earlier that could upset the market.

So, let me take you through my logic. The tax cuts are positive for earnings, but they come at a time when the U.S. economy is strong and near capacity. To date, there have been no excesses that would cause the Federal Reserve to clamp down on monetary policy. However, stimulus on top of an already strong economy could change that balance, especially if that stimulus results in higher inflation. Today, most economists have disavowed the Phillips Curve that predicts an inverse tradeoff between unemployment and wages. So far, it hasn't happened for many reasons: demographics, technology, foreign competition and the Amazon effect. But the labor market is tight and with corporate profit margins expanding due to tax cuts, companies could compete away some of those gains by raising wages on top of already legislated minimum wage increases.

The tax cuts also move the government sector from a detractor to GDP, i.e. less government spending, to a contributor and may cause the economy to run hotter than expected.

Core inflation has averaged 1.76% since 2009. The current forecast is for 2.1% but the Federal Reserve of New York's, "Underlying Inflation Gauge" predicts 3%, an eleven year high. You also have Trump's trade negotiations which could cause higher import prices from higher duties as we're currently seeing on lumber.

Although the laws of economics have been slow to develop this cycle, I don't think they have been repealed.

Will a stronger economy and a bit more inflation cause the Federal Reserve to become more aggressive?

And what about the other central banks? As stated previously, Canada has raised rates a little but the ECB is still expanding its balance sheet at least until next September while the BOJ seems to be on hold. By next fall, if economic conditions prevail, we're likely to be looking at most major central banks transitioning towards tighter monetary policy and higher interest rates, if only to reduce the extraordinary accommodation put in place since the financial crises. A pickup in inflation would no doubt quicken that pace. If this is the demand side for bonds, the supply side won't be helpful. The U.S. government is still running huge deficits while the economy is arguably at full employment. Now multiply that number by 10 and add $1.455 trillion from tax relief, resulting in another $8 trillion in government debt on top of the current $14 trillion. And that is without an interest rate increase. It results in record net new issuance of treasury debt at a time when central banks could be contracting their balance sheets.

Then there is the question of exactly how beneficial the tax cuts will be. Right now, it's a generalized positive but the exact answer will have to be determined one company at a time. In the meantime, no one knows what corporations will do with the earnings windfall. They could compete part of it away by raising wages. Or they could also cut prices to be more competitive. Or they could spend more on capital expenditures. All of these would reduce earnings.

We've already mentioned that the effective tax rate is something less than 35%. Federal Reserve data on non-financial corporations says the average effective tax rate has been 21.6% over the last four quarters ended last September. Worse still, the IRS data shows a tax rate below 20% since the second quarter of 2008 and only just over 13% in the last four quarters ended last fall. With effective rates so low, will the projected benefits really be there?

So, for 2019, the boost from tax cuts will fade and increases in interest rates will likely start to bite. Will it result in a recession from too tight of a monetary policy? We don't know.

However, we would contend it isn't good for valuation.

We're late in the economic cycle and the second derivative of earnings will likely roll over in 2019. This is a little sophisticated, but it has to do with growth rates. Theory says that you give a lower valuation to earnings when the growth rate is slowing. This year's earnings growth rate will be high when considering the tax cuts. Next year's will be lower.

Furthermore, tax cuts are a one-time item. They don't deserve even a market multiple because they don't recur.

Higher interest rates not only slow the economy, but they are inversely correlated to price earnings ratios as is inflation. With both potentially increasing by the end of this year, it will probably be bad for the market's valuation.

All of this suggests that there probably shouldn't be any valuation improvement in this market. But that doesn't mean that it can't improve by the amount that earnings advance.

Conclusion

For 2019, we could be looking at conditions that would result in a reversal for valuations, higher interest rates and slowing growth.

The market works on anticipation, it buys the rumor. There's no doubt things look good for this year, but we may have sown the seeds for some disappointments in 2019. The question is, when will the market start to focus on those concerns? If they're real and start to surface, my bet is that the second half of this year could become problematic.

In the near term, the "news" will be in fourth quarter earnings reports. We'll soon know if that's as good as it gets and Mr. Market decides to heed an "old adage".

GRC/amh

January 12, 2018

Credits:

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