CORRECTION, TRANSITION OR BEAR MARKET

Believe in the Easter Bunny? Then maybe you're an April fool. Believe in foxes, as in "Crazy like One"? Then maybe Trump's tariff strategy isn't that bad. OK, my apologies to the foxes.

Nonetheless, tariffs and trade seem to be the latest issue to afflict this market which came shortly after an inflation scare in the form of a higher than expected January wage increase which sent the market to its first correction of over 5% in more than a year.

Although they may seem like uncorrelated issues, they are not. Both factors have an impact on profit margins. But I'll come back to this shortly because it is the essence of the bear case for this market.

In the meantime, I wonder if this market is like the proverbial bug in search of a windshield; it is looking for a reason to correct and these are the most convenient excuses. Earlier, many thought the market was overvalued and should correct. But, with tax cuts and synchronized global growth, valuations have come back into the reasonable zone.

Nonetheless, the market still feels extended, Trump wears on you and investors know it's getting late in the cycle.

I wrote in my year-end commentary that the first quarter earnings releases might be the "news" that should be sold. Investor sentiment was at a peak and there was concern of potentially rising interest rates. Prophetically, the interest rate scare from higher wages came in the middle of earnings season and January's strong start to the year was wiped out within a week.

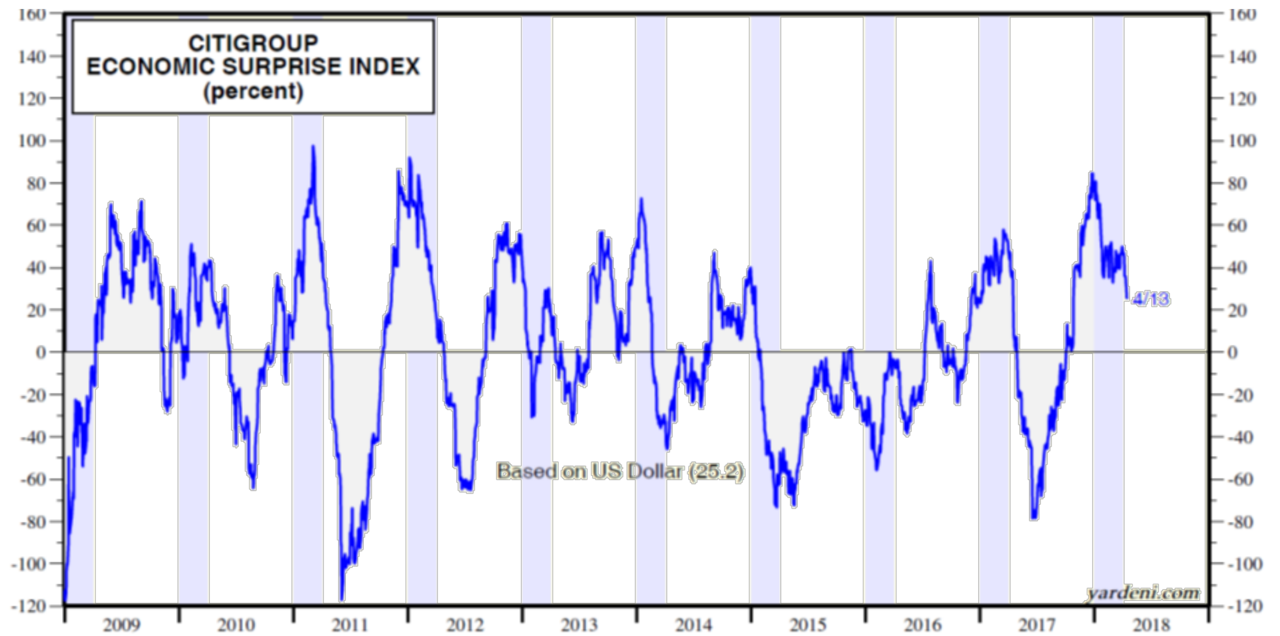
So, what is going on with this market? I would contrast it as a battle between the 'Macro' and the 'Micro' policy issues versus corporate fundamentals, and ultimately valuation versus earnings growth.

The real question is how it gets resolved since it will determine whether we are going through a normal market correction, a transition reflecting some of these factors, or whether we are headed into a bear market.

The ingredients for this concoction are the economy, the Federal Reserve, earnings and politics. So, let's take a look at each of them and how they factor into the possible outcome. Bear in mind many of these are interrelated and overlap.

ECONOMY

The US and global economies remain strong but are coming off their peak momentum. The best representation of this is probably the Citigroup Economic Surprise Index.



It shows a pullback from last year's spike higher. It's true that the Small Business Optimism Index dropped in March but it still remains near the highest level since 1984.

Consumer confidence also eased in March after hitting a 17-year high in February but remains at the second highest level since December 2000.

Meanwhile, most gages of inflation are increasing. Year over year, the Consumer Price Index was up 2.4% in March while the Producer Price Index was up 3.0%. Remember the Federal Reserve's goal is 2.0% and core inflation excluding fuel and food is running at 2.1%.

Furthermore, European sentiment fell for the third consecutive month after reaching a 17-year high but still remains elevated.

So, for now there is no recession in sight. However, in the context of where we are in the cycle, we have had a slow growth expansion that hasn't created any excesses that would prompt the Fed to hit the brakes. Tax cuts and fiscal stimulus on top of an economy running at full employment threatens this balance. Economic cycles usually end with excesses causing monetary policy tightening.

Regardless, tax cuts and fiscal policy are likely to keep the economy strong this year and into the next. However, once it works its way through the system, we'll have to deal with higher interest rates and peak consumer spending as employment gains reach a limit. Right now, the Federal Reserve estimates that the Fed Funds rate will be 3.4% by the end of 2020 versus 1.5% today.

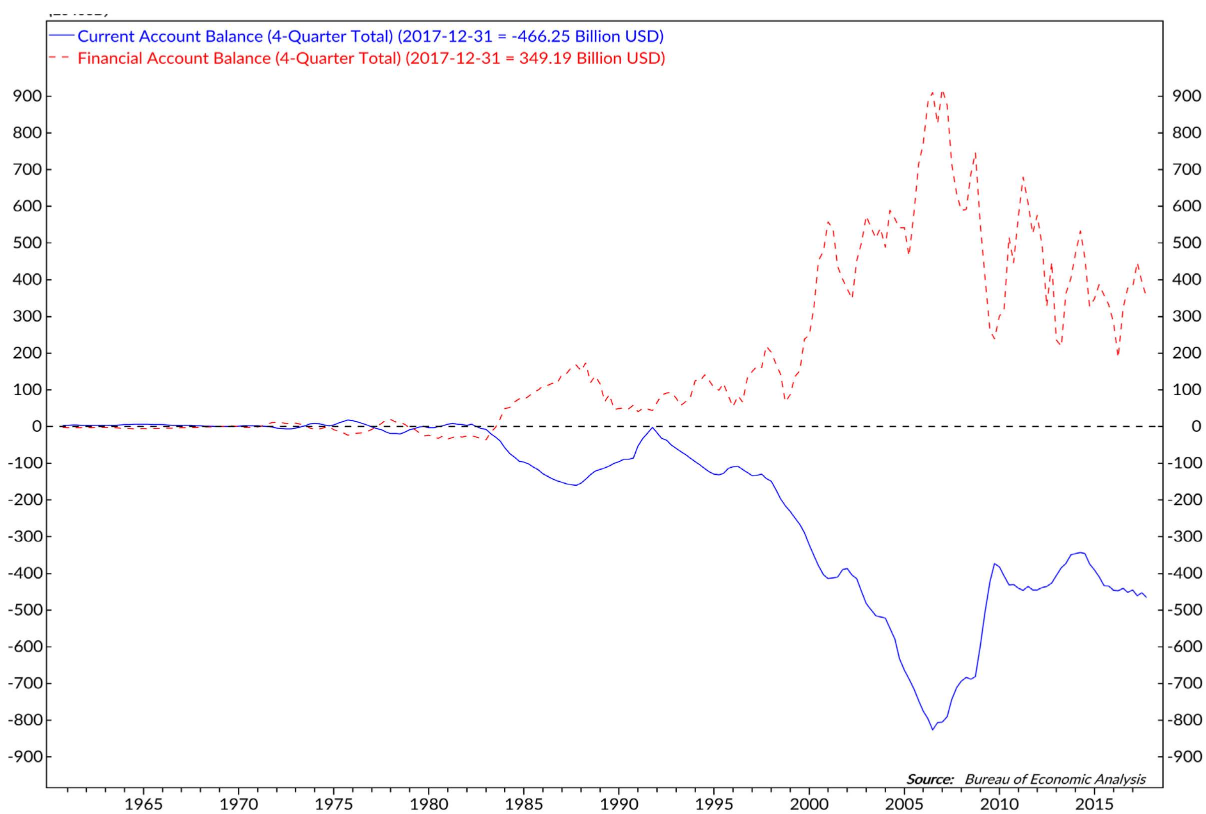
Now let's talk about trade and tariffs and its impact on the economy.

TRADE AND TARIFFS

The exercise here isn't to detail the current tariff war nor its threatened escalation. Is it justified? That depends on who you talk to but the facts support Trump. In fact, not many will disagree with this. However, the status quo, although unfair, is considered a better alternative than an all-out trade war. Tariffs are a tax and they raise prices. Although they can be quantified, they are not as big an issue as the disruption to the flow of trade and collateral effect of lost business confidence.

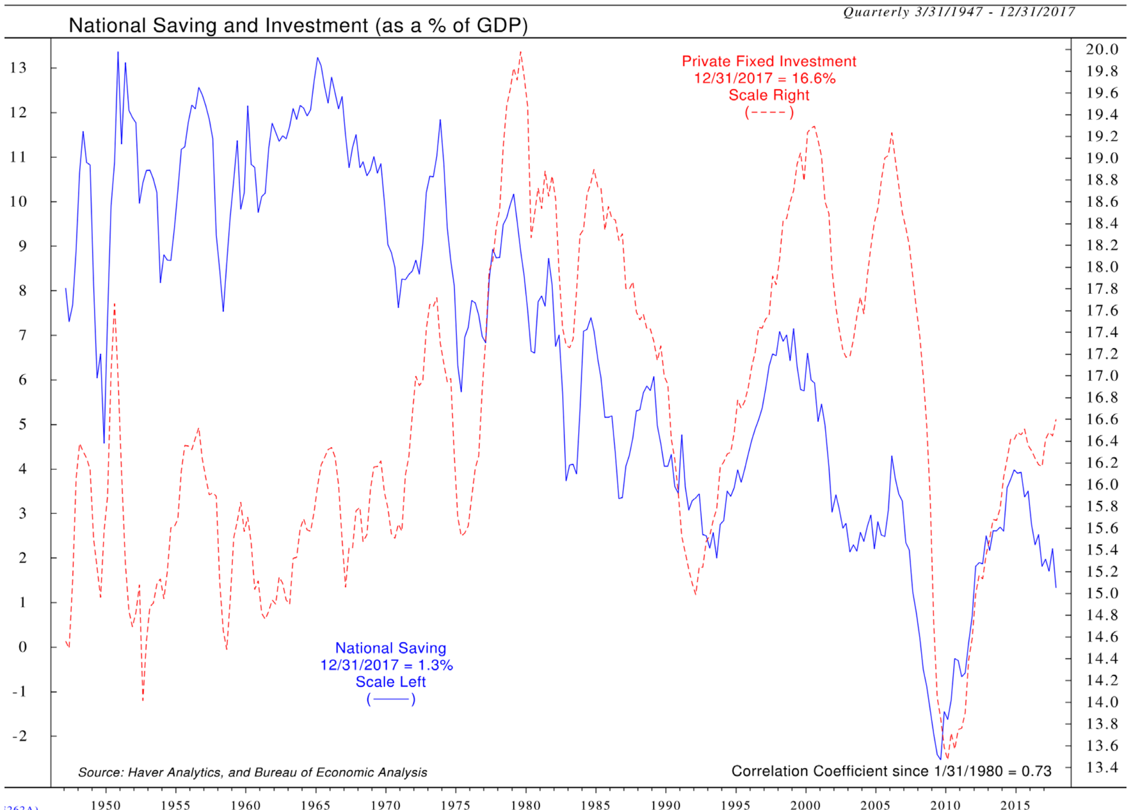
The consequences of a trade war will be higher inflation and likely higher interest rates which are bad for profits and the stock market. The Trump administration is likely willing to risk this as they see their recently passed tax cuts being used to buy foreign goods, in turn helping the other country's economy to the detriment of the U.S. deficit. In other words, why should the U.S. government borrow more money to see it leave the country through trade deficits? Today the U.S. runs a trade deficit of $776 billion, $376 billion of this is with China, up 20% in the first quarter. In fact, the trade deficit reduced the fourth quarter GDP by 1.3%. So, cutting this deficit and spending the money at home should be good for the domestic economy.

Unfortunately, this is only half of the story. There is another side to it that compounds the problem. It is true that as a dollar is spent on foreign goods, it creates a deficit that hurts the economy. However, once the foreign government, in this case China, gets the dollar they must do something with it. They could sell it which would depress the US dollar and make the Chinese Yuan less competitive. They would then have another currency which they would have to invest. Consequently, they usually keep it in US dollars and invest them in US treasuries. Right now, that is very convenient, as the Trump tax cuts and the recent budget will drive the US budget deficit even higher and is expected to exceed $1.0 trillion by 2020.



Source:Ned Davis Research

You can see this symmetry between the current account deficit and the financial account balance in this chart. The projected budget deficit isn't going to change. But if foreigners don't finance it by selling goods to the U.S., it will be up to the American consumer where the national savings rate has fallen to 1.3%.



Source:Ned Davis Research

The question then becomes, how high do you have to drive interest rates to encourage people to save instead of spending and what does that do to the economy? This is the other side of the trade deficit equation and represents the catch 22 of a trade war.

So why is the Trump administration pursuing this strategy? Is he that stupid? (Sorry I asked that question). I think he has people around him who fully understand the situation. Consequently, I don't think Trump is a protectionist. I think his actions are intended to cause a change in behavior. The thought that his tact could devolve into a trade war has to be considered real if it is to actually be an effective negotiating tactic. "Crazy Like a Fox" is defined to mean that their behavior appears to be insane or nonsensical at first glance but there's actually something very clever and subtle to it that's working toward their interest in unexpected ways. Dates back to 1908.

So far, there has been more rhetoric than action. He did impose steel and aluminum tariffs but then immediately waved them for Canada, Mexico, Argentina, Brazil, the EU, Australia and South Korea. He threatens to unilaterally withdraw from NAFTA but we're still negotiating.

Occasionally, he has to actually do something to remain credible. But do tariffs on solar panels and washing machines sound too threatening?

I think Trump is right to try to change behavior and right now, believe the saber rattling will get resolved without a full blown trade war. If I'm wrong and negotiations get out of control, the consequences for the market are pretty damaging.

FEDERAL RESERVE

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

Recently, the Federal Reserve raised the Fed funds rate to 1.5% and they expect to raise rates an additional two or three times this year which would take us to 2.25% to 2.50% by year-end. This was the sixth rate hike since December, 2015 when the rates were pegged at 0 - .25%. For 2019, three hikes are projected which would take us 3.0% to 3.25%. This rate is set or managed by the Federal Reserve and Fed Chairman Powell has said that although the economy is strong and unemployment has reached their goal, he sees only a gradual pace of rate increases. However, inflation is reaching their 2% target and Powell believes that wage growth has been slowly ratching up, and expects it to intensify as competition for workers increase.

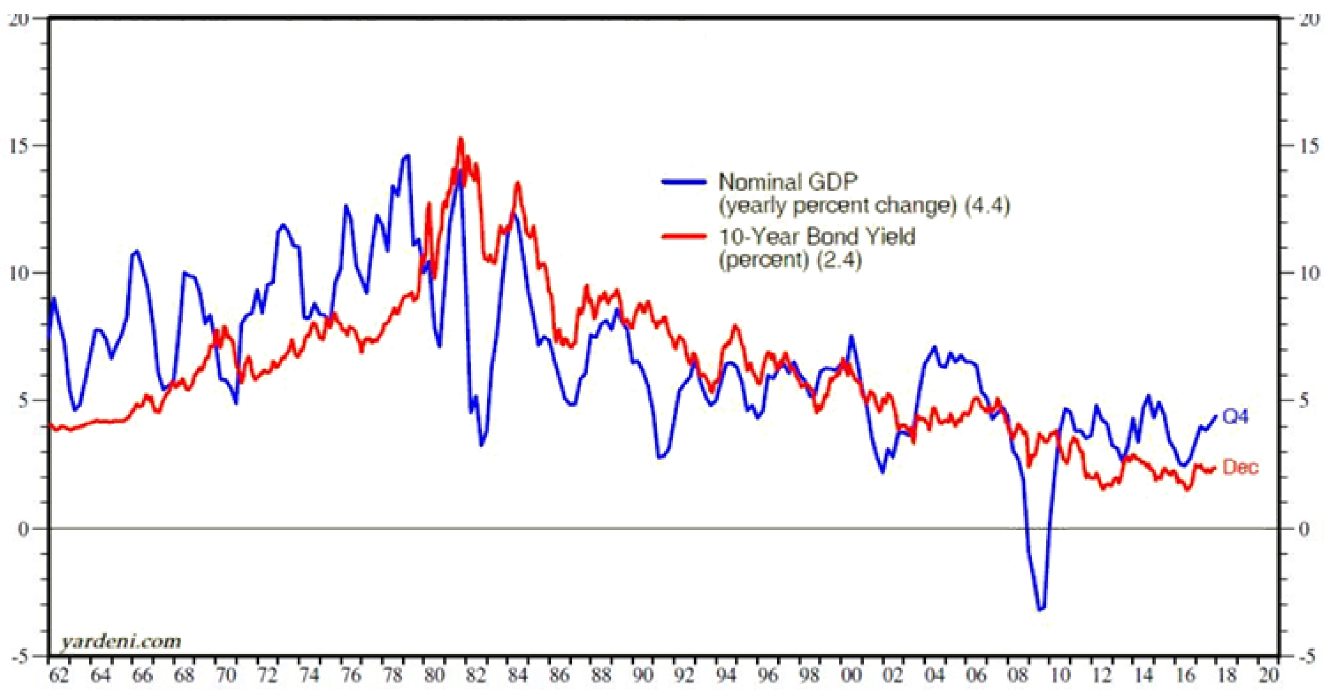
The supply demand equation for the bond market is also not encouraging. Fixed income supply including government and corporate issuances will increase from $1.0 trillion in 2017 to $1.5 trillion in 2018 and possibly $2.0 trillion in 2020 thanks to the $1.3 trillion budget for this fiscal year and a $1.5 trillion tax cut spread over the next decade. Adding to this selling pressure are corporations that are disposing of overseas investments to repatriate foreign cash holdings. At the same time, the demand for these bonds is shrinking as the Federal Reserve will reduce its holdings of Treasuries by $180 billion this fiscal year and by $360 billion in fiscal 2019 as seen in this chart #4. Furthermore, savings rates have already collapsed to 1.3% of income and the picture worsens if the foreign trade deficit declines due to trade wars as discussed in the previous section.

The Social Security and Medicare Trust Funds that only own government debt complicate the outcome. In 2018, they will buy $72.8 billion in bonds and a further $18.9 billion in 2019 but in 2020 it reverses course when they become sellers.

Furthermore, the European Central Bank (ECB) is still committed to buying $30 billion of Euro debt every month until September when it will end. The Bank of Japan has also said they will start to tighten monetary policy in April, 2019.

Historically, economic expansions and bull markets have ended when monetary policy becomes too restrictive and interest rates rise.

Right now, 10 year-Treasuries trade at a low 1.25% spread over Fed Funds rates. If we assume we're headed for 2.75% Fed Funds rate by year-end, it wouldn't be unreasonable to see 10 year Treasuries at 3.75%.



Source: Federal Reserve Board and Bureau of Economic Analysis

This would be consistent with the historical correlation between Treasuries and nominal GDP as seen in this chart. If we assume GDP growth of 2.5 % this year and inflation of 2.0%, we get nominal GDP of 4.5% while 10 year-Treasuries are currently closer to 2.80%

In order to mitigate against over tightening, the Federal Reserve has provided repeated reassurances that they will "gradually" "normalize monetary policy and that a "mild" overshoot in inflation could occur to ensure that inflation rises sustainably to their target.

From our perspective, we think the Fed will allow the economy to run a little "hotter" than expected before tightening too much. They know that the only way to reduce the debt to GDP ratio is through growth. It is a well-travelled strategy known as "financial repression" where interest rates are held below the rate of inflation but will result in a steeper yield curve.

It's complicated, I know. So, let me see if I can simplify the explanation. In 2007, Federal debt in the public's hands stood at $4.9 trillion. Today, it has exploded to $14.7 trillion while interest rates have declined and are now going up. The money to pay that bill will either come out of the economy or the stock market. Furthermore, the recent Congressional Budget office projects the government borrowing at an additional $12.4 trillion over the next ten years. In 2028, the government will have $28.7 trillion in debt outstanding which will amount to 96% of GDP compared to 39% ten years ago. By the way, things in Canada don't look much better where foreign direct investment in 2017 was 56% less than it was in 2014. So, we'll also eventually face a funding problem.

In the short term, tax cuts may defer the impact of rising interest rates for both corporations and consumers. However, the economy may not benefit if interest rates eat up the tax cut benefit.

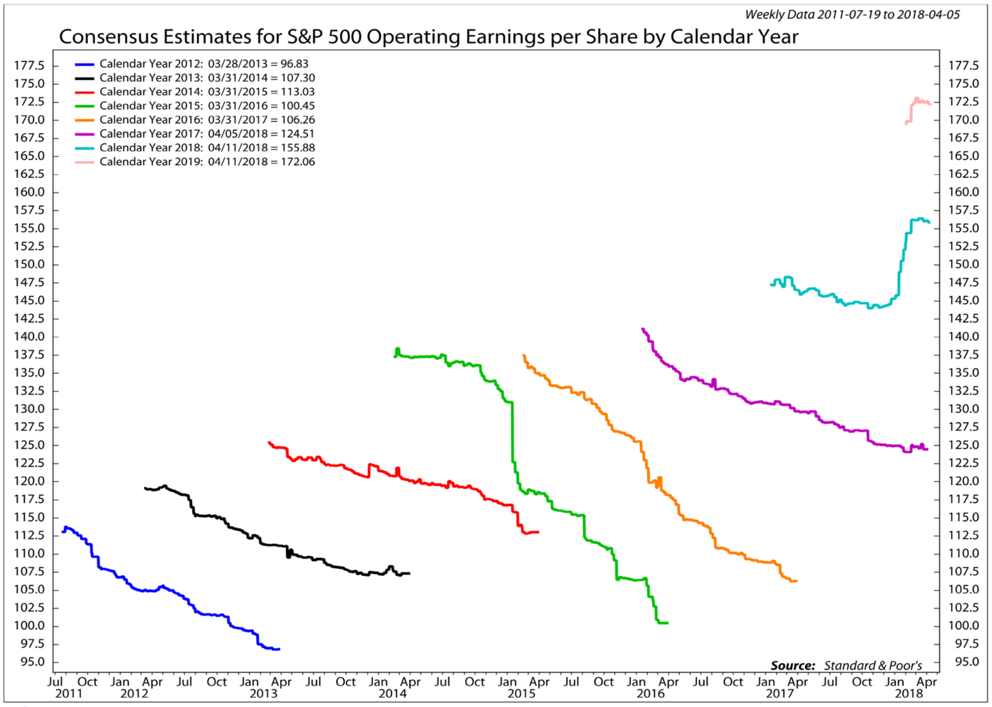
EARNINGS

Earnings are the bright spot. At the end of last year, we were worried about the market's valuation and suggested that the problem could be resolved in one of three ways.

1. Tax reform
2. A market correction
3. Marking time until earnings caught up.

Well, we got tax reform and a little bit of a market correction.

Before tax reform, S&P earnings were expected to grow by 11.2% to $145.20. With tax reform, earnings are now expected to reach $157.92 or roughly 19% higher than last year and further projected to grow 8.5% in 2019 to $171.36 as seen in this chart.



Source:Ned Davis Research

The market responded to this good news with a 7.5% advance in January that ended on the 26th at a record high 2,873 on the S&P 500 before dropping 10.2% through February 8th. That leaves the market trading at about 16x forward earnings. Not cheap but at least fairly valued.

POLITICS

Besides the 3:00 a.m. tweets, President Trump has had an unsettling impact on the market. Not only has he had personal conflicts over the investigation of Russia's role in the 2016 election, there have also been constant changes to his administration with further departures rumored to come.

But maybe the biggest political issue on the horizon is this November's mid-term election. And here, history can give us some direction.

The President's party historically tends to lose congressional seats, especially in the House of Representatives. However, mid-terms have been stronger for Republican presidents.

On average, the incumbent party loses 28 House seats and 4 Senate seats. However, with a Republican administration, this declines slightly to 26 and 2.

In the five cases of a new Republican president, the odds are even better at losing only 18 House seats and actually gaining one Senate seat.

Currently, the Republicans hold 241 of 435 seats in the House and 51 of 100 seats in the Senate. If the Democrats pick up 24 seats in the House, the Republicans will have, at best, a split Congress. Currently, there are 18 Democrats and 39 Republicans not running for re-election in the House, one of which is Speaker of the House, Paul Ryan. In the Senate, there are 34 seats up for grabs, 26 from Democrats and 8 from Republicans.

History suggests that the stock market could come under pressure if the Republicans lose either Chamber with the average decline of 6.05%.

CONCLUSION

So, these are the factors influencing the market and as I said, I see three outcomes. This is either a correction in an ongoing bull market due to trade worries and slightly less inspiring economic statistics.

Or, we're seeing a transition. Monetary policy is moving from accommodative towards restrictive. Interest rates are moving higher and the Fed is now selling bonds instead of buying them. Inflation concerns have gravitated from fears over deflation to appearing signs of inflation. Our slow but steady economic growth is now being threatened by a tax cut and fiscal stimulus that could lead to extremes that will force a greater than anticipated reaction from the Fed.

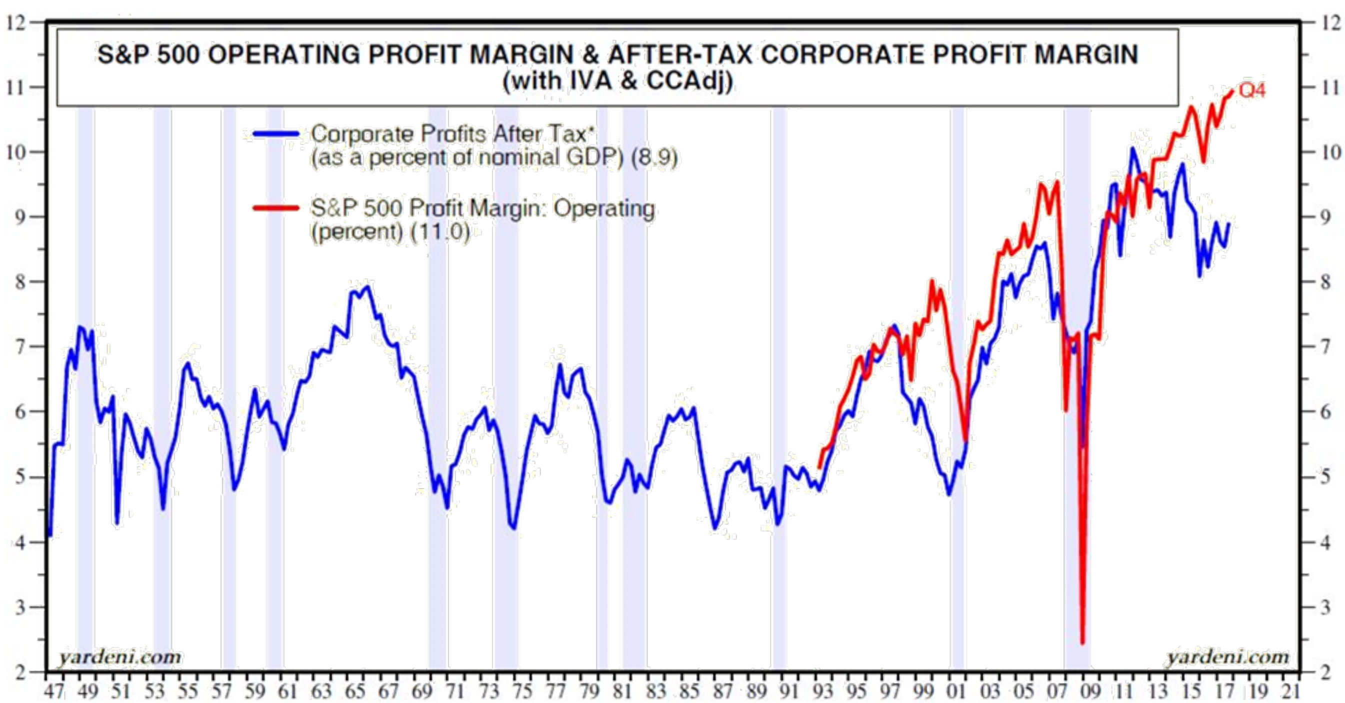
Furthermore, businesses are responding to the change from over regulation to less government interference.

As I said in the beginning, this market is a battle between the 'Macro' versus the 'Micro.' Valuations against earnings growth. Interest rates, politics, trade wars and economic forecast are in control of valuation. Meanwhile, earnings are growing. We're likely at that stage of the cycle where the market's performance is dependent on earnings growing faster than interest rates increase and can depress valuations.

Transitions are usually choppy which is what we are currently experiencing. However, the ultimate distinction from a correction will be a change in market leadership from growth to more economically sensitive companies.

Or, option three, we're going into a Bear market. The failure of the averages to make new highs, economic statistics rolling over are early symptoms to be followed by disappointing earnings as profit margins regress due to higher interest rates and inflation, possibly driven by a trade war.

The Bear case is pretty straight forward and explains why the market reacts negatively to both the wage inflation scare in February and again to the tariff threats. They're related in that they both hurt profit margins and therefore earnings.

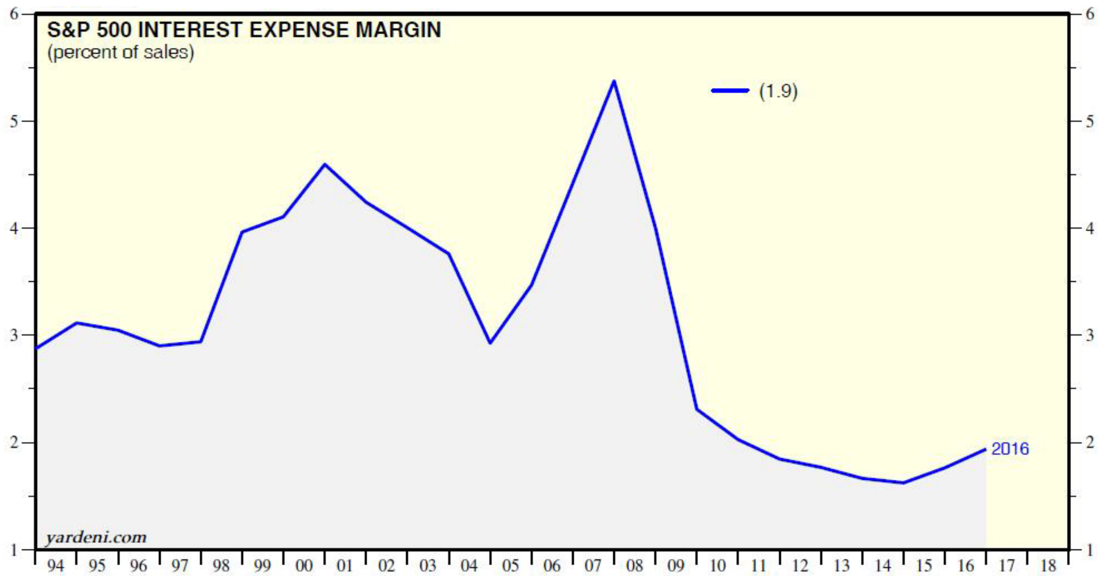


Note: Shaded areas denote recessions according to the National Bureau of Economic Research.
* Profits after tax with IVA and CCAdj.
Source: Standard & Poor's Corporation and Thomson Reuters I/B/E/S and Bureau of Economic Analysis.

We've heard that the economic expansion that started in 2009 has been slower than normal. Yet profits have grown better than average rates. That's because profit margins were expanding. You can see that in this chart which shows profit margins at post WWII highs. Although revenues were growing modestly, costs were declining to generate higher profits on every dollar of sales.

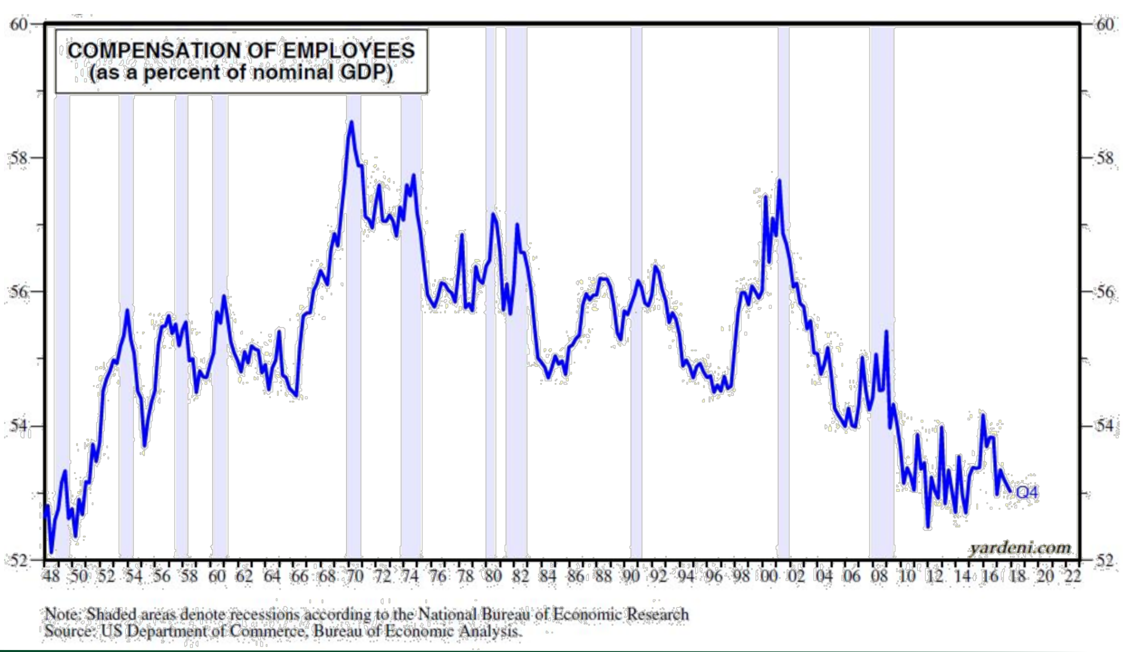
The two biggest cost declines were:

1. Interest costs
2. Labour costs



Source: Haver Analytics and Standard & Poor's Corporation

First interest costs. You can see from this chart the collapse in interest expense after the financial crises.



The second big contributor to profit margins was labour costs as seen here. Although they were rising in absolute terms they were declining as a percentage of sales. If these two costs start to increase faster than sales, then profit margins will decline. That's not good for earnings growth and is the essence of the bear case for the stock market. So you can see why the 2.9% jump in January wage inflation got a reaction. Tariffs and trade wars, as explained earlier, affect both inflation and interest rates.

We're currently starting the release of first quarter earnings. They are likely to be good and an added benefit will be news on corporate buy-backs. After the 2005 tax repatriation holiday, $0.79 of every returning dollar went to share buybacks and $0.15 to increase dividends.

Companies have already announced a record $170 billion in new buybacks so far this year.

Last year buybacks were $548 billion, down from a peak of $646 billion. This year, buy-backs are forecast to be close to $800 billion funded from a combination of base line earnings, surplus funds from the tax cuts and repatriated foreign earnings which would equal about 3.5% of the S&P 500 market capitalization.

Furthermore, merger and acquisition announcements are up 46% year over year. Both of these could put some support under this market.

So, notwithstanding the turmoil from headlines on valuation, the underlying conditions of a strong economy and a reasonable monetary policy still support this market. However, there is no doubt that expectations for monetary policy and sustained economic growth diminish as we look further out into the future.

GRC/amh

April 17, 2018

Credits:

Ned Davis Research

Yardeni Research