CHASING THE TAX CUT CARROT

Although tragic, the nice thing about hurricanes Henry and Irma is that they took President Trump off the front page, temporarily.

Nonetheless, politics on both sides of the border have had an influence on the market. We shouldn't forget we have our own tax drama going on here at home with Mr. Morneau's proposed tax changes.

I'll address the Trump effect, but first let me give you my conclusion.

Bottom line, I'm still positive on the stock market. The economy is growing as are earnings while the U.S. Federal Reserve maintains a modestly accommodative monetary policy. I don't anticipate this stance changing until we get either the threat of a recession or much tighter monetary policy. The only concern I have is with valuation. The stock market isn't cheap. Other forecasters however, have conflicting opinions about the market, but the reality is that the stock market is at an all-time high despite greatly reduced expectations about the Trump administration's economic agenda.

This begs the question, how much expectation is still built into this market and what happens if Trump can't deliver?

So, let me take a stab at answering that question but to do so, we have to back up to last summer before the election.

The stock market was already appreciating after the Brexit vote last spring. The Federal Reserve had indicated they were going to raise interest rates as the economy was showing signs of improvement and the U.S. fiscal policy was shifting from austerity to stimulus with inflation modestly picking up.

Trump's election promises included the following:

- Cut corporate and personal taxes, including a tax break on foreign cash holdings;
- Deregulate;
- Repeal Obamacare;
- Create more infrastructure spending;
- Renegotiate trade deals and immigration policy.

This agenda gave a shot of adrenalin to the trends that were already in place. Tax policy, deregulation and infrastructure spending would help the economy and corporate earnings while pushing interest rates higher.

Renegotiating trade deals would cause the dollar to appreciate but this would help small businesses given their lower exposure to exports.

So, by the end of the year, everyone was predicting higher interest rates, a strong U.S. dollar, benefits for small caps over large caps and potentially higher earnings depending on the timing and amount of the tax cuts.

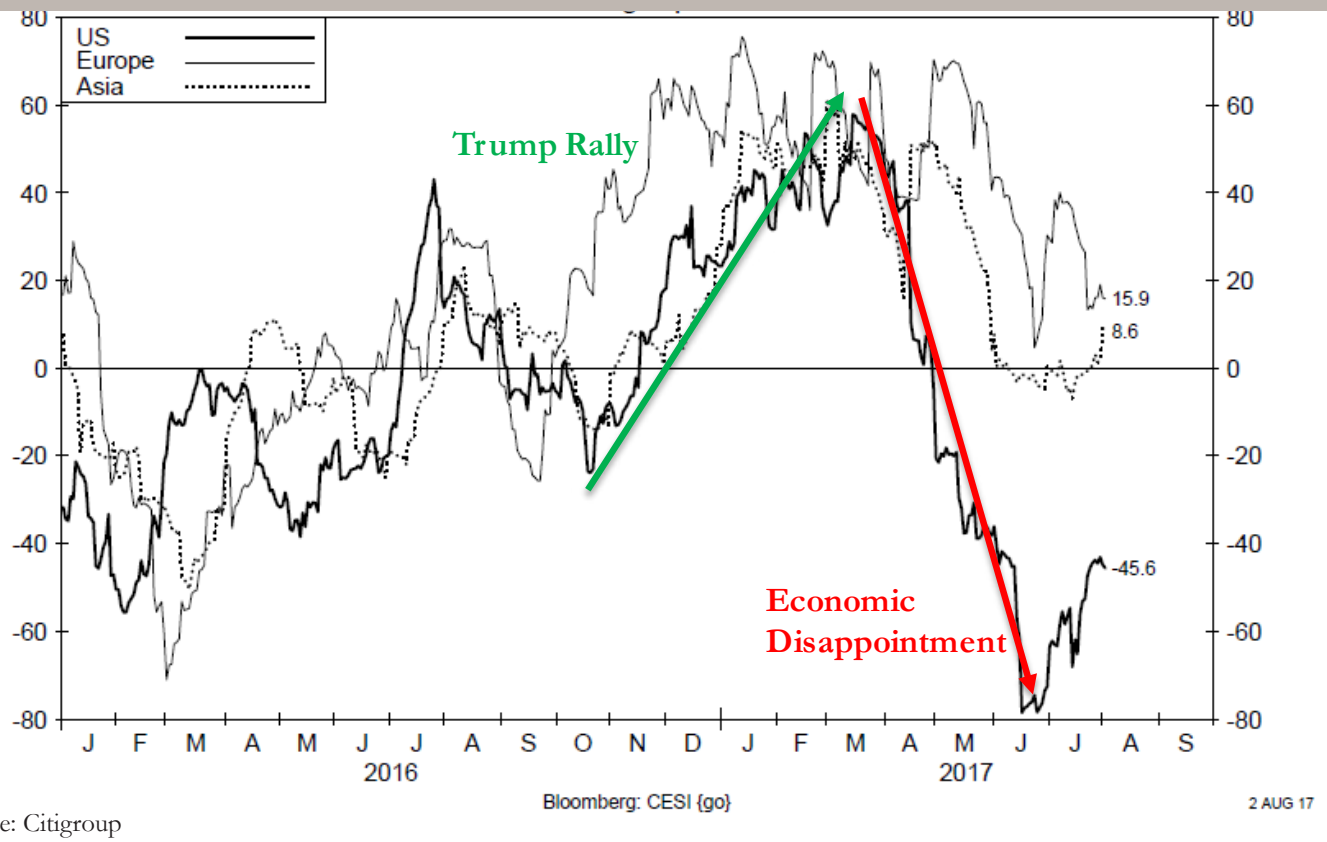
This caused the S&P 500 to advance over 8% between election-day and the year-end, and saw its valuation move from 16x earnings to 17x earnings.

That was the Trump premium. But replacing Obamacare failed and infrastructure spending has been pushed off until next year at the earliest. His immigration policy has amounted to restricting travel from seven Arab countries and seeing many of the immigrants heading for Canada. He did back away from the Trans-Pacific Partnership, a global trade deal, dropped out of the Paris Environmental Accord and is trying to fast track our NAFTA trade negotiation once he figures out what he is trying to accomplish.

Deregulation is happening in a minor but constructive way and tax reform is now on the agenda but expectations have been significantly watered down.

So, let's take a look at what has happened.

Economic Surprise Indexes



Source: Citigroup

1. This first chart is the Citigroup Economic Surprise Index. It compares the actual economic performance to expectations. As you can see, expectations took off after the election and were pretty high by the end of the first quarter. But the economy hasn't come through, so you're now seeing a significant decline in expectations.

Nonetheless, the economy is doing pretty well. GDP for the second quarter was just revised higher to 3% and the Atlanta Fed is forecasting 3.2% growth in the third quarter. Capital spending also rose to a new record high in the second quarter. Furthermore, global GDP is picking up. Europe's over 2%. Canada just recorded 3% GDP growth and even Japan came in at 4%.

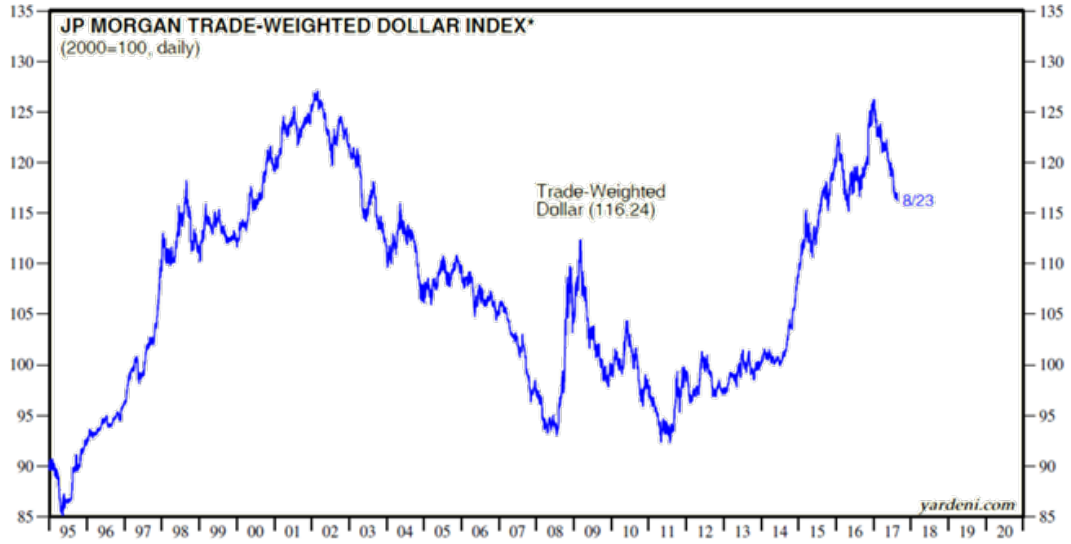
Nonetheless, expectations got a little ahead of themselves last year and have adjusted.

10-Year Constant Maturity Treasury Note Yields (Since 2007)

Source: Ned Davis

2. The same can be said about interest rates. The 10-year U.S. government bond yield bottomed last July at 1.37% and had recovered to 1.88% by Election Day. It is one of the trends that was already in place. By the end of the year, the bond yield had increased by another 57 bps to 2.45%, finally peaking at 2.62% before falling to a recent low of 2.07% on Sept 5th.

U.S. Dollar

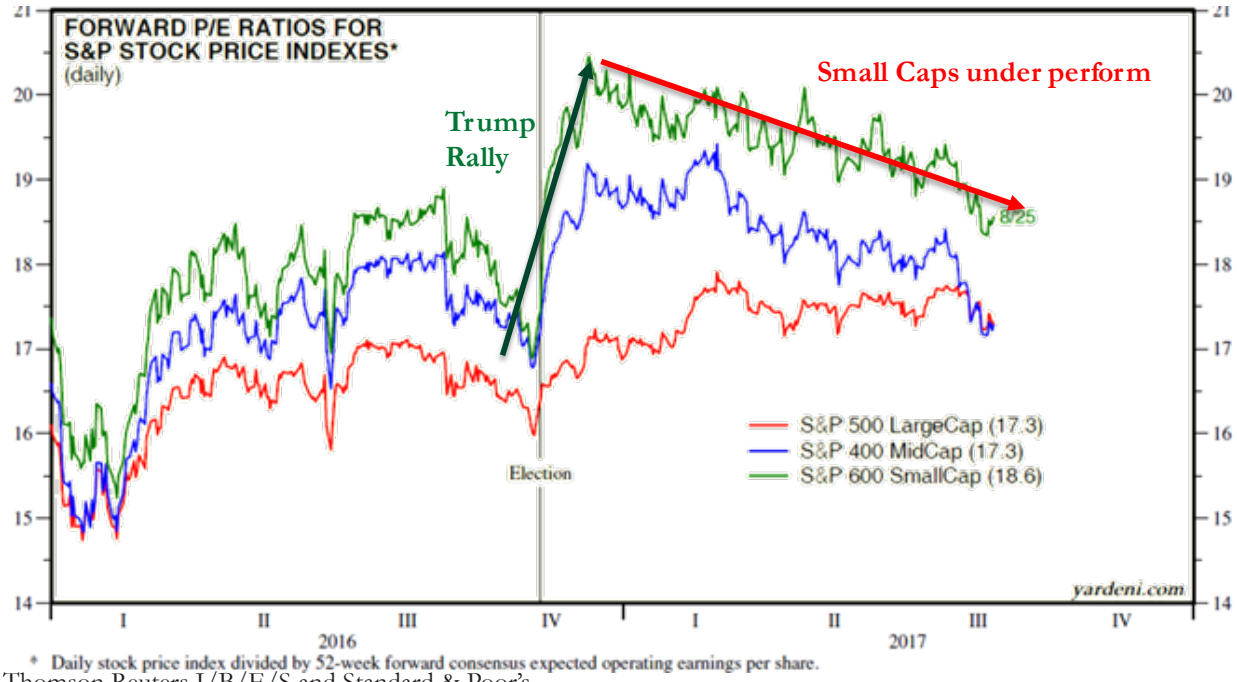


Source: JP Morgan

3. The US dollar was also expected to be strong but has instead fallen over 8% from its January 11th peak.

4. Consequently, small caps have underperformed after rallying 15.6% (U.S.) in the wake of Trump's election through year-end 2016. Since then, the small cap index is up only 8.9% (U.S.) while the S&P 500 is up over 14.2% (U.S.) year-to-date.

Small Caps



* Daily stock price index divided by 52-week forward consensus expected operating earnings per share.

Source: Thomson Reuters I/B/E/S and Standard & Poor's

This next chart clearly shows the decline in valuations for the smaller cap companies. This is the same group that would benefit the most from a strong dollar and tax reform.

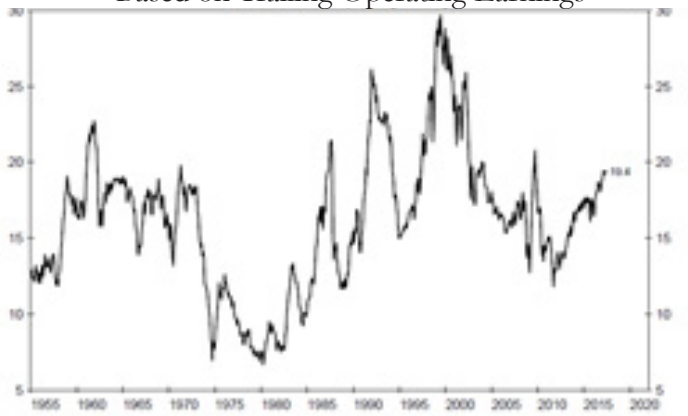
When you translate this to the stock market, we've seen technology perform well while financials and infrastructure companies have underperformed. Exactly the opposite of what was expected.

Consequently, a number of market strategists have concluded that the Trump expectations have been extinguished. I don't agree. I think there is still a residual expectation for tax reform, which is the most important element of the Trump expectation. If he fails with this piece of legislation, I think it could be the catalyst for a market correction.

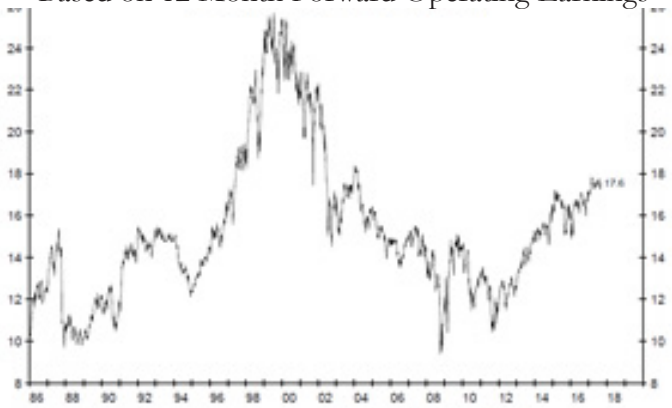
Right now, the S&P 500 is expected to earn $130.62 this year and $145.20 next year. It is important to recognize that there is no tax reform built into those numbers.

S&P500 P/E Multiple

2017
Based on Trailing Operating Earnings



2018
Based on 12 Month Forward Operating Earnings



Source:Citigroup

Consequently, the market is trading at about 19x this year's earnings and just over 17x next year's earnings. That's expensive relative to historic averages.

Before Trump's election, this market was trading at 16.03x expected 2017 earnings. Today, the market is at roughly 17.58x next 12 months' earnings. So, in my opinion, for the Trump expectations to be totally eliminated, we would have to see the multiple decline back to 16x which would equate to about 2,269 on the S&P 500 or a correction of 250 points or about 9.9%. That's a correction, not a bear market.

So, what is the market still expecting?

Well, should tax reform take place, each 1% reduction in corporate taxes equates to about $1.82 per share for the S&P 500. Expectations on tax reforms have been watered down considerably but a 5% cut on the effective rate is still possible which would amount to $9.10.

If this happens in the first quarter of next year, a 5% tax cut would result in 2018 earnings of $154.30. You'd then be looking at a market trending at 16.12x earnings. Not unreasonable. Furthermore, Trump has proposed a tax break on repatriation of overseas earnings. These currently amount to $2.6 trillion. To put this into perspective, Apple has more than $262 billion overseas. That's more than the entire market cap of 490 of the S&P 500 companies.

If you assume only $1.0 trillion is bought back and 35% goes toward share buybacks, it would equate to 1.8% of the S&P market cap and this could add 1% to 2% to S&P earnings or another $1.42 to $2.83 per share.

The low estimate would push 2018 earnings to $155.72 and we would be trading at less than 16x.

I think what is important to recognize is that whether President Trump is successful or not, the market is expecting over 11% growth in earnings next year. Maybe it's a little expensive and long overdue for a correction but there is nothing that suggests we're about to go into a bear market.

Furthermore, there are a couple of positives that are in play and not yet baked into the earnings. One is deregulation. It will be significant but is hard to quantify. Jamie Diamond, CEO of J.P. Morgan wrote a long letter to Shareholders on how regulations have constrained the economy. In just one example, he suggested the regulators have reduced mortgage lending by more than $300 billion annually. Had that been fixed 5 years ago, they estimate that at least an additional $1.0 trillion in mortgage loans would have been made – about 3 million new loans and could have equated to a 0.5% pick up in GDP in each of the last 5 years.

Also, as noted earlier, the US dollar has declined, not appreciated. It is estimated that a 2% change in the dollar equates to a 1% change in S&P earnings. The dollar is down 8%. That's another $5.80 in S&P earnings.

Summary

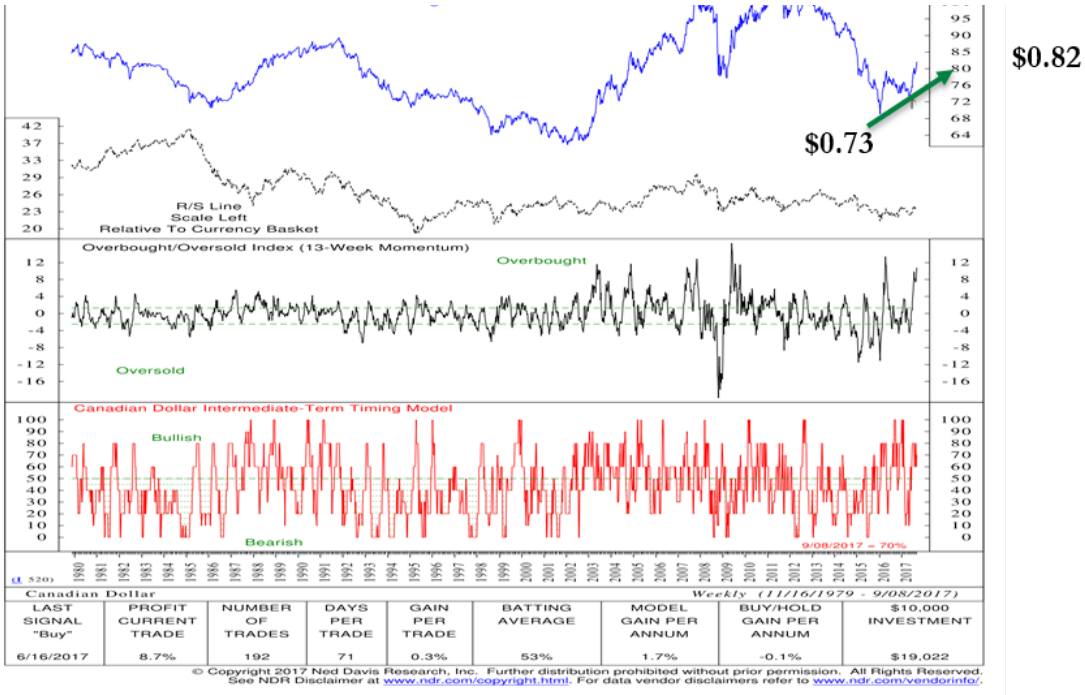
Consequently, I'm cautious on the market because it's expensive and long overdue for a pullback. Furthermore, I think there is still some Trump expectation built in. If he is not able to get tax revisions through, I think it could be the catalyst for a correction.

Otherwise, I don't see the conditions required for a bear market given the economy continues to grow slowly without creating any excesses and consequently, I don't see the Federal Reserve aggressively tightening monetary policy.

Our current overvaluation will get resolved in one of three ways. Firstly, we can have a correction, which would be a buying opportunity, or secondly, the Trump tax cuts will come through, or lastly, the market will mark time allowing normal course earnings growth to catch up with valuations.

I also want to add an addendum on the Canadian dollar. It's another high profile topic that we get asked about regularly.

Canadian Dollar

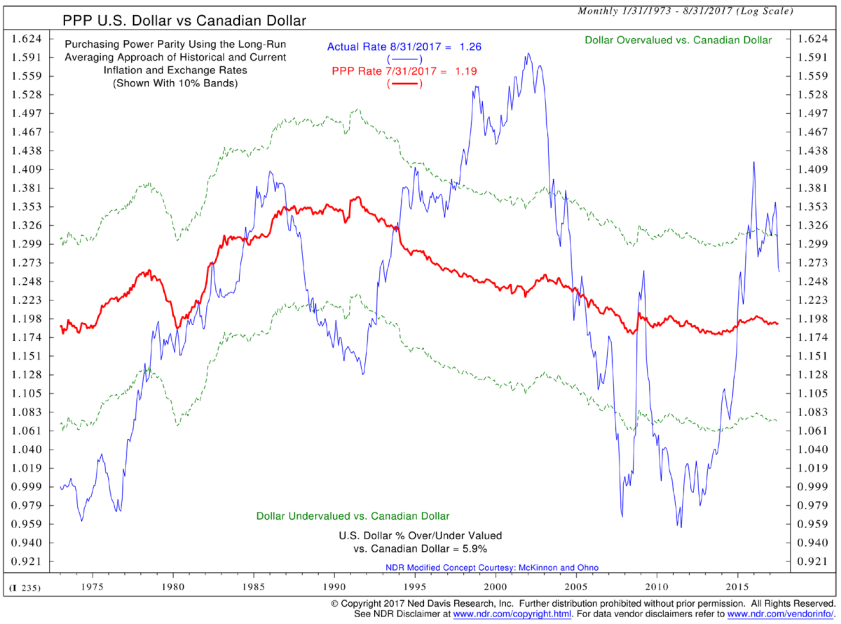


LAST SIGNAL "Buy"	PROFIT CURRENT TRADE	NUMBER OF TRADES	DAYS PER TRADE	GAIN PER TRADE	BATTING AVERAGE	MODEL GAIN PER ANNUM	BUY/HOLD GAIN PER ANNUM	$10,000 INVESTMENT
6/16/2017	8.7%	192	71	0.3%	53%	1.7%	-0.1%	$19,022

Source: Ned Davis

As most are aware, the Canadian dollar has seen a sharp rally from about 73 cents to over 82 cents, inspired by the Bank of Canada's recent rate increases.

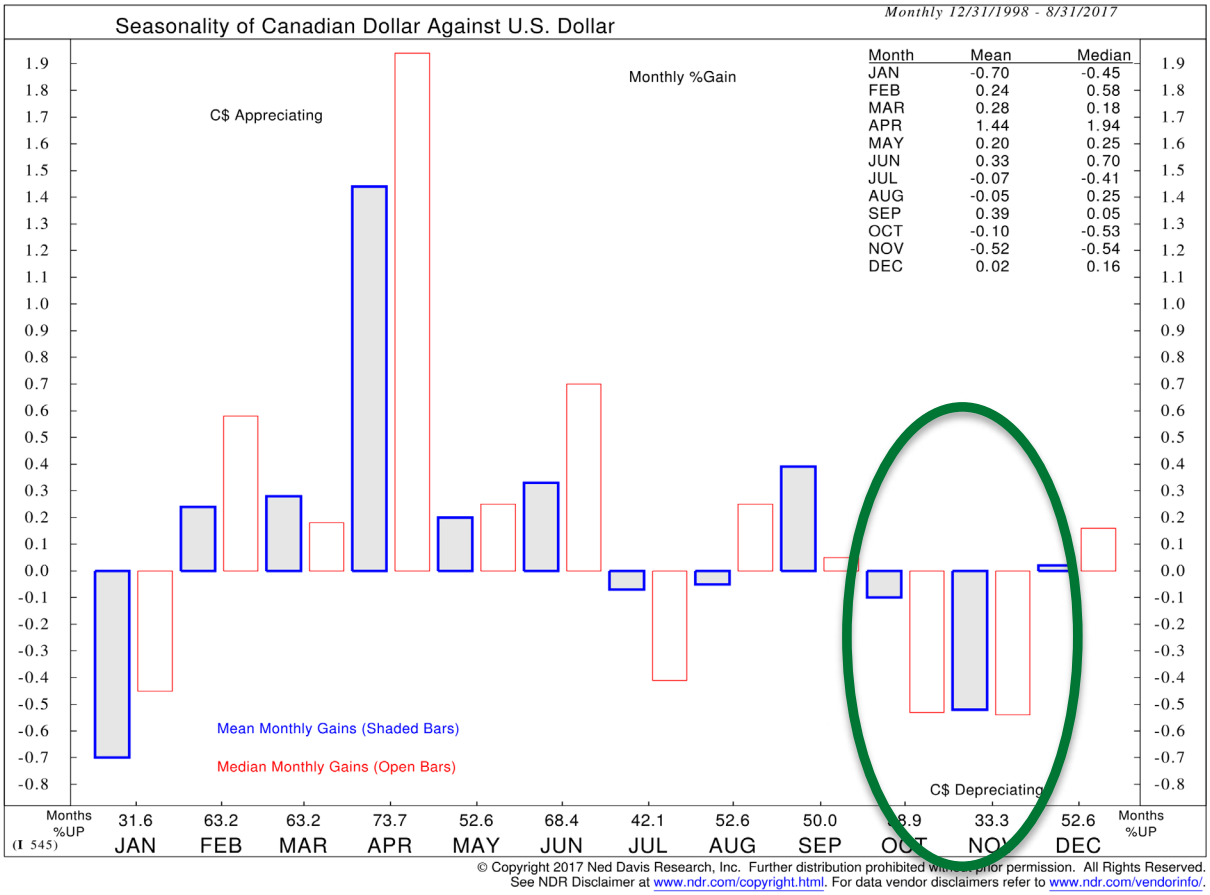
U.S. vs. Canadian Dollar



Source: Ned Davis

Part of the rally is justified by fundamentals. It got too cheap by Purchasing Power Parity models as seen above which suggests fair value is around 84 cents or $1.19 Canadian per U.S. dollar. It's possible that the Canadian dollar could continue to rally, especially if the Canadian economy continues stronger than the U.S. economy and if oil prices improve.

U.S. vs. Canadian Dollar

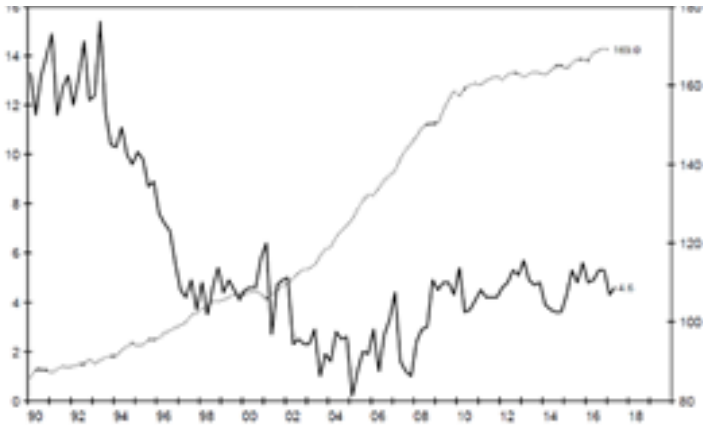


Source: Ned Davis

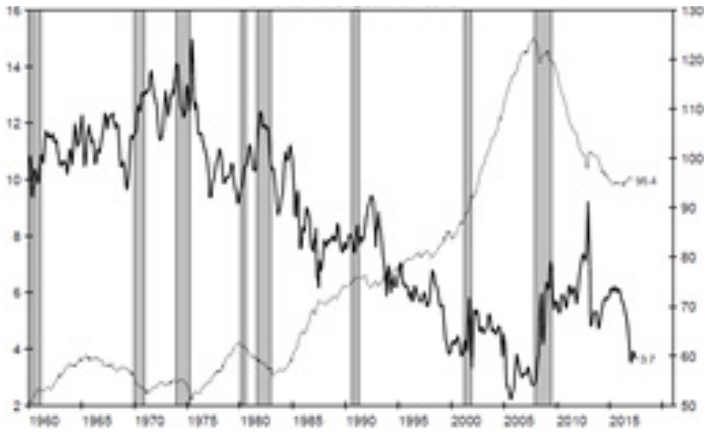
However, we're going to run into some short term seasonal head winds in October and November as seen here. Furthermore, I don't think there is a lot more coming from the Bank of Canada. Economically, the consumer is too stretched as seen in this chart.

Canadian Household Debt

Canada Personal Savings (_) and Household Debt (_) As Percent of Disposable Income



U.S. Personal Savings (_) and Household Debt (_) As Percent of Disposable Income



Source: Ned Davis

As you can see, Canadian household debt relative to disposable income is at 169%, significantly above US comparable at 95% and well above the U.S. peak of about 125% in 2007. Housing and home equity loans have contributed to this increase. But Toronto housing sales volumes have declined for 5 months and prices are off 20% from their April highs. Rates and the burden of debt may be starting to bite.

Politically, I also think the recently proposed tax changes will be detrimental to our economy. In my opinion, I think it is dangerous to focus on only wealth redistribution and not wealth creation. Without this, there is nothing to redistribute.

You don't build prosperous nations by excessively taxing those who create prosperity and jobs. No nation has ever taxed itself into prosperity.

GRC/amh
October 4, 2017
Credits: TD Securities
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