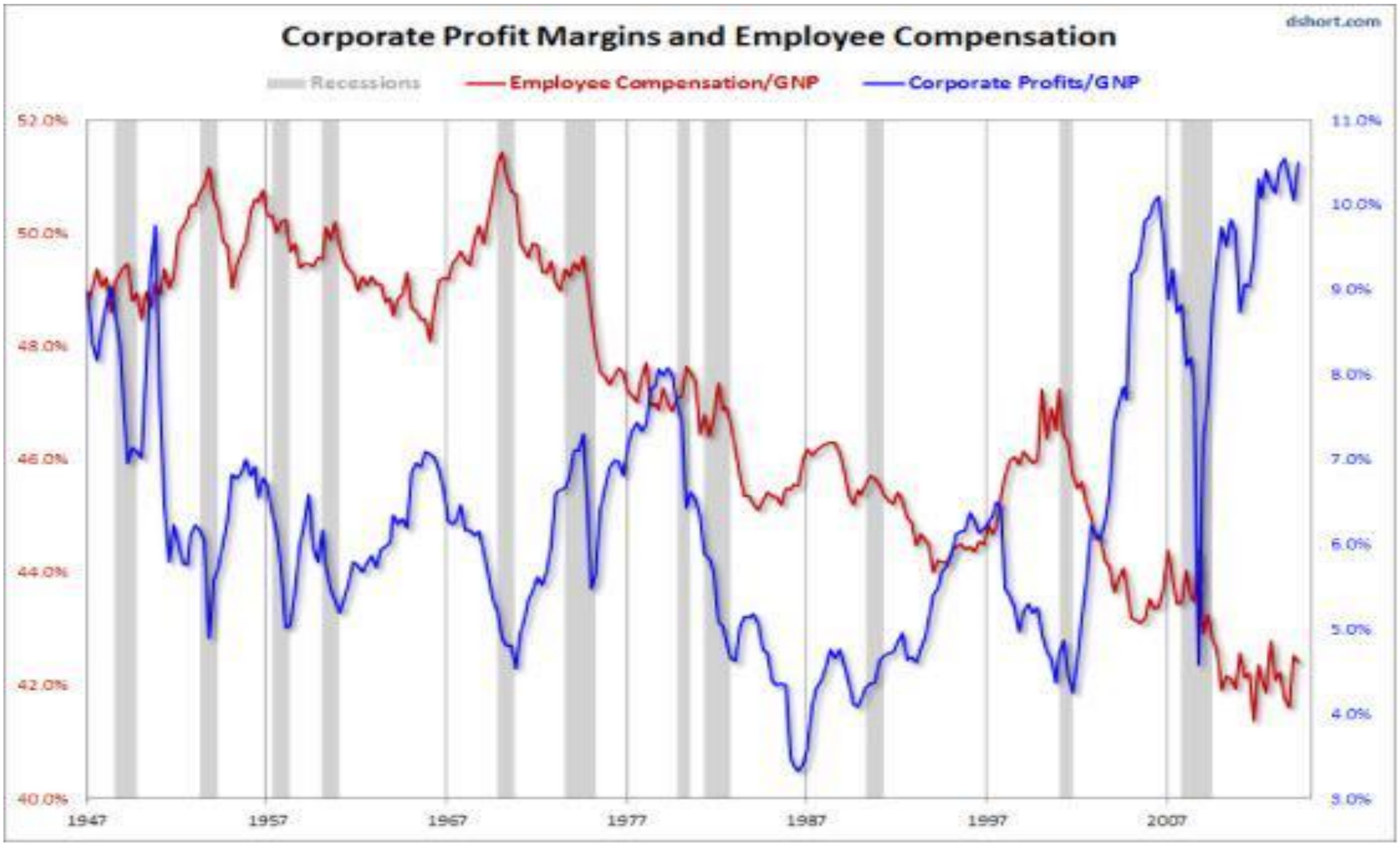
November 13th, 2017

Follow the money…

It was quiet on the economic data front last week, but filling the void was the highly anticipated release of the tax plan from the Senate which opens what is a narrowing pathway for the GOP to put a legislative win on the board after what has been a more challenging year than expected since their sweep last fall. It's difficult to size up with a high degree of confidence the short- and long-term implications on the economy of what will ultimately become law as there are so many additional variables that will change as a result of what ends up getting passed. Here are some thoughts on this topic that I do have a reasonable level of confidence opining upon:

- Tax cuts will not be a panacea to what remains the most anemic economic expansion in the post-WWII era. Moreover, I struggle to be able to connect the dots in the same manner as this administration's economic team in believing that corporate America is the group that is most in need of a tax break. What I mean by this is that corporate profits as a share of GNP (Gross National Product) is at a 70-year high while compensation to labor as a share of GNP is at a 70-year low (see chart below courtesy of Doug Short).



If anything, this trend – which took off in earnest at the start of the century (a period that coincided with China being allowed into the WTO and hence opening up to the world their ample supply of cheap labor) – is one of the major explanatory variables for the global rise in populism playing out at the ballot box over the last several years.

There is little reason to question the math that should the corporate tax rate get cut from its current 35% level to the 20% rate both the Senate and House plans are targeting that it will move the needle in terms of corporate earnings and hence provide a fundamental support to equity prices. But this line of thinking is a bit short-sighted in my opinion as it will represent a one-off bump in corporate profits in whatever year it is implemented, yet there is little historical evidence that any of this increased earnings pool will find its way into wage earner's paychecks (reversing the trend that has been in place since the turn of the century). What's more is that this cash infusion into corporate coffers perhaps has the unintended impact of hastening what is already an accelerating trend towards technological / robotic innovation that is displacing the labor force.

- I have and continue to doubt the narrative espoused by this administration that these tax cuts will pay for themselves through increased economic growth. This isn't about disagreeing for the sake of disagreeing or getting into partisan politics on one side or the other – it's strictly about simple math. At the end of the day, GDP can be simplified into two components: labor force growth + productivity growth = growth in GDP, where both labor force and productivity growth have averaged less than 1.0% over the last five years. I'll concede that it's reasonable to forecast productivity growth can improve going forward, but labor force growth is a function of population growth which is a function of demographics, where the script is already written with population growth reaching its lowest level in nearly seven decades in two of the last three years.

Then there is the empirical evidence already proffered from tax cuts in the past where the evidence is obvious as federal debt was higher after the Presidential terms of both Reagan and Bush Jr. (and this is a trend that hasn't changed since then with federal debt at an all-time high today).

- My last thought is on the motivation behind this administration getting something done on the tax file being extremely high so they have something to show voters going into a mid-term election year. Without question, the results out of the most recent elections in

Virginia, New Jersey, and Washington shifting to the left will resonate with the GOP and creates some uncertainty on how closely incumbents want to hitch their wagon to a President carrying an uncomfortably low 35% approval rating. It's not nearly the longshot many thought a year ago for the House to flip back to the Democratic side next November when you consider that a total of 29 Republicans are not running in next year's midterms versus 9 Democratic incumbents.

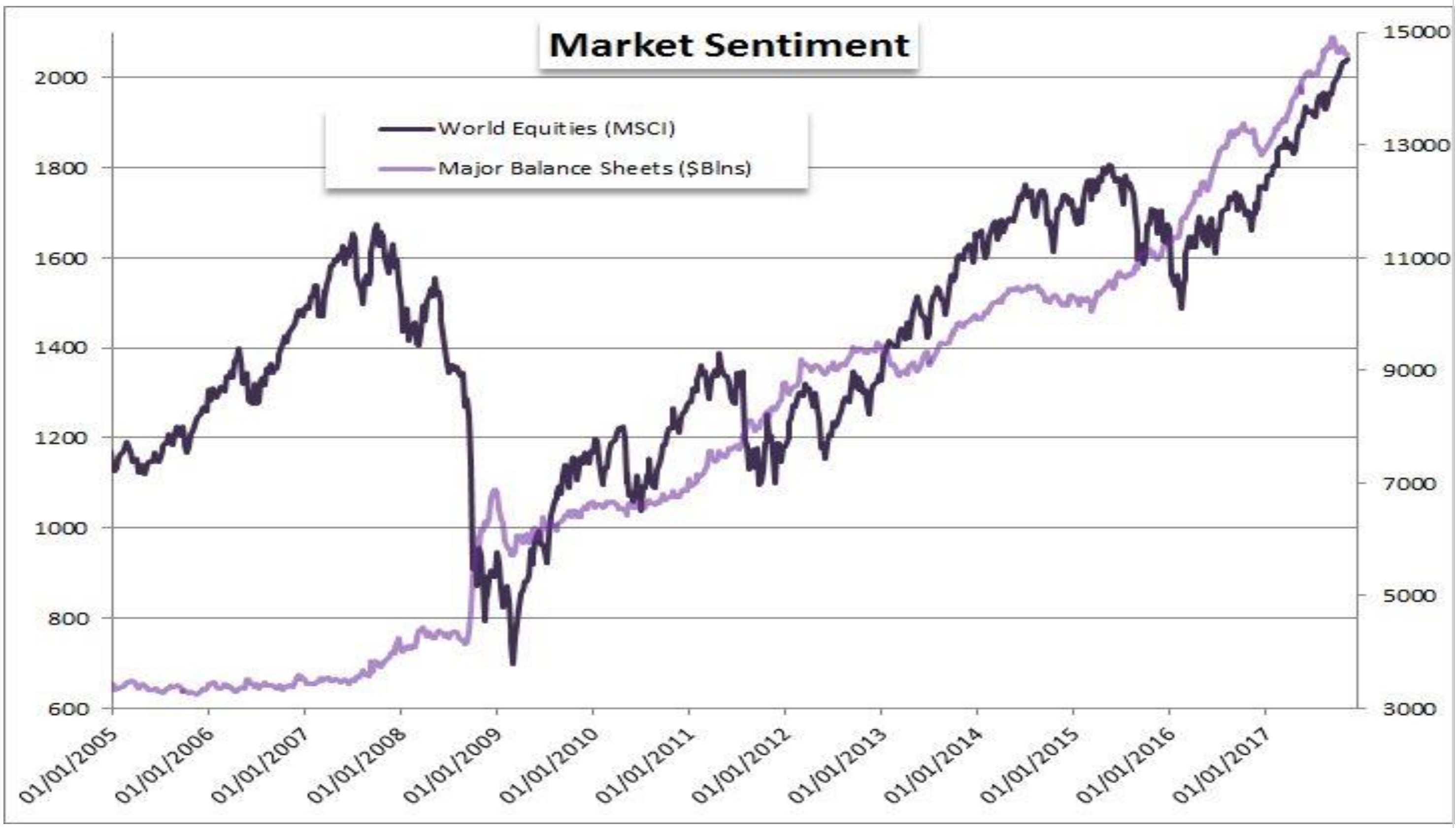
This only raises the stakes, in my opinion, of not only getting something done on the tax reform campaign promise, but also having it structured in such a way that the motivation perhaps starts to gravitate towards making sure the end product of this tax package benefits their respective constituents and less so the major lobbying groups. With that said, it begs the question more so than anytime leading up to this point, what if the tax plan passes and it ends up doing more harm than good for both the economy and GOP re-election chances?

As for the U.S. stock market right now, 'frothy' is the one word that comes most to mind and that says nothing about where it goes in the near-term as momentum remains a tailwind, but caution is warranted. I understand full well that throwing out a term like 'frothy' is a strong indictment that should only be used with evidence that can support such a claim, so let's elaborate on what is leading me to this description. For starters, the latest swath of investor sentiment data can hardly be interpreted any other way with the Investors Intelligence poll showing the bull camp hitting 64.4% last week (this is just 0.6% shy of the all-time high it reached back in 1987 just before the biggest one-day decline in history). It wasn't just the bull camp in this survey that raised eyebrows but the share of bearish opinion fell to 14.4%, which pushed the bull/bear ratio to a hefty 4.47x (highest level in the last three decades). And it's not just this survey measure that is brimming with optimism: Market Vane bullishness is near the high end of its historical range at 70%, the American Association of Individual Investors poll showed the bullish camp jump to 45.05% from 39.64% previously while the bear camp fell to 28.57% from 33.03%, and the net speculative long in the S&P 500 futures and options contracts is at its highest reading since the end of August.

Add to this U.S. equity based portfolio managers sitting on a record low cash position of 2.8% in anticipation of a year-end melt-up and it begs the question as to where the incremental demand for equity purchases will come from. All the while the major averages continue to cling to all-time highs while market internals are weakening (only 58% of NYSE stocks are above their 50-day-moving-averages compared to 80% a month ago) and volume has lagged the price action. Cyclically sensitive market leadership groups like small caps, the transports (down 9 of the last 10 trading days and off more than 5% from their October high), and the financial sector have been relative underperformers of late while the yield curve compresses to its flattest level since late 2007. However, even with this growing number of indicators showing a stock market that is extremely overbought, extended, and screaming for a breather – they are readily dismissed by the FOMO (fear of missing out) crowd chasing the averages into what has historically been a constructive seasonal period.

With all deference aside among the bull / bear debate and as to where asset prices go from here, the biggest question mark any investor or market prognosticator has to answer at this point going forward is the sustainability of current asset price levels as well as the global economy. It's the sustainability of this move in the economy and asset prices over the last year that has always been highly suspicious in how the analysis plays out. Almost anyway I turn at this point I see a backdrop that has a real tapped out feel to it and screams late cycle. Adjust the latest Q3 GDP print for the hurricane impacts to inventories and imports and you're talking about an economy growing at a sub 2% rate, not 3%. Also consider what has transpired in the household segment over the last year which has pared its savings rate to a decade low of 3% with precious little left to fall back on in the event of an unexpected emergency. Without this raiding of the piggy-bank, real GDP growth would be tracking barely higher than 1% at an annual rate which is right in line with the growth rate in real disposable income over this period. Meanwhile, households have reverted to tapping the credit spigots to subsidize their lack of wage growth with credit card balances approaching the levels they reached just prior to the GFC.

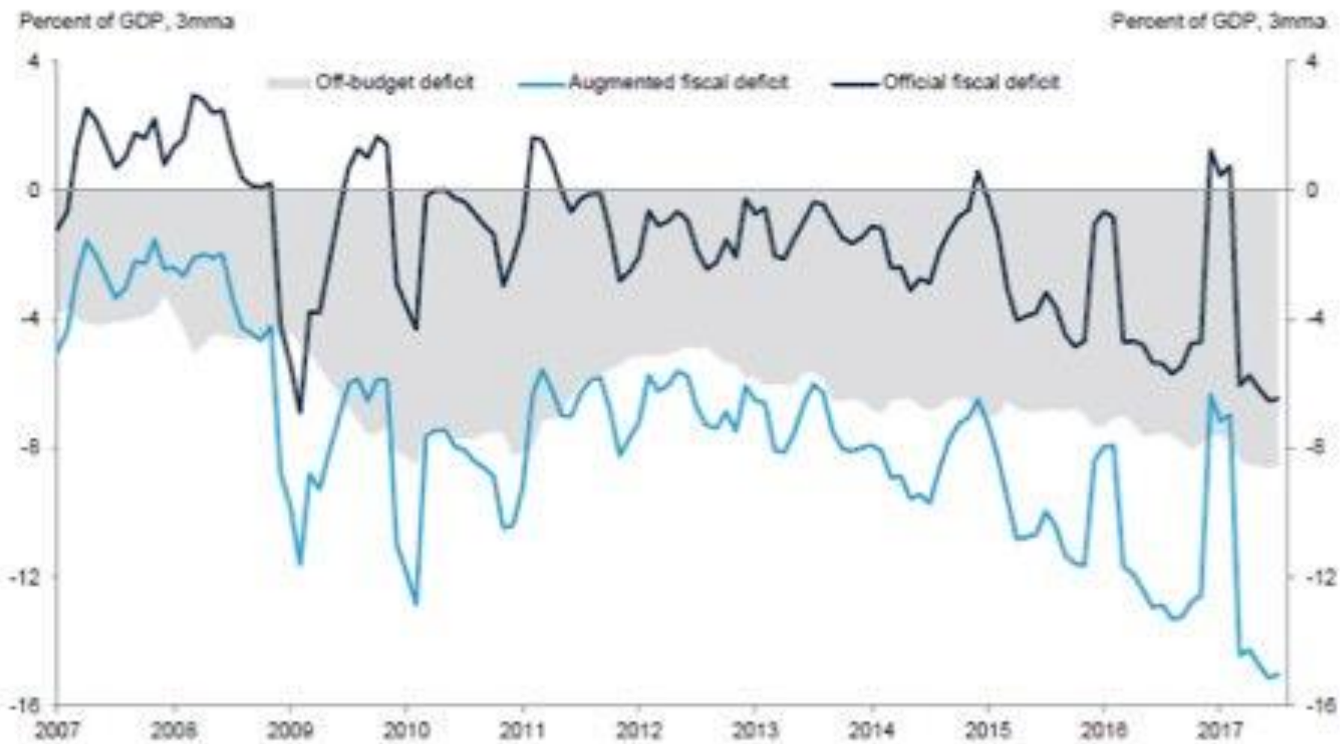
It's not only the fragility of the U.S. consumer that has me worried, but continuing along this theme of unsustainable forces that have acted as a tailwind over the last year is central banks and government support. The poster child of this largesse are global central bank balance sheets which have expanded over the last 18 months at their most robust pace of this entire expansion. That’s saying something when you consider that over $5 trillion of electronic money has been created since February 2016 with much of that finding its way into financial assets. The following chart plots the MSCI all-Cap World Equity Index versus the size of central bank balance sheets – a relationship that is undeniable.



However, we know based on the forward guidance from recent announcements out of two of the major players in this balance sheet expansion experiment (the Fed and ECB) the rate of expansion is going to go to an outright contraction (should they stick to what they've outlined) by this time next year.

China was another economy that had strong political incentives to make sure global economic and financial stability was maintained leading up to the 19th Party Congress that concluded at the end of October. The incentive for the President of the People's Republic of China, Xi Jinping, was so high that fiscal policy in China was the most expansionary it has been in the last decade – a policy that is now expected to reverse following the successful consolidation of power under Xi. The below chart from Goldman Sachs details the growing fiscal deficit balances out of China since 2007 with both official as well as off-budget deficits running at post-GFC highs.

Exhibit 2: Fiscal stance has been very supportive



Source: Goldman Sachs Global Investment Research, CEIC, WIND

So here we are, where for the first time in this post-GFC era investors are going to finally see whether this expansion can sustain itself organically without the substantial support of central banks. What's unfortunate is that the backdrop coinciding with this turn could hardly be less supportive: debt across the spectrum is at all-time highs (Sovereign, Corporates, and Households), pent-up demand is all used up, interest rates remain near historical lows but are up sharply relative to last summer's all-time lows, the consumer is tapped out, equity valuations have rarely been more expensive, and geopolitical uncertainty is a material risk. If past is prelude then it makes sense to follow the money – in this case, central bank liquidity – which looks to be hitting its apex at the moment, with the descent from this altitude likely to be challenging.

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