March 27th, 2017

Some market segments are unwinding the post-election optimism…

One of the narratives driving asset price movements since the U.S. elections last fall, where the Republican sweep ushered in widespread optimism that a pro-growth/pro-business policy agenda would be a panacea to all that ails this stubbornly sluggish economic recovery, is in the process of being recalibrated by investors following the failure to pass healthcare reform last week. Thus far it seems as though investors are taking this setback in stride, with the news that the AHCA bill was being pulled hitting the wires just prior to Friday's market close in which the initial reaction was stocks jerking lower, yields falling, oil sliding, and the dollar selling off. This impulse reaction picked up steam heading into this morning's trading session with the major equity averages nearing -1% declines, gold spiking +1%, oil down almost -2% and the 10-year Treasury yield sliding to 2.36% (near the low end of a key moving average), but much of these moves have already been reversed within the first couple hours of trading.

More on the implications from the legislative stumble in a minute, but perhaps what is being overlooked by market participants in the last several weeks is the visible signs of tiring in the reflationary support that has perked up the economy and acted as a tailwind to asset prices since last summer. This reflationary impulse got an additional boost following the

U.S. election, but looking at some key market price signals today relative to where they have been since the election should give investors some pause on their conviction about what may lie ahead. Consider that the DXY dollar index ticked below 99 today and is approaching its key 200-day moving average at 98.65 – the last time the DXY was at today's level was back on November 11th (the S&P 500 traded at 2,165 that day). The Russell 2000 Small Cap index (an investor favorite following the election) traded down to 1,335 this morning (-5.6% off the high it reached on March 1st) and is now the same level it was on November 22nd (the S&P 500 closed that day at 2,204). Lastly, the 10-year Treasury yield traded as low as 2.36% this morning, which is the same level it was at on November 23rd. Same story for gold as it has now retraced all of its post-election decline and at $1,256/oz today it is at the same level it was at on November 10th.

You see the point, and this by no means is a forecast of what one should expect for the S&P 500, but if it were to follow the path of these other market price levels then it should not be a surprise if this mild -2% pullback in the S&P 500 off its March 1st highs ends up turning into a more meaningful and deeper retrenchment before all is said and done (and wouldn't that perhaps be a welcomed opportunity for those that have the ability and are inclined to take advantage of it). After all, the hopium narrative applied to this post-election market move has always been suspect to me, mostly on the premise that it is built on a high level of confidence that every piece of a very aggressive administrative agenda would be perfectly landed.

I found it humorous to leaf through the weekend periodicals and listen to the legislative leaders being run out on the news circuit to deliver the spin, touting how in the end this will be a big positive as it will allow the administration to move straight into tax reform while no longer having to worry about this piece of the economic growth agenda item being bogged down by healthcare reform. Come on already, if we learned anything from what just played out with the healthcare reform failure it is that the GOP remains a very divided party with deeply segregated views. This is likely to make tax reform more complicated (not less) when you consider the differing views as it pertains to what is the appropriate top marginal tax rate, the extent to which a tax reform plan has to be revenue neutral, and how it will be funded.

Anyone continuing to hold on to the view that "one party rule" will quicken the pace of legislation should give former House Speaker John Boehner a call, as I'm sure he can shed some light on the subject. The writing is already on the wall that confrontation awaits in terms of the divisive views between the various factions of the Republican Party, whether it be on the appetite for a border adjustment tax or the extent to which dynamic scoring is used to make up for the $1 trillion windfall the administration was banking on from the repeal of the ACA as a way to offset the level to which they could cut corporate tax rates. Wall St. has penciled in the following rough estimates for how much a cut in the corporate tax rate from the current 35% level would positively boost corporate earnings:

- 32% Corporate Tax Rate = 0% earnings boost

- 30% Corporate Tax Rate = 3.5% earnings boost
- 25% Corporate Tax Rate = 6.5% earnings boost
- 20% Corporate Tax Rate = 9.5% earnings boost
- 15% Corporate Tax Rate = 12.5% earnings boost

It took President Reagan five years to pass what was the last major tax reform policy back in 1986 and that administration had the luxury of cutting individual tax rates from a post-WWII high of 70%. The environment and situation is vastly different today compared to back then with deficit and debt levels as a percent of GDP three to four times higher. President Obama spent a year-and-a-half coalescing his own party to get on board with the Affordable Care Act – a political gamble that cost the Democrats many seats in the 2010 mid-terms. These examples stand in stark contrast to what can be observed from the current administration where President Trump spent 17 days on healthcare reform before throwing up his hands and moving on. It's a reasonable guess to think that the patience and willingness to reach across the aisle is nowhere close to where it has been under previous administrations when seeking the passage of major policy reform – keep this in mind as we move down the path with tax reform.

Look, it's not my intention to be critical of this administration nor its ambitious agenda as I do think they want to make a positive impact on people's lives in the places they are most passionate about and in which they command a very high level of intellect – the economy and growth. I've said it before and I'll say it again – President Trump, through no fault of his own, came into this term with the worst fundamental economic set-up of any President since Herbert Hoover. Now what he does in terms of policy actions will play an integral role in how well (or poorly) this auspicious set-up is navigated over his term, and an investment community that has been yearning for a break-out in economic activity for several years hasn't done him any favors (in my opinion) by jumping on his coattails and pushing equity valuations into rarified territory on the belief that he has some type of magic wand that will make all the troubles that have tripped up this recovery since the Global Financial Crisis just go away overnight.

What too often gets overlooked and goes unaccounted for is that the U.S. economy continues to push up against decades of policy makers choosing to defer the hard decisions they faced by always kicking the can down the road and making it the next administration's problem. Well, with the demographic and debt profile of the U.S. at its weakest and most extended state since the 1930's, it's created a daunting set-up where the long-term policy solutions are extremely limited. Yes, there are some policy levers that can be pulled to move the needle in terms of short-term economic impacts, but this only further exacerbates the long-term structural challenges – challenges that transcend regulation, healthcare, taxation, and trade agreements.

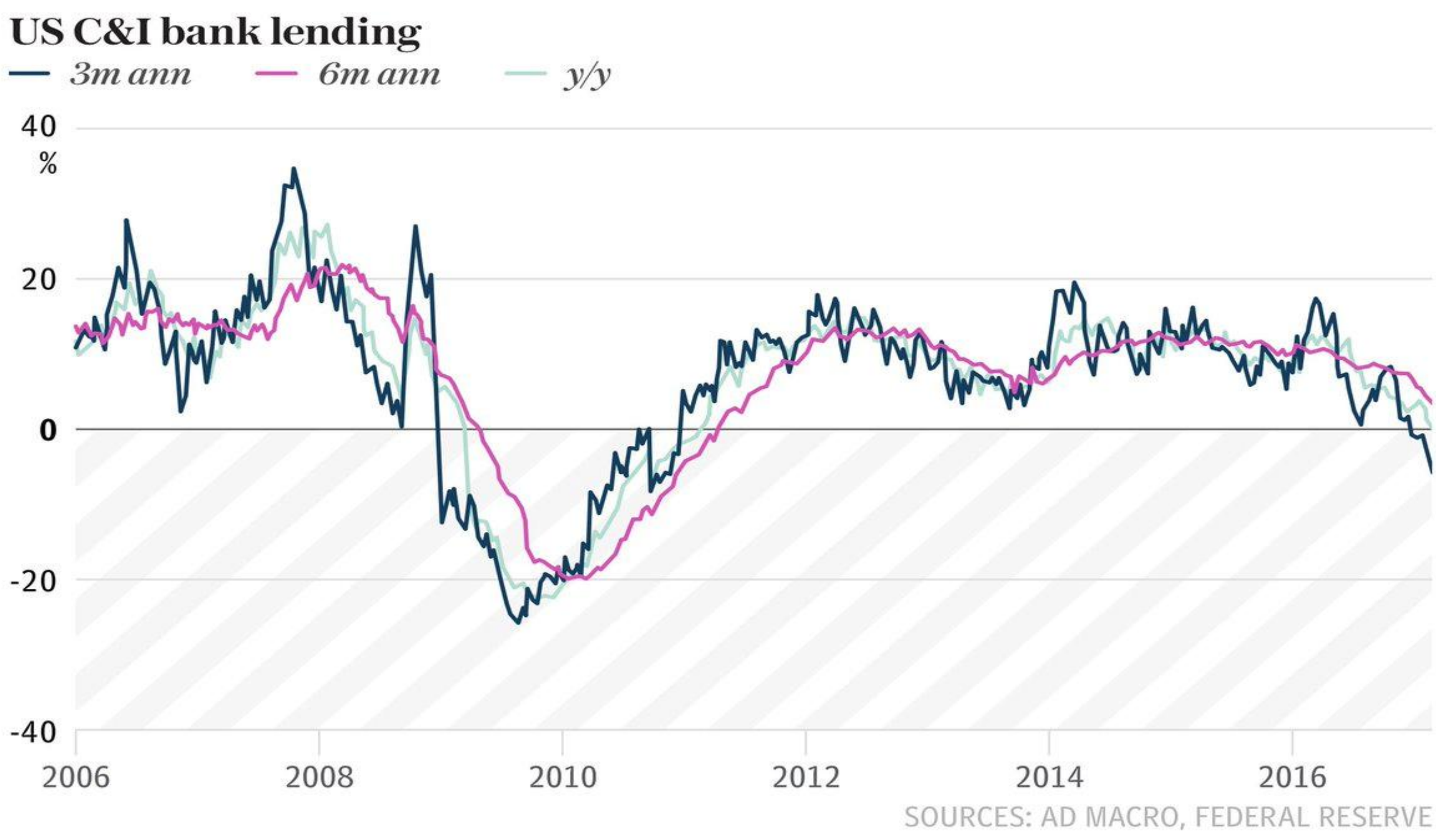
On the data front last week, there wasn't much in the way of market moving releases. Core capital spending orders per the February durable goods report, like many economic indicators, show an economy that is neither improving nor deteriorating much in either direction. At this point investors have shifted their focus to April when we'll get the next batch of data to gauge the health of the economy. What is also coming down the pike is Q1 earnings season which will begin in earnest in a couple weeks' time and if the corporate news we've seen of late is any indication, then it could very well be an interesting earnings season:

- FedEx reported a solid quarter last week while raising guidance, but the price action in the stock indicates that it wasn't enough for Mr. Market as the stock fell -4% over the course of Thursday and Friday, dropping it below its 50-day moving average.
- Nike crushed earnings expectations, but this was more a result of how well corporate executives have become at managing earnings because it missed its revenue estimates, gross margins fell,

and it provided a rather cautious commentary on the retail climate.

- Ally Financial (one of the largest auto lenders) issued a warning that earnings will come in below expectations due to pressure from falling used-car values.
- Ford warned that it wouldn't meet Q1 earnings expectations, citing weaker demand.

One important variable that started popping up on my radar screen back in December as something to keep an eye on as we moved through this year is bank credit data. Data from the Federal Reserve shows that the $2 trillion commercial and industrial loan market peaked in December and has weakened at a disturbing -5.4% annual rate over the last three months (a pace of decline not seen since December 2008). The year-over-year pace has decelerated from 7% at the turn of the year to under 3% currently, and is the softest pace since the spring of 2011. With the widely held belief that economic growth in the U.S. is strong and improving, notwithstanding estimates for Q1 GDP growth sliding to around 1.5% (just as the 1.9% Q4 2016 GDP print was dismissed as being an anomaly) it begs the question of what U.S. banks are seeing that the majority of prognosticators are missing?



The deterioration in credit is not just confined to C&I loans as the broader $9 trillion loan and leases market has declined at a -1.6% rate on a three month basis, auto credit growth has almost vanished (down to a +1% annual rate over the past 13 weeks from nearly 5% at the start of the year), and the same story is at play for credit cards and other forms of revolving credit which on a 13-week trend has gone from +5.4% annualized in early January to +1.2% at last check.

So the banks seem to be de-risking and/or business and household demand for credit have gone on sabbatical (perhaps a combination of the two) and while these readings are not flashing warnings of an imminent crisis, they do convey a message that runs counter to the pervasive belief that accelerated economic growth and increased corporate profits are right around the corner.

Credit is a leading indicator, so it's too early to determine whether this is just a short-term stumble or something to be concerned about, but it's worth considering whether this is an effect of the Fed rate hikes working their way through the system. After all, monetary policy does work with a lag and while the Fed has only implemented three 25 basis point hikes since December 2015 (two in the last four months), the Fed's Wu-Xia model (which incorporates the impact of withdrawing stimulus via QE) suggests that the extent of monetary policy tightening in the U.S. this cycle is equivalent to thirteen 25 basis point rate hikes. What is most interesting about this period of unprecedented monetary policy is that no one knows where the pain threshold lies in a global financial system that is more leveraged than at any time in history, and where only eight months ago global interest rates reached levels that were the lowest in recorded history.

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