Financial Markets Perspective

October 2018

The Fiscal Policy Roller Coaster and the Record Bull Market

An Accelerating Economy Rolls On

Natural disasters around the world are occurring at an alarming rate in 2018. Every few weeks, we are witnessing disasters such as earthquakes that demolish whole cities, wildfires that burn thousands of acres, and cyclones that cause mass flooding and property damage. More recently, the earthquake in Indonesia also set off a massive tsunami that was merciless and immeasurable. In the face of both climatic and political disturbances around the world, the U.S. is experiencing record stock market gains and a rising value for the dollar. Why is there such a performance diversion between domestic and foreign equity markets in the face of turmoil and strong resistance to President Trump's hard line trade policy?

The simple answer is that the impact of a massive change in U.S. fiscal policy has had profoundly different effects on market sectors. The federal government's policies of taxing and spending is otherwise known as fiscal policy. Not too long ago we wrote about the fiscal policy vacuum, a time when these policies were not contributing to economic growth. The previous administration raised taxes and the Congress kept a lid on increased spending. As a result, a below average 2% growth rate persisted for over eight years.

The upside is that a new administration determined to drive growth in the U.S. economy supported the largest corporate and personal tax rate cut in history. By lowering tax rates, consumers benefitted in two ways. Firstly, many received bonuses or increased salaries. Secondly, consumers owning stocks benefitted from dividend increases and stock buybacks and increased after-tax income from these payouts. According to the White House, more than 430 companies have announced pay raises, bonuses or 401(k) hikes, benefiting more than 4 million Americans. No wonder both business and consumer confidence are at all-time highs!

The massive reduction in regulations is another effective "tax cut" and should be considered as another form of fiscal stimulus. Regulations place burdens on companies that, many times, may have benefits to society but are worth much less than the cost of the regulation. When the government lowers regulations, companies experience a decline in the regulatory costs that, in turn, can end up adding to profits.

The downside of this fiscal story is not as pleasant and detracts from positive stimulus. Trade protection (aka tariffs) are a form of tax increase. The president's game plan is to outsmart trading partners who have benefitted from their high tariffs on U.S. goods. If the president succeeds in getting net tariffs reduced, this headwind will become a tailwind and add to fiscal stimulus, most likely to the benefit of all countries. Tariff agreements with Canada, Mexico and South Korea are a good start in this direction. The risk is that reciprocal trade tariffs effectively increase taxes and lower economic output until negotiations play out.

While some economists applaud a strong dollar because of lower import costs, a strong dollar negatively affects our exports and acts like a tax on those exports. By making U.S. goods less competitive abroad, foreign manufacturers gain an advantage and manufacture the goods that were previously imported from the U.S. A strong dollar is another form of fiscal policy restraint and, if left unchecked, can restrain U.S. growth. A stable dollar is preferred.

President Trump asked to implement a ten percent tariff on $200 billion of Chinese goods on September 24th and an additional 15% on January 1, 2019. When a future economic event such as a price or tax increase is announced, market participants will take advantage of that event in the short-term. In other words, economic activity will accelerate before the increase and then slow once the tax is implemented. If negotiations fail to lower trade barriers, we could have a stronger than expected fourth quarter of 2018 and a weaker first half of 2019.

Recently the House of Representative entertained the idea of "Tax Cut 2.0" where the temporary tax cuts would be made permanent and a further tax enticement for programs that foster savings for retirement. Success in this effort is likely to add to consumer confidence in coming months.

The Changing Role of the Federal Reserve

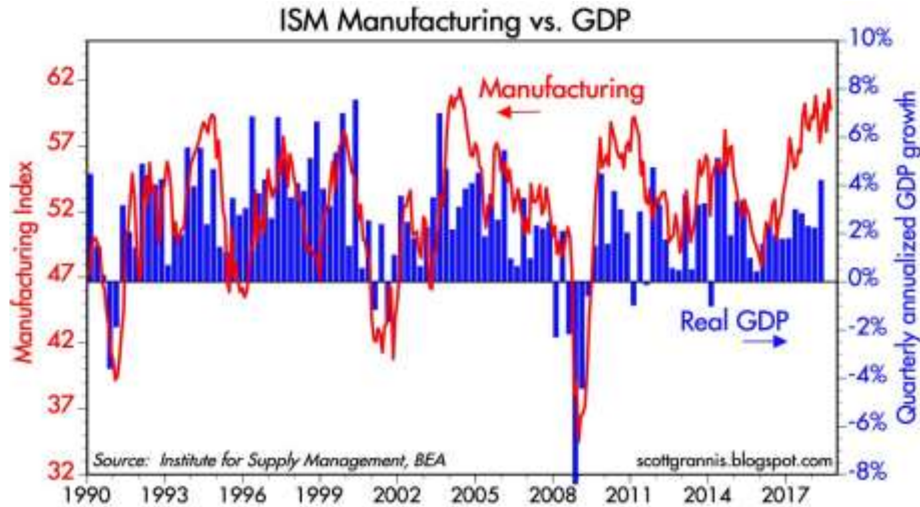
Since the financial crash of 2008, the Federal Reserve has provided monetary stimulus to keep the U.S. from slipping into recession. By providing liquidity in the trillions of dollars, the financial sector was able to recover; and in turn, support the balance of the economy getting back on its feet. However, the lack of fiscal stimulus during this extended period of "easy" money kept the rate of recovery at historically low levels. For eight years, the Fed held the fed funds rate (the rate that banks lend to one another) near zero hoping to stimulate the economy through inexpensive borrowing. During those eight years the Fed continued to call for support from the Congress but there was no fiscal policy response. However, the election of President Trump and his policies of fiscal stimulus accelerated economic growth to such a degree that the Fed began to increase interest rates to avoid being too stimulative.

Last quarter, the Federal Reserve Bank of Atlanta forecasted third quarter GDP at 4.1%. Although the measure can change from week to week, there has been solid growth in GDP since the beginning of 2017.

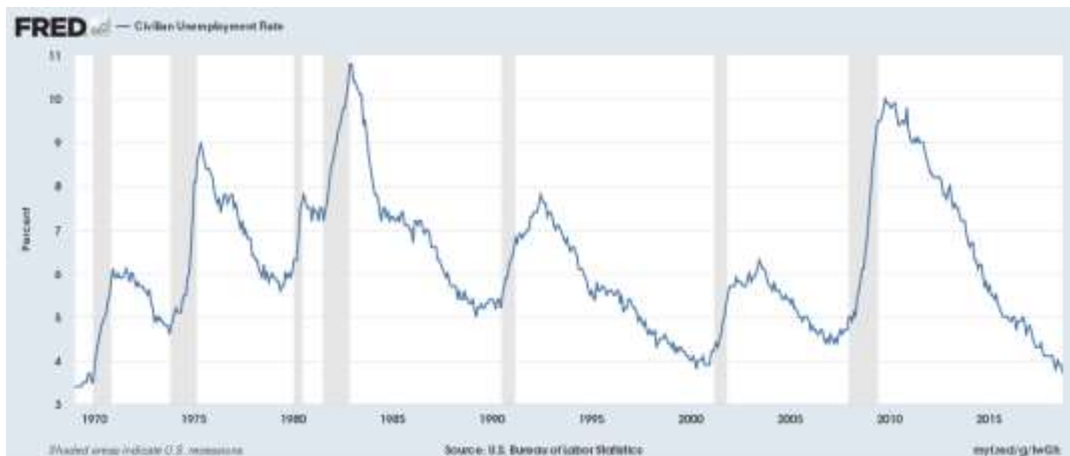
In August, the Federal Reserve Bank of New York provided forecasts for short term GDP growth of near the same rates but sees the second quarter as a temporary phenomenon with growth falling back to the 2% rate in future quarters.

One factor the Fed may not have considered is that rising interest rates affect the interest earned on money market funds and related floating rate securities where savers' income will get a continuing boost from rising fed funds rates. We have not seen any economic studies contrasting the potential impact of higher interest rates on borrowers vs. the higher interest rates for savers but given the growing size of baby boomers who depend on such income, we wouldn't be surprised if those rising levels of income contribute to and not detract from economic activity.

Another key indicator of economic health is factory output. In September, the Institute for Supply Management (ISM) index rose to a level of 61.6 — the second highest level since May of 2004 as seen in the chart below! Analysts had expected a level of 57.5, indicating that the consensus is underestimating the strength of economic growth. A stronger economy goes hand in hand with higher real interest rates. Our economy is being built on a foundation of rising confidence and increased after-tax rewards to workers and risk-taking.



There are many important economic reports that gives us confidence about the future. Since consumers account for over 70% of economic activity it is important to note that the level of consumer confidence climbed to 138.4 in September — the highest level since September 2000. Another positive is the fact that the unemployment rate dropped to 3.7% — the lowest since 1969 as can be seen in the chart below.



A long, hot summer did not deter the secular bull market in stocks—the longest in modern history and one that has the underlying fundamentals to continue its record run. Suffice it to say that the most important indicator for stock market investors is growth in corporate earnings. Using the S&P 500 as a benchmark, the following exhibit provides a good picture of corporate profit growth both now and expected over the next four quarters.

Evaluating the Importance of Secular Trends

More market observers are discussing the end of the bull market in the context of the end of the business cycle. They use the economic history of the past fifty or so years to come up with their forecast of an economic downturn. For observers who recognize that the Energy Renaissance in the U.S. has been an economic game changer, there is the possibility of a much longer economic cycle than those that occurred post the Arab oil embargo in the early 1970s.

The turning point in this major secular trend was 2012 when fracking in the U.S. unleashed a huge new source of domestic oil and gas. Back then, economic forecasters were expecting $200 per barrel oil when the price was $110 per barrel. Imagine what would have happened to an economy that was just limping along at a 2% growth rate if oil prices had soared to $200 per barrel.

Prior to the proliferation of fracking in the U.S., most of those petro-dollars were going to the Mid-East and funding the building of great cities. U.S. wealth was being depleted because of the need for imported oil. Fracking triggered not only an increase in domestic production of oil and gas but also contributed to a price decline of oil from a peak of around $110 a barrel to a low of $26 per barrel in the first quarter of 2016. Sales of domestic oil and gas fostered not only a boom in domestic oil and gas but also created the energy wherewithal to fund a resurgence in an industrial renaissance in the U.S.

In 2007, domestic oil production was about 1.5 million barrels a day. In September of 2018 that rate was 7.5 million barrels a day, an increase of 6 million barrels a day or about $420 million dollars a day that stays in the U.S. and contributes to economic growth. Note that the rig count has not recovered to the peak reached in 2015, yet oil production continued to new highs. At a current price of $74 per barrel of oil, the profitability of fracking is high.

Political Fracture and the Economy

The upcoming elections could have an important impact on the economy and financial markets. Ever since President Trump was elected, the ongoing deterioration in the formal management of the political environment is evident. Having a businessman as president rather than a traditional politician from the legislative side of government helped get the new presidential cycle off to a fast start. The president's policies of lower tax rates, less regulation and higher tariffs have been opposed by many traditional politicians on both sides of the aisle who complain about higher deficits and trade wars.

The mid-term elections in November should give us a clearer idea if there will be a forced change or deviation in the president's economic policies. No matter how the elections turn out, financial markets may reflect short-term uncertainty if the perception of the election is not favorable for the economy. However, the success of the president's programs will be difficult to refute or replace given the positive outlook reflected in both business and consumer metrics.

Conclusions

Economic growth is still above average for the 3rd quarter with forecasts between 4-5% as the U.S. is enjoying a strong economic expansion. Global growth will also push oil prices higher even though U.S. oil and gas output continues to rise. Since oil is an important component of overall prices, we may see a short period of higher inflation due to that rise. However, recent inflation numbers are not indicating a surge in prices.

Politics will continue to play a prominent role in the economy. Will we continue down the path of higher growth and lower inflation or will we experience a return to higher tax rates? Part of that answer will arrive in mid-November.

Corporate earnings reports, starting the second week in October, could set the stage for further stock market gains as fourth quarter market performance is usually favorable. There is still meaningful divergence among the large, mid and small-cap indices; and foreign stock markets are experiencing actual year-to-date losses. After a strong rally in the NASDAQ composite this year, we expect to see some market rotation through the balance of the year.

Recent stock market records confirm that we are in a long-term secular bull market that is being sustained by major tax reform, low interest rates, relatively low inflation and expanding consumer and business wealth. We can still characterize this market as the stealth bull market as politics dominates the headlines with the media ignoring good news on the economic front. Ending this bull market will take either an unexpected event or a major negative change in the country's political landscape. Our friend Larry Kudlow likes to say: "Earnings are the Mother's Milk of the stock market". We agree!

Diane V. Nugent
President/CEO

Thomas E. Nugent
Executive Vice-President

October 10, 2018