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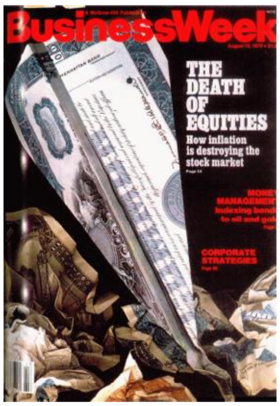
MACROCOSM

Global Bull Market: Still Not Loved and Still Not Over

Monday, October 16, 2017
Donald Luskin

Strong stocks are justified by fundamentals – more to come as pro-growth policy rolls on.



The consensus seems to be catching up to what we've been saying for several years – that we are in a global bull market. We have been told by a number of clients that one of our main competitors in the macro forecasting business has switched to bullish from the recession-call that has been the cornerstone of their outlook for two years. And clients have drawn our attention to last week's cover of *The Economist* – noting "The bull market in everything" – wondering if it's the upside-down equivalent to 1979's famous "The Death of Equities" cover of *Business Week*. And with the VIX Volatility Index at all-time lows, and other risk indicators such as credit spreads showing a great deal of investor risk-tolerance, clients are asking us: is there too much complacency?

- The contrarian in us takes these things as noteworthy reminders to be careful. But we're always careful. A correction could set in any time for any reason – maybe now, given all the attention the bull market is getting. *But looking at these and similar signals in an integrated context of the entire investment environment, we don't see any evidence of an important turning point here.*
- *In fact, we see the concern with such seeming signals as, itself, strong evidence that there is still a great deal of investor caution out there, which tells us that this great unloved bull market still has a strong wall of worry to climb.*
- Take an actual look at that *Economist* "bull market" cover story. It's not a celebratory puff-piece that could mark a top, revealing the capitulation of long-time bears. *It was instead a bear case itself*, repeating the fiction that the global bull market has been the result of "ultra-loose monetary policy" and warning that it is "coming to an end."

- Now it has been replaced on news stands with a cover celebrating General Secretary Xi Jinping as "The world's most powerful man" – warning

Update to strategic view

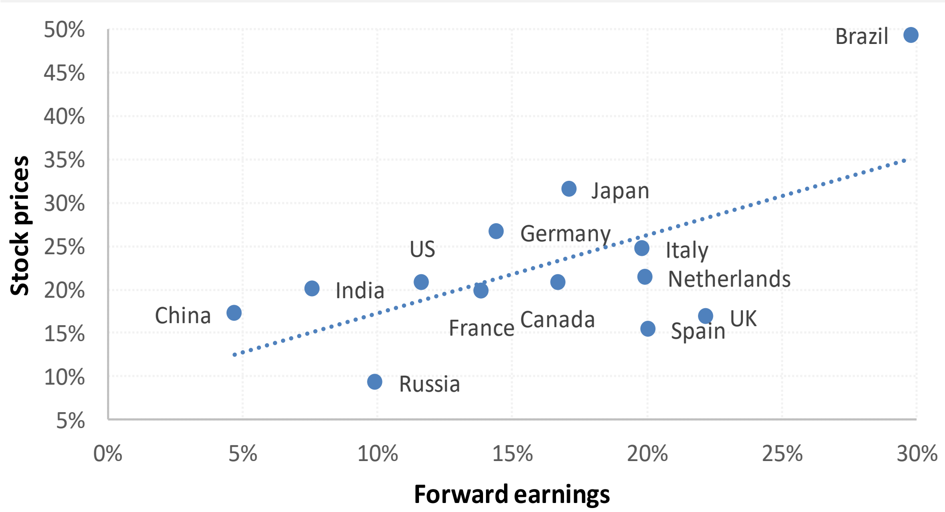
US STOCKS, EUROPE STOCKS, ASIA STOCKS: There's some evidence of capitulation by longstanding bears, making us ask whether we need to revise our ongoing contrarian – and correct – expectation for continued and accelerating growth and strong equity performance. We find the seeming capitulation to be mostly just more bearishness, and we see a continued unfolding of the global "turning" toward the pro-growth devolution of power from central authorities to local authorities and individuals. Brexit continues to catalyze pro-growth change throughout Europe. Macron has liberalized labor markets, and is poised to cut taxes. Merkel has had to listen to the right, and limit potentially illiberal Muslim immigration. Japan is electrified by the threat of North Korean nuclear capacity. China has learned to manage its currency without a dollar peg. And in the US, Trump's election has already accelerated global stock markets, and now points to pro-growth tax cuts with powerful second and third order effects.

[Strategy dashboard]

that "The world does not want an isolationist United States or a dictatorship in China. It may get both." Another bear case.

- *As to low VIX and tight credit spreads – we think that speaks not so much to the sheer amount of risk that investors are constantly told to expect, but rather a grass-roots repricing of that risk.* Even if investors objectively expect to bear more units of risk, if they are becoming more risk-tolerant – or even just inured to the constant media-barrage of fake news and bear cases that never materialize – then the price per unit of risk can nevertheless come down.
- *To be sure, this unloved global bull market is getting more recognition – if not more love – than ever before.* For example, here in the US, we're sensing from clients increasing optimism that corporate tax cuts might actually get enacted this year – somewhat of a turnaround from the universal skepticism of a month or two ago (see "Tax Cuts Start to Get Real" September 28, 2017).
- *But we're not seeing any signs that the many positive secular developments we've been pointing to over the last couple years* (see, among many, "Trump May Be First Since Reagan To Unleash America's Animal Spirits" March 19, 2016) *are being accepted anywhere near universally.*
- *Most of the gains in world stock markets* – using the bottom of the July 2016 post-Brexit panic as a starting point – *are explained by nothing more exotic than increases in consensus forward earnings* (please see the chart below). We've been pointing this out to clients as it has developed week-by-week, in the global forward earnings tracker we present every Monday morning in our Strategy Summary.

Change since July 6 2016 post-Brexit panic ••• Linear trend



Source: Bloomberg, TrendMacro calculations

- While this observation is evidence that rising stock markets world-wide are justified by fundamentals, it begs the question of first causes – where did those fundamentals come from?
- We think *The Economist*'s explanation of "ultra-loose monetary policy" is poppycock. We don't think global monetary policy has

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Bloomberg
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ever been "ultra-loose" – it has just mirrored the low natural rate of interest (see "Gundlach and Load" September 12, 2016) in the era of so-called "secular stagnation". *Most critically, even seemingly ultra-loose monetary policy has been decelerating or reversing for several years now everywhere in the developed world except Japan* (see, among many, "I Shall Fear No Taper" January 27, 2014). *It appears that the more monetary policy has normalized, the better the global economy has behaved.* Gosh, maybe Kevin Warsh and other Fed skeptics and reformers are right after all (see "Warsh the Reformer, Powell the Plodder" October 3, 2017).
- If not monetary policy, what then?

We think the apparently synchronized brighter tone across the global economy – and global stock markets – is the result of a synchronized re-discovery, in many parts of the world, of the social pre-conditions for growth. We have argued that this seeming synchrony of global "animal spirits" represents a generational "turning" in the global culture, at the margin, toward the devolution of power from central authorities to local authorities and to individuals (see "Make My Inauguration Day" January 23, 2017).

Let's take a quick world tour of the devolution revolution.

- **UK** The surprise decision by the UK electorate to leave the European Union was greeted with forecasts of immediate economic disaster for the UK and the world. We disagreed, seeing this as a salutary devolution of power from a central authority (Brussels) to a local authority (London) at the command of individuals (the British voters). We predicted correctly that world markets would recover quickly from the post-referendum shock, that the UK economy and markets would flourish once out from under the smothering embrace of Brussels, and that Brexit would be a wake-up call for the reformation of Europe's economic sclerosis and political opacity (see "On the Brexit Referendum" June 24, 2016).
- We think we've been right on all counts, and observe that the panic two weeks after the Brexit referendum marks the bottom for global safe-haven bond yields, the top for equity risk premia and volatility indices, and the launch-pad for the present rally in global forward earnings and stock prices.
- **France** Markets this year treated the French presidential primaries and general election as a potential crisis – but we confidently and correctly predicted that anti-euro Marine LePen could not win, and that Emmanuel Macron was more of a reformer than he was being given credit for (see "On the French Presidential Primary" April 24, 2017).
- While the world press slavishly reports Macron as a liberal globalist very much in the European mainstream, he is, in fact, an agent for exactly the devolutionary deregulatory economic policy that Donald J. Trump is catalyzing in the US. He has forced through the French legislature a robust package of politically difficult labor market reforms aimed at loosening the grip of labor unions on all but the

largest French firms, and making it less expensive for firms to terminate surplus or unsatisfactory workers.

- This echoes the epochal changes in Germany in 2003, when Chancellor Gerhard Schröder initiated the “Agenda 2010” program that turned Germany from “the sick man of Europe” into Europe’s economic powerhouse. And it echoes the reforms in Spain by conservative President Mariano Rajoy – reforms that have enabled Spain’s GDP growth to beat that of both Germany and the US in recent years. Next, Macron says he wants to abolish the French “wealth tax,” and dismantle the welfare state that he holds to be a cultural dead-end financed by future generations. Could this kind of thing have happened without Brexit as a competitive wake-up call? We don’t think so.
- **Japan** From the day that Shinzō Abe was elected prime minister more than five years ago, we predicted not only the bullish implication of “Abenomics” – though, admittedly, only its “first arrow” of monetary policy reform has actually been fired – but also the likelihood that he would drive Japan toward becoming a nuclear power (see "The Abe Restoration" May 10, 2013). We argued that his campaign promise to amend Article Nine of Japan’s constitution – forced upon it during US occupation in 1946 by General Douglas MacArthur – renouncing war and requiring that "land, sea, and air forces, as well as other war potential, will never be maintained" – would reach fruition as North Korea developed its own nuclear potential. So far there has been no actual amendment, only an official “reinterpretation” that permits Japan to participate in “collective self-defense.” While at first blush one might have thought that the heating up of North Korea’s nuclear brinksmanship this year would been devastating to Japan’s markets – especially as two North Korean ICBM’s have done overflights above Hokkaido – just the opposite has occurred. In part that’s because this external threat has catalyzed support for the militarist Abe, and allowed him to call a snap election in which he will likely prevail – giving him and his cabinet another shot at “Abenomics.” At least that keeps out the opposition who would oppose restarting Japan’s shuttered nuclear power plants.
- But that’s only the conventional interpretation. We think it’s more likely that the North Korean threat will lead to more military independence for Japan, and likely the development of its own nuclear weapons. For all the irony – and some horror – that would attend Japan as a nuclear power, it would be a form of “Jexit” as Japan exits the US nuclear umbrella, devolving military responsibility onto itself. That drives social coherency and awakens “animal spirits” in a way that usually triggers a growth spurt, just as the September 2001 terror attacks in the US did.
- **Germany** One of the most enduring bear cases of the post-Great Recession years has been the idea that German Chancellor Angela Merkel – a reliable force for globalization, a supporter of the euro currency, and the deep pocket capable of bailing out lesser European nations – would be deposed in favor of far-right isolationist extremists. After last month’s election, she is on track to begin a fourth term as chancellor, and all is well. Nevertheless it is

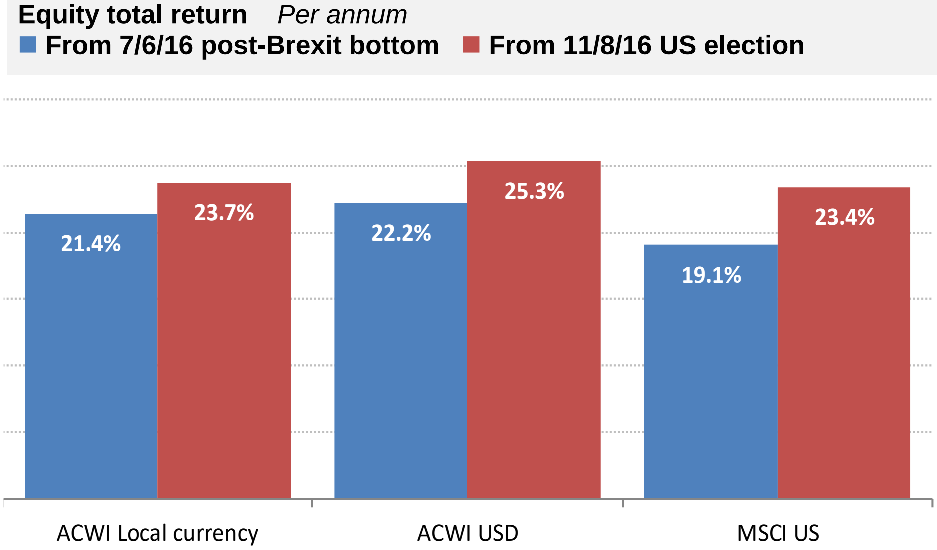
the case that 94 of the 709 seats in the Bundestag went to Alternatives for Germany (AfD), a party generally thought of as far-right, at the expense of more centrist parties.

- Don't jump to the conclusion that Nazism has reasserted itself in Germany. AfD is actually a highly diverse group – unified now, mostly, in their opposition to unlimited immigration by Muslims. AfD's leader in the Bundestag is Alice Weidel, a former Goldman Sachs economist, and a lesbian in a long-term relationship with a Swiss woman of Sri Lankan origin, with whom she has two children – hardly the skinhead with swastika tattoos that we are led to imagine. In part, she opposes unlimited Muslim immigration to Germany because of Islamic culture's illiberal attitude toward homosexuality. Her concern is more associated with left-wing politicians, and it has earned AfD the surprising support of many gays in Germany. As recently as three weeks ago Merkel was sticking with her position for unlimited asylum for Muslim refugees in Germany – but now, having to form a governing coalition with fewer potential centrist partners, she has had to agree to accepting only 200,000 per year. We believe this chain of events is very bullish for Germany and for Europe. While preserving the power of a pan-European elite capable of dealing with economic crises, that power finds itself suddenly accountable – having to devolve some power to divergent voices within the electorate. This is exactly what we expected in the wake of Brexit.
- **China** Let *The Economist* rave about the dictatorship of General Secretary Xi. The great lie about China is that it has ever been anything but that, leading to all kinds of analytical errors arising from comparing its macroeconomics to those of free nations. For example, why be concerned with excessive debt in China when it's mostly owed by one state-owned entity to another state-owned entity? China experienced a big speed-bump in 2015 when a 25% rally in the US dollar in less than a year caused the RMB – which at that point was still pegged to USD – to appreciate versus JPY, EUR, GBP and virtually every other world currency, posing a serious threat to China's export economics. While it was a consensus that China's 2015 devaluation would be systemically destabilizing, leading to uncontrollable capital flight, we said it was nothing more than smart self-defense against the too-strong USD (see "On the RMB Devaluation" August 11, 2015).
- Indeed, the 2015 devaluation proved to be the turn-around point for China's flagging economy. By devolving its currency management from the USD peg to a "reference basket" of world currencies, China has been able to expertly navigate another big move up – and another down – in the dollar (see "Our Contrarian View on the Dollar" January 5, 2017).
- **US** In the framework of this kind of general overview, what can we say about the US that we haven't already said? Clients know that we predicted the rise (see "Trumped!" December 14, 2015) and the election (see "Trump's the One" May 4, 2016) of Donald Trump. But we've been careful to always be clear that Trump himself isn't the important thing about his surprising election, and all that has come since. What's important is the generational

"turning" of the culture toward the devolution of power from the federal government to lesser jurisdictions, and to the individual – a "turning" that picked Trump not because he was ideal, but because he was the best available candidate for these purposes (see "2017: It's Bigger than The Donald" December 30, 2016).

- We know from constant contact with clients that there remains a great deal of frustration about Trump's style – and with what seems to be the difficulty of getting anything done in a Republican Congress with narrow majorities. We warned about that the day after the election, noting that while Trump had managed to pull off a surprise win (a surprise to everyone but us, at least), it was a narrow victory, he would remain a controversial figure, and the GOP lost seats in both the House and the Senate despite what is normally a "coat-tails" effect (see "Our Hot Take on the Trump Upset" November 9, 2016).
- For all that, we think there is a great deal of cognitive dissonance – some of it provoked by Trump himself, very much on purpose – that prevents our clients from seeing how much has already been accomplished (see "Drop the BAT and Run" July 31, 2017), and taking that as a token for how much can still be accomplished.
- *Again, we continue to think that tax cuts – especially a large cut in the US corporate tax rate – will happen this year,* That will be a US contribution of the devolution revolution we are seeing everywhere in the world.
- Yet here in the US, we are all so focused on Trump we assume perhaps that the US markets are on some very different trajectory than all the others. In reality, US stocks have lagged a bit on a *per annum* basis since the July 2016 post-Brexit panic bottom (please see the chart below). But since the US election, US stocks have performed substantially identically to world stocks. *What stands out to us is not just that US stocks have caught up since the election – but rather how much better all stocks have done, again per annum since the election. It's slender evidence, but it points in the direction*

Equity total return *Per annum*



Source: MSCI, TrendMacro calculations

of concluding that the "Trump effect," if any, has operated on a global basis rather than exclusively to the US.

- *It makes sense that the rising global economic tide – as nation by nation, there comes a cultural "turning" to devolution of power toward "animal spirits" – would accelerate as it comes to the large and pivotal choke point in the global economy that the US represents.*
- As we saw in the late 1970s and the early 1980s when there was a similar pro-growth global revolution, reforms take time to have effect – which means that the accelerating growth and rising stock markets that accompany them can keep accelerating and rising as one reform begets the next, and as first-order effects turn into second-order and third-order.
- Consider the effects of the cut that we expect in the US corporate tax rate. *As the consensus comes around to agreeing with us that tax cuts will in fact be enacted, there is increasing downside risk if we are wrong, and decreasing upside potential if we are right. At this point our confidence is something like 75%, and we would say on the same scale that our estimate of consensus confidence – based on conversations with clients – is something like 20%.*
- *But at the same time, we think investors systematically misunderstand – and so underestimate – the long-term economic gains arising from this kind of tax cut.*
- Clients keep asking us – and we certainly understand why they would ask – what companies or sectors will benefit the most? The usual answer has something to do with looking at companies' or sectors' exposure to US earnings and to high US taxes. Banks always get mentioned as big winners – while there would be no benefit at all for loss-making Tesla. But that would be to focus only on the first-order effect – the tax cut's impact on after-tax reported earnings.
- But when the first-order effect increases after-tax bank earnings, wouldn't that allow banks to make more loans, pay higher dividends, and do more share buybacks – and wouldn't those things lead to higher investment and consumption everywhere in the economy, and wouldn't that help Tesla sell more cars? That's a second-order effect, and it's probably bigger than the first-order effect.
- Then what happens when other countries realize that, to compete, they have to cut their own corporate tax rates? It will be like protectionism in reverse – a race-to-the-top to see who can be the most globally competitive by being the nation that most liberates its corporate sector. That's a third-order effect and it's probably bigger than the second-order effect.
- *To put it in the lingo of traditional macro-economic analysis, pro-growth economic policy has a multiplier. And in defiance of conventional economic wisdom, that multiplier is subject not to diminishing returns, but rather to increasing returns.*
- These are some of the reasons why we think that this synchronized global "bull market in everything" is far from over.

Bottom line

There's some evidence of capitulation by longstanding bears, making us ask whether we need to revise our ongoing contrarian – and correct – expectation for continued and accelerating growth and strong equity performance. We find the seeming capitulation to be mostly just more bearishness, and we see a continued unfolding of the global "turning" toward the pro-growth devolution of power from central authorities to local authorities and individuals. Brexit continues to catalyze pro-growth change throughout Europe. Macron has liberalized labor markets, and is poised to cut taxes. Merkel has had to listen to the right, and limit potentially illiberal Muslim immigration. Japan is electrified by the threat of North Korean nuclear capacity. China has learned to manage its currency without a dollar peg. And in the US, Trump's election has already accelerated global stock markets, and now points to pro-growth tax cuts with powerful second and third order effects.