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MACROCOSM

2018 Outlook: From Denial to Acceptance

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The US corporate tax cuts are not fully discounted, and will drive another good year.

We'll get to our 2018 outlook in just a moment. But first, indulge us while we make you wade through a little self-congratulation (and self-criticism) on our past year of global macro and market forecasts.

- We were never hypnotized by all the goofy stuff Wall Street was saying, after Donald Trump's surprise presidential win, about "stimulus" from "debt-financed infrastructure spending." We said that wouldn't happen, and it didn't. And we weren't worried about protectionist saber-rattling. We bet on deregulation and tax cuts, and we kept on when everyone else had given up. And we said it would drive a growth acceleration and a banner year for global equities, low volatility, and narrowing risk premia world-wide. It did.
- We said the movement to pro-growth pro-business policy would spread in Europe in the wake of Brexit, despite scare stories about right-wing populism. With Emmanuel Macron's election in France, and his labor market and immigration reforms, it did.
- We said emerging markets would outperform. They did.
- We said the US dollar would weaken. It did, a lot, and this was key for US investors to experience a truly global bull market.
- We said the Fed would move only tentatively and gradually as it observed the natural rate of interest strengthening – hiking, but not tightening. It did. We said the onset of normalization of the Fed's balance sheet would be a non-event. It was.
- We said it would be a poor year for Treasuries. Compared to equities, it was. But we are surprised that the 10-year yield is ending 2017 about unchanged, having spent most of the year lower. We are proud to have perfectly called the bottom in September at 2.01%, but we hadn't expected that drop, and we thought yields would end the year higher than they did.
- We said crude oil would hit \$65. The Brent benchmark did, and exceeded it. WTI just broke above \$60 this morning. But we said it would happen early in the year, and instead it happened near the end. We doubled-down in June when WTI fell to \$42, and we're glad we did. But because crude's highs came only late in the year, energy stocks were among the worst performers for 2017, and stagnant inflation expectations held the 10-year yield down.

Okay. We got that out of our system. Now, on to 2018.

Update to strategic view

US MACRO, US STOCKS, US BONDS, US FED, FX, OIL, EUROPE STOCKS, ASIA STOCKS, EM STOCKS: The first-order and higher-order effects of the US corporate tax cuts will be the big driver of the economy and markets in 2018. The first-order effect – a discontinuous jump in forward after-tax earnings – is already known, but only partially discounted. The higher-order supply-side effects aren't even being discussed, and the global tax-competition effects are not understood as a positive-sum game. We expect another good year for stocks, with low volatility. Growth and inflation will be higher, and the Fed will hike more than anticipated, but will not effectively tighten. Emerging markets will outperform, and China won't blow up. Oil will trade at the high end of the range. Our biggest event-risk is the mid-term election, in which the GOP loss of congressional control could reflect a diminishment of pro-growth "animal spirits."

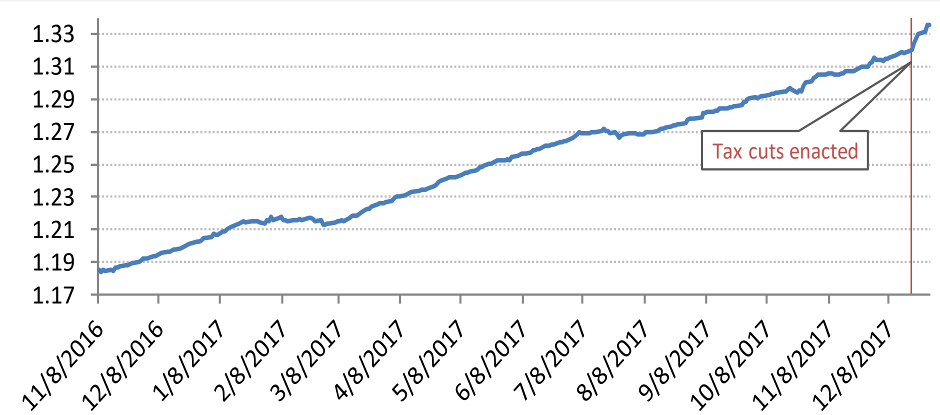
[Strategy dashboard]

Our baseline outlook is that the trends in place in 2017 will continue and evolve in 2018. That's not as obvious a viewpoint as it may seem, because the underlying dynamics of the trends in place are not obvious, and are blurred by cognitive dissonance. The global economy is stumbling toward the exits from "secular stagnation" to greater risk-tolerance and faster growth, driven by a generational "turning" that has up-welled into the economy from deep reservoirs of culture and politics. We said that at this point last year (see "2017: It's Bigger than The Donald" December 30, 2016), *and we think it is an outlook that will continue to serve us well.*

Tactically, for 2018, the great unknown is the impact of the US corporate tax cuts, and the extent to which markets have already discounted it.

- *Generally, our view is that markets have not already fully discounted it – at least not the second- and third-order effects.* After all, the consensus only came to believe that the tax cuts could even be enacted until a month or two ago. *Confusion still reigns.*
- High-earners – many of whom are influential market participants – especially in high-tax states – are in shock from the *personal* cost of the loss of the deductibility of state and local taxes.
- Meanwhile, ordinary Americans are being whipsawed – by claims by Democrats, such as Nancy Pelosi, that the tax cuts are "the wholesale robbery of the middle class," and Larry Summers, that "thousands will die as a consequence of this tax bill" – and, on the other hand, by an ad campaign paid for by the conservative Koch Brothers to highlight the tax cuts' pro-growth aspects, and moves by Boeing, AT&T, Wells Fargo and Fifth Third Bank to immediately demonstrate trickle-down benefits to workers.
- *Reality matters, but the atmospherics around the tax cuts matter too.* We know from the research of Christina D. Romer and David H. Romer that the growth consequences of changes in tax policy are influenced by the advertised purpose of such changes.
- *The first-order effect – a jump in after-tax corporate earnings – is already showing up as a visible discontinuity in consensus forward estimates* (please see the chart below).

S&P 500 forward earnings since presidential election USD trillions



Source: Bloomberg, TrendMacro calculations

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Recommended Reading

Mapping The Swamp, A Study of the Administrative State
Open The Books
December 26, 2017

The Lawyer Who Beat Big Tobacco Takes On the Opioid Industry
Esmé E Deprez and Paul Barrett
Bloomberg BusinessWeek
October 5, 2017

Analysis of US Corporate Tax Reform Proposals and their Effects for Europe and Germany
Friedrich Heinemann and Christoph Spengel
ZEW
December 11, 2017

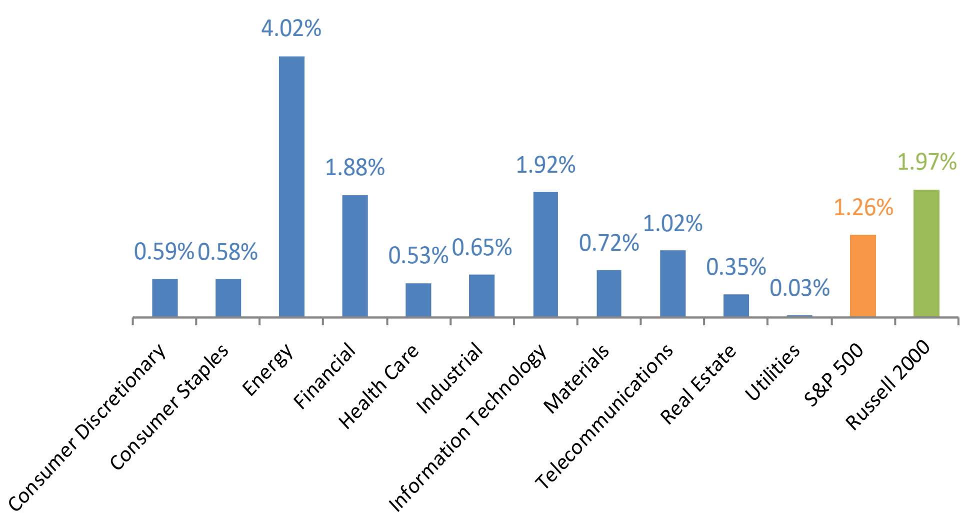
The Story Behind 'A Christmas Story'
Thomas Lipscomb
Wall Street Journal
December 22, 2017

Democrats Are Fooling Themselves About Tax Reform's Unpopularity
David Harsanyi
The Federalist
December 21, 2017

[Reading home]

- Since the December 19 enactment of the tax cuts in the Senate, S&P 500 consensus forward earnings (calculated bottom-up) have jumped $154 billion, on net, or 1.16%.
- That's an astonishing 59% per annum growth rate – just to give a sense of scale. But it won't go on all year. It's a one-time recalibration to a new lower cost-function driven by a new lower tax rate. *As a very rough approximation* (see "Tax Cuts: Smells Like Victory (For Some more than Others)" December 18, 2017), *we think overall S&P 500 forward operating earnings will be about 10% higher before very long. We've already accomplished a little more than a tenth of that in six market days.*
- *Reported* earnings will be all over the lot for a while, as companies use every trick in the book to take every loss possible at 2017's 35% marginal rate, and revalue deferred tax assets and liabilities. But forward earnings won't be much perturbed by that noise.
- So far the jump in forward earnings is visible in all sectors (please see the chart below). Don't read too much into which sectors have benefited most and least. It's still early days. *Remember, the biggest jumps will be in companies that have US earnings as the largest share of global earnings, and that have little deferred taxes on foreign earnings* (again, see "Tax Cuts: Smells Like Victory (For Some more than Others)").

Growth in forward earnings from Dec 19 enactment of tax cuts



Source: Bloomberg, TrendMacro calculations

- All this is known, or at least knowable. *So why wouldn't it already be fully discounted?*
- Who can say for sure? Maybe it is. Since the 2016 presidential election (the moment at which the market could reasonably start to discount a corporate tax cut), up to the December 19, 2017 enactment of the tax cuts, the S&P 500 forward price/earnings multiple has risen a little more than 10% – about the same as our anticipated jump in earnings. Hypothetically, we could conclude that the entire earnings jump has already been discounted by the P/E multiple. If so, as the earnings jump plays out, all else equal

stocks will stay about unchanged, and the P/E will float back down to where it started. For what it's worth, so far stocks haven't been much changed over the six market days since the tax cuts were enacted.

- But all that would be to assume that the corporate tax cuts were the one and only thing that has driven the multiple expansion since the election. Is there no "Surprise! It's not Hillary!" effect? No "animal spirits" effect? No deregulation effect? No synchronized global growth effect?
- To be sure, we don't see how markets could *not* have discounted *some portion* of the first-order effect of tax cuts on earnings – but we doubt markets have discounted it all. And so far all we've talked about is the first-order effect – what we call the demand-side channel (see "Delayed Gratification for Corporate Tax Cuts" November 20, 2017).
- There is also the supply-side channel, in which firms are liberated to pursue growth activities that weren't economic at a 35% tax rate, but are economic at a 21% tax rate (again, see "Delayed Gratification for Corporate Tax Cuts"). By its very nature, such entrepreneurial venturing is both difficult to anticipate and long-fused – and we haven't seen one word about this important dynamic in any analyses other than our own – so we doubt markets are discounting it.
- We identified another channel a couple months back, the international tax competition channel (see "Tax Reform: The Sausage Factory Moment" November 8, 2017). This idea has suddenly become well-known, with a report last week from Germany's respected Centre for European Economic Research warning that Germany would "lose out" from the US corporate tax cut. That sparked a flurry of commentary on how Europe's export-driven nations would have to cut their corporate taxes too. We call that "reverse protectionism," in which nations race to the top to see which can liberate their productive sectors more. It's hard to think of anything that would be better for global growth. But while much discussed now, it too is long-fused – and generally misunderstood as provoking counterproductive "trade tensions." So we doubt markets are discounting it.

We conclude that markets have discounted some of the first-order effects of the corporate tax cut, and pretty much none of the higher-order effects. We continue to feel that the consensus has to be dragged kicking and screaming, from denial to anger to bargaining to depression and then, finally, someday, to acceptance. The consensus was barely able to accept that the tax cuts could even be enacted, until they were; now there is no consensus that they will be good for growth; and when it is seen that they are, then everyone will worry that the Fed will tighten all the benefits away.

What do we think it means for markets and the economy, if our more optimistic view of the effects of the corporate tax cuts play out over the year, driving the consensus from denial to acceptance?

- Continued accelerating growth worldwide as the US corporate tax cuts kick in, as part of a global “turning” to greater risk-tolerance and faster growth
- Slightly higher inflation, driven by greater risk-tolerance and less savings-preference, and higher oil prices on average over the year
- Higher stock prices, driven by sharply rising earnings; volatility stays low by historical standards thanks to higher risk-tolerance, but winners and losers from the tax cuts drive greater dispersion between companies and sectors; growth broadens out to non-tech and lower-cap sectors, where the after-tax earnings shock will be greater
- This is where we are supposed to hedge by saying corrections are always possible; okay, in fact, ominously, we find ourselves spending too much time admiring the 2017 results in our personal accounts, which is never good
- Emerging markets outperform again, while China steadfastly refuses to blow up
- More Fed hikes than the two the market is discounting, but given faster growth, they will be true-ups rather than tightenings, and won’t inhibit growth; Powell will be an unimaginative and compliant chair, who will carry on the Yellen-Fischer legacy of focus on the neutral rate of interest, and in a pinch he will be the puppet of the Treasury secretary
- Higher long-term bond yields as nominal growth and inflation both improve, and safe-haven demand lessens; with a higher funds rate, higher yields don’t mean the curve will necessarily steepen
- Credit spreads stay narrow
- We don’t see any particular impact on the US dollar, but greater risk-tolerance points, if anything, to USD weakness
- Oil in the upper end of the $45 to $65 range, with possible upside overshoots
- Bitcoin will fluctuate

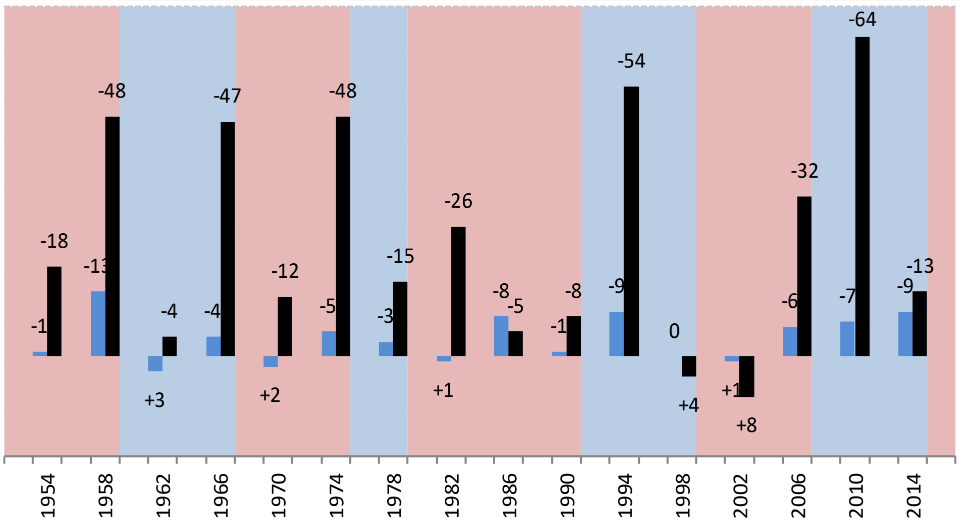
What could go wrong?

Any number of things, naturally. We all have our own lists of things that could blow up. We won’t take up your time with more analysis of things like North Korea – they’re potentially important, but they’re ongoing and well-known, and not market-moving until they suddenly are.

- We think the biggest event-risks ahead are political.
- Europe always needs watching, because of the systemic fragility of the euro currency. So we’ll have to get through Italy’s general election in March.
- And we’re going to be keeping an eye on possible US antitrust action against Amazon, Google or Facebook – a political risk that we fear both parties might find common cause in triggering.
- *But the main political event will be the mid-term elections in the US. For the “turning” toward faster growth to continue as robustly as possible, it would be counterproductive for the GOP to lose control of the House or the Senate.*

- History is not encouraging on this. Mid-terms are usually a set-back for whichever party controls the White House – but by no means every time, and by no means big enough every time for control to change, given today's current majority margins (please see the chart below).

■ Senate ■ House midterm losses, for president's party ■ GOP ■ Dem



Source: House, Senate, TrendMacro calculations

- But the Senate electoral map is set up for GOP gains. There are only eight GOP senators standing for re-election in 2018, versus 26 Democrats (ten of whom are in states that Trump carried in 2016). We see the Roy Moore debacle in Alabama as a special case (indeed, the sex-scandal frenzy that brought down Republican Moore has put Democrat Al Franken's seat in play in Minnesota).
- As to the House, the Democrats could win all 23 GOP seats in districts carried by Clinton in 2016, and still miss winning control by one. And so far, the GOP has won five out of five special elections in the House.
- *The constant drum-beat about a Democratic "wave" in 2018 is just part of the media's conflict-driven business model – every election has to be a heavyweight match, and every match has to be the bout of the century. Don't believe it simply because it's titillating.*
- Okay, but – what if? The consequence of the GOP losing one or both chambers – that is, the resultant difficulty of continuing with pro-growth policy either by legislation or by appointments to courts and regulatory agencies – is obvious. *But President Barack Obama was able to carry out, to some extent, what we believe was effectively an anti-growth agenda despite a GOP congress, so Trump's pro-growth agenda would not be entirely stymied by a Democratic congress.*
- For us, the larger concern would be what the GOP's loss of congressional control would say about diminished "animal spirits" of the economy – an economy made up of voters who, in 2016, were risk-tolerant enough to roll the dice on Donald Trump in order to kick-start growth and pull out of "secular stagnation."

- That's not exactly a black swan. Yet from here that's what worries us the most. But if our expectations for faster growth are fulfilled, then we doubt such worries will come to pass.
- It is a political strategy for Democrats now to foment self-fulfilling negative prophecies about the tax cuts in order to fertilize the ground for the mid-terms. But if the GOP wins the messaging war on the tax cuts – or if the sheer reality of them carries the day, no matter the two sides' persuasion efforts – then growth will prove to be the self-fulfilling prophecy, and a GOP that retains congressional control because of growth will have learned that the public wants more growth.

Bottom line

The first-order and higher-order effects of the US corporate tax cuts will be the big driver of the economy and markets in 2018. The first-order effect – a discontinuous jump in forward after-tax earnings – is already known, but only partially discounted. The higher-order supply-side effects aren't even being discussed, and the global tax-competition effects are not understood as a positive-sum game. We expect another good year for stocks, with low volatility. Growth and inflation will be higher, and the Fed will hike more than anticipated, but will not effectively tighten. Emerging markets will outperform, and China won't blow up. Oil will trade at the high end of the range. Our biggest event-risk is the mid-term election, in which the GOP loss of congressional control could reflect a diminishment of pro-growth "animal spirits."