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MACROCOSM

A Trump Correction at Last?

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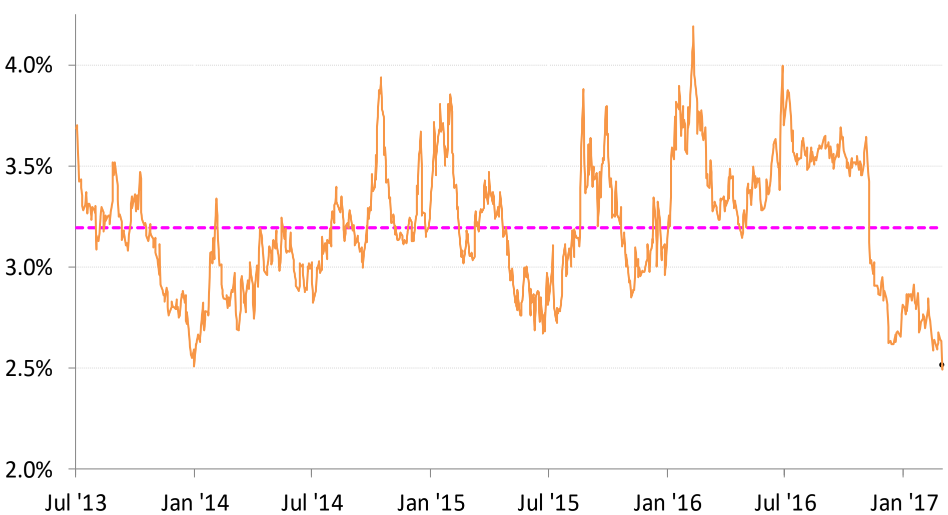
Two warning signs we've been waiting for materialized all at once. Then, a third one.

Attempts to call a correction in the bull move that began in November on election night have been fruitless. There haven't even been any dips to buy (see "From Executive Orders to Spontaneous Order" February 17, 2017).

- *As bullish as we have been all along, we've always held the mental reservation that there would be two signs to look for that could indicate the onset of the inevitable correction. We are obliged to report that they both occurred within 24 hours of each other this week.*
- *First, in the rally following President Trump's joint session address the equity risk premium on Wednesday narrowed to its lowest level since the end of the financial crisis, surpassing the low market on December 31, 2013* (please see the chart below).
- *Second, with that same address, Donald J. Trump has started to act more presidential.*
- *And a third element – one that we hadn't particularly been looking for – is a new sense of bullishness we are detecting in conversations with investors, suddenly replacing months of skepticism. Does this imply some degree of capitulation?*

S&P 500 equity risk premium ··· **Post-financial crisis mean**



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US STOCKS: Three key indicators of an inevitable correction are suddenly in place. The S&P 500 equity risk premium has made new post-crisis lows, Trump is acting "more presidential," and we are detecting a strong shift away from months of skepticism toward a hint of capitulation. The ERP is mean-reverting to be sure, but the new lows don't necessitate a strong correction as the mean itself is highly likely moving lower. Trump's possible re-branding toward a gentler style – shifting away from an abrasive persona that has worked very well for him – is a risky move that may or may not work for him. We are very bullish, so we can't criticize investors who suddenly agree with us – but short-term, such shifts in sentiment tend to be punished.

[Strategy dashboard]

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The equity risk premium – we define it as the forward earnings-yield of the S&P 500 minus the 30-year Treasury yield – is a reliably mean-reverting series. It can be very useful for contrarian tactical asset allocation decisions when it is at extremes. But the art of it is to detect when an extreme is truly extreme. Unfortunately, what seems extreme can get more extreme still. We need to know what the mean is that it is supposed to be reverted to – a function both of how much past data to include in the calculation in the first place, and then the stationarity of that mean into the future, however it is calculated. Unfortunately, means are non-stationary at critical strategic junctures.

- *In a strictly tactical framework, the break to new lows in the equity risk premium calls for a dip in the stock market.* But there is no law saying it has to come precisely now or be especially notable, just because new lows by a few basis points have been achieved. For what it's worth, following the December 31, 2013 ERP bottom at a similar level, the S&P plateaued for a month and then corrected a mere 6%.
- Our overarching strategic view argues against a severe correction now. Indeed, we think we are at one of those critical strategic junctures at which means become non-stationary, in this case one in which global risk-preferences are becoming more tolerant. That explains why, when there is so much apparent "chaos" in the news, market volatility has fallen and risk-spreads of all kinds – including the equity risk premium – have narrowed (again, see "From Executive Orders to Spontaneous Order").
- *So we fully expect the mean equity risk premium to shift lower – secularly so. That necessarily implies that we also fully expect the equity risk premium to go lower than the supposed extreme at which we now find it – over time, we think a lot lower.*

Much more qualitatively, it worries us that Trump's joint session address was universally perceived as a maturation to "more presidential" demeanor. *More worrying to us: he has pretty much stopped tweeting.* Only one in the two days after the address, very bland. We got some encouragement this morning, seeing a four-tweet series tweeted around midnight in defense of Attorney General Jeff Sessions, and one this morning calling Democrats "pathetic."

- We have taken the contrarian view that Trump's rambunctious style has been a deliberate and effective "maximax" game-theory strategy designed to exploit his seeming mandate as Tribune of the People (see "Make My Inauguration Day" January 23, 2017). It has been in synch with the global mood of liberated "animal spirits" (see "2017: It's Bigger than The Donald" December 30, 2016).
- In part, it has served to goad his opponents into unseemly attacks against him and his supporters that serve to unify and strengthen them by repeating Hillary Clinton's lethal "deplorables" blunder.
- Far be it from us to pre-judge what may be an effective tactical shift by this master manipulator who, even with a gentler tone, effectively got sulking Democrats in Tuesday's joint session to

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repeat that blunder yet again (see "Joint Session Overshadows FOMC Session" March 1, 2017).

- But it doesn't comfort us when, two days later, his media arch-nemesis, the *New York Times*, runs a front-page story headlined, "In Speech, Trump Tests a New Tactic: Toning It Down" – which we read as encouraging him to do more of it. It's generally not a good idea to do what your enemy is encouraging you to do.
- We are very aware from talking to clients about this every day for months that Trump's abrasive style is widely seen as self-defeating. We have not agreed, observing that this is the style that got him elected against all odds – and arguing that changing it now would be like Samson letting Delilah cut his hair. Let's not take this Biblical reference too far, especially as it concerns the jawbone of an ass.
- If nothing else, his controversial style was an attention-getting misdirection in Trump's magic show. Without it, the world will be more able to focus on the not-very-magical realities of what's happening onstage, including difficult congressional policy processes around Obamacare and tax reform.
- On the latter, we not that the border-adjustment tax idea seems to be enjoying a bit of a moment. We still think it stands no chance in the Senate. But as it is currently proposed, it is a very dangerous idea (see "For Free Traders, Trump's Corporate Tax Cut Is the Better Way" January 18, 2017) – and if it happens, we would have to pull back some of our optimism.
- Let us just say that if indeed this is an exercise in "re-branding" for Trump, such things are – as Coca Cola learned with "New Coke" – inherently risky schemes. *Markets buoyed for months by an abrasive yet ascendant President Trump may pause to take the measure of a new kinder-and-gentler brand-strategy, if that is indeed what this turns out to be.*

Finally – and even more qualitatively – we must report that we have begun to hear a lot of deep bullish conviction in investor conversations all of a sudden. To be clear, we don't mean in the slightest to be critical of these investors, some of whom are treasured clients and all of whom are great investment minds. Indeed, we have a lot of bullish conviction ourselves, so how critical can we be?

- We merely mean to humbly point out that, for months, our bullishness has crashed up against a wall of worry – while stocks just kept melting up.
- *Now, suddenly, the equity risk premium is at post-crisis lows – yet skepticism about seemingly high valuations has vanished.*
- *Now, suddenly, Trump takes a risky turn toward a new brand-image that may or may not synch up with rising animal spirits – that is, stops doing what works – and suddenly he is widely regarded as finally doing the right thing.*
- *This has about it, ever so slightly, a whiff of capitulation, which markets tend to punish.*

We’re not trying to make a big deal out of any of this, or pound the table particularly. But a correction – a buyable dip, if not “a necessary end” – “will come when it will come.” Maybe now.

Bottom line

Three key indicators of an inevitable correction are suddenly in place. The S&P 500 equity risk premium has made new post-crisis lows, Trump is acting “more presidential,” and we are detecting a strong shift away from months of skepticism toward a hint of capitulation. The ERP is mean-reverting to be sure, but the new lows don’t necessitate a strong correction as the mean itself is highly likely moving lower. Trump’s possible re-branding toward a gentler style – shifting away from an abrasive persona that has worked very well for him – is a risky move that may or may not work for him. We are very bullish, so we can’t criticize investors who suddenly agree with us – but short-term, such shifts in sentiment tend to be punished.