ARJUNA CAPITAL

ENLIGHTENED INVESTING

MARKET OUTLOOK

January 2018 / 1st Quarter

By most economic measures, things are about as good as they get—without spurring inflation. This is textbook behavior in the late stages of an economic expansion when inflation poses the key risk to a Goldilocks environment.

A STELLAR YEAR

2017 proved a stellar year in the stock markets, with the S&P 500 returning 21.83% for the year. Foreign markets were even stronger with the EAFE index (developed foreign markets) gaining 25.03%.

Those overall return numbers tell the tale of 2017 in the stock markets. You'll note that foreign returns were higher than US returns. That's, in part, because at the start of 2017, the US economy was very sluggish, with first quarter GDP growing just 1.2%. With the US economy running slow, most global forecasts expected the Eurozone and Japan to follow suit, as their economies are heavy exporters to the US.

But then a funny thing happened: Economies in the Eurozone and Japan accelerated, decoupling from a sluggish US economy—a highly unusual occurrence. Stronger economic prospects abroad naturally led to stronger stock markets abroad as well.

That foreign strength, however, fed back into the US economy and markets by way of the US export sector, which accounts for about 12% of the overall US economy. More notably, foreign revenues account for around 40% of the total revenues earned by companies in the S&P 500. So, to a greater extent than the US economy, the US stock market benefited from the acceleration in foreign economies.

As the year progressed, the US economy strengthened and by the third quarter was steaming along at a robust 3.2% pace. The stock market was also climbing, partly in response to strengthening economic prospects but also in anticipation of corporate tax reform being delivered by Congress.

While we strongly disagree—politically and economically—with the individual-tax side of the Republicans' tax legislation, there's little doubt its corporate-tax aspects will stimulate the US economy in the medium term and widen US corporate profit margins. Both are good for the US stock market.

AND THE ECONOMY?

Lowering corporate tax rates means widening after-tax profit margins, which means more profit per dollar of revenues. And profit growth drives stock prices.

Were the only benefits of cutting corporate tax rates simply a boost in corporate profit margins, you wouldn't expect that to have ongoing benefits for investors. You'd expect a one-time upward adjustment in stock prices to reflect a new, higher baseline of corporate profitability and that would be the end of it.

But Republicans argue that won't be the end of it and we agree. First, profit growth drives corporate spending. As companies become more profitable, they feel more able to expand their operations to pursue further opportunities. And that means increased spending on new capital equipment and/or hiring new employees.

Second and more obscurely, the new tax legislation creates a window of time during which companies can fully expense capital investments in the year they're purchased, rather than depreciating them over time. This effectively makes them cheaper sooner. And that incentivizes corporate spending on capital equipment while the window is open (fully open for five years).

So, the impact of the corporate tax reform on the US economy should be twofold: greater hiring and increased capital spending. Together, these twin boosters should spur the US economy in 2018.

Combine that with the strength in Japan and the Eurozone, and steady growth in emerging economies, and you get a picture of a synchronized global expansion.

GOLDILOCKS REDUX

The last time we enjoyed a synchronized global expansion with low inflation and low interest rates was the 1990s. And that was a very good time for stocks. Indeed, solid growth with low inflation and low interest rates are the Goldilocks trifecta when it comes to equities: not too hot, not too cold, just right.

Why? Because bull markets don't die of old age. They typically die because central banks—e.g., the Federal Reserve—raise interest rates to quell rising inflation produced by an overheating economy. This puts the brakes on the economy and the stock market. Absent inflation, however, the Fed has little incentive to aggressively raise rates and this allows stocks to climb further, as happened in the late '90s.

This time around the picture is a bit more complicated. Following the Great Recession, the Fed held short-term interest rates near 0% for seven years—an extreme measure taken in response to extreme conditions. As manipulating short-term interest rates is the Fed's chief tool for managing the US economy, with rates at 0% the Fed can't do much should the economy weaken. And, so, the Fed has been eager to "normalize" monetary policy as soon as possible by raising short-term rates to get that tool back in its toolkit, if you will. And this despite inflation being quite tame.

Consequently, the Fed has been very cautious in raising short rates and transparent in broadcasting its policy intentions—the idea being to raise rates slowly and with enough warning to avoid creating a drag on the economy. So far, it's working.

ON THE HORIZON

The fly in the ointment here is that the tax legislation will deliver a booster shot of fiscal stimulus at a point in the business cycle where the economy is already operating near capacity. Leading indicators of the economy are about as positive as they get. Confidence gauges from consumers to CEOs are at historic highs. The US unemployment rate stands at 4.1%, the lowest level in 17 years. Projections have it falling to 3.5% later this year—its lowest level in 49 years.

The point here is that by most economic measures, things are about as good as they get—without spurring inflation. For example, while fatter corporate profits ordinarily lead to greater hiring, when the economy is near full employment the demand for labor may rise but the supply of labor can't keep up. That eventually spells wage inflation. And wage inflation is typically a harbinger of more general inflation to come.

This is textbook behavior in the late stages of an economic expansion and poses the key risk to the current Goldilocks environment.

TIMING

As inflation is the culprit in this tale, it's encouraging to see that, so far, core inflation at 1.7% is running below the Fed's stated target of 2%. A certain amount of inflation is a good thing and since the Great Recession the Fed has been more worried about ***de***flation in a struggling global economy. So, the Fed wants a bit more inflation, which means the economy has a ways to run before the Fed starts worrying.

As noted above, wage inflation is typically the precursor to the more general and worrisome core inflation, and it leads the latter by about a year. As wage growth so far remains healthy yet contained, we're guessing that any sort of troublesome core inflation—the kind that worries the Fed—is at least a year out.

That said, the stock market prices future outcomes, generally forecasting about six to twelve months forward. So, it's safe to assume that contained inflation in the first half of 2018 is already baked into the cake, as it were, of current stock prices.

The questions then become: When does troublesome core inflation raise its ugly head? And how far beyond the stock market's current forecast window does this occur? The answers to those questions, which we'll know only in hindsight, would tell us how far stocks have yet to run.

For now, our view is that Goldilocks is alive and well and the coast is clear. But we're scanning the horizon for signs of trouble.

One final note: The US stock market has now gone a record number of days without a pullback of 5%. So, that's overdue. This, in itself, wouldn't affect our outlook and, indeed, would be welcome to calm the animal spirits currently animating markets.

Farnum Brown, Chief Strategist