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Quarterly Outlook Q2 2017

Overview

Although the first quarter of 2017 seemed to be a volatile one, most of that volatility played out in the political arena, rather than in the financial one. The mainstream media is all aflutter with the Trump presidency. It is not business as usual in Washington. The mainstream media is a bit bent out of shape and sees (and is reporting on) a forecasted disaster lurking behind every tree.

The financial markets were a bit calmer. In fact, there was a 64 day stretch in the first quarter without the market suffering a 1% decline. Since 1962, the next longest trading period without a 1% decline was 34 days in 1995. The fact is that significant movements of more than 1% up or down are common and, by themselves, they are not really that significant. (Not that there is any veracity to time-based projections, but forward returns are generally good following periods of low volatility.) That said, the average year since 1928 has seen 29 trading days with declines of more than 1% and 31 trading days with an advance of more than 1%. That is a total of 60 trading days with greater than a 1% movement, or better than one day a week. We just went 64 days without a 1% setback. So the message from the financial markets is "relax". The media is bouncing off the walls, but the financial markets are not.

In fact, the S&P500 is up about 6% for the year including dividends. Somewhat surprisingly, the S&P earnings improved 4.9% Y/Y in Q4, 2016, basically in line with the gain in the index in Q1, 2017. The consensus earnings gain for 2017 for the S&P500 is 9.0%. On a quarterly basis, there is no guaranteed correlation between earnings and prices, but they do tend to follow each other longer term.

Economic Outlook

The domestic economy is reasonably good. By classical measures of the economy, it has achieved both "full employment" as well as "price stability". Full employment means a headline unemployment rate under 5%. Price stability means a headline inflation rate between 1.5 and 2%. Both these goals have been achieved. To attempt to prevent overheating, the Fed has begun raising interest rates. At their latest meeting, they implemented another 0.25% increase in the very short term Federal Funds Rate. This rate increase followed a similar increase in December and puts the target rate at 0.75% to 1.0%. It is widely expected that there will be two more increases in the short term peg later this year.

These increases in the Federal Funds rate are very small and the rate itself is very low, compared to anything historically. We do not foresee any possibility of the increases triggering a recession in the next 12 months. In fact, we believe the probable error in the business cycle will be to overshoot a sustainable growth scenario near term leading to a possible recession in 2020, and possibly sooner depending on how quickly the Fed raises rates. The overshoot will be evidenced by inflation surpassing the 2% Fed target later this year. It will be difficult to keep the lid on inflation once the genie gets out of the bottle and we could easily see 3% inflation long before 2020. We do not, however, see inflation reaching the levels seen in the 1970's and early 1980's where it often exceeded 7%, as those were led by rapidly rising oil prices - something we don't expect with today's ample energy supply.

The shape of the yield curve is more indicative of a looming recession than is the actual rate level. A yield curve with higher short-term rates than long rates (or even about similar rates) can lead to a significant economic slowdown if not outright recession. In spite of two raises in the Federal Funds Rate since December, the shape of the curve is virtually identical. On March 30, 2016, the 1 month rate on Treasury bills was 0.14%. The rate on 10 year Notes was 1.83% - a spread of 1.69%. On March 30, 2017, the 1 month rate was 0.75% and the 10 year rate was 2.42% - a spread of 1.67%.

We expect at least two more small increases in the Federal funds rate this year, putting the range from 1.25% to 1.5%. We expect nearly a similar rise in the 10 year rate to almost 3.0% or a little less than 1% over the general price inflation we should be seeing at that time.

Corporate Earnings up 9%

In Q1, 2017, the consensus forecast for S&P 500 earnings is a 9% gain year over year. The forecast was for a 12.3% gain on December 31, 2016, but a 9% gain is still quite good, considering what should be a 3% gain in domestic (real) GDP.

As discussed in the January economic outlook, a substantial portion of the S&P 500 earnings recovery will transpire from energy companies. In 2014, the price of the West Texas Intermediate (WTI) benchmark was well over $100 per barrel. Then it began to fall, reaching about $25 in February 2016. Earnings from the energy sector fell precipitously during the same period. The price average for WTI in 2016 was about $37. WTI pricing early in the year was about $52 and has since slipped back a bit, but has hovered around $50– still substantially over the 2016 average. Drilling costs, particularly in the US over the period from 2014 to the present have fallen considerably, so oil company profitability at a $50 per barrel price is relatively good and way better than at an average price of $37. Saudi Arabia and OPEC have held to their reduced output agreement, which is supporting the price of oil at the $50 level. Saudi Arabia is also in the process of initiating an IPO and NYSE listing for Saudi Aramco, its state owned energy company. Clearly, Aramco is worth a lot more with oil at $50 per barrel than with oil at $25 per barrel. Granted, Aramco can make money at both levels, but you would want the higher price level to prevail at the time of an IPO. So, there is every incentive for Saudi Arabia to continue to restrain supply to keep the price of oil up to $50 per barrel. With oil at $50 per barrel, the earnings increment from the energy industry is virtually guaranteed.

Markets up 9%?

Of course, an increase of 9% for the markets for the year is possible, but if it is up that much, it will be driven by something other than improved corporate earnings. The plus from the energy sector is well known and we believe it is already built into today's price levels. Our forecast for the US stock market at the beginning of the year was for an overall increase for the year that about equals that of Q1. Given the underlying driver of better profits, the market would see little change from now to the end of the year. Overall, treading water for the balance of the year would be our best guess.

Portfolio positioning is a bit different from a baseline market forecast. We see virtually no chance of a domestic recession for the next 18 months. We also see a possible rally due to forces beyond the profitability drivers noted above. Little downside plus some probability of upside calls for a normal portfolio positioning for equities. Just how your individual portfolio is positioned will be a factor of your financial goals and risk profile.

International Markets

We are looking beyond the domestic economy and equity markets. In the broader picture, we see improved economic activity in Europe, some pick-up in Japan, good growth in China (on what is now a large economic base) and general improvement in the emerging markets group as a good portion of their economies depends directly on their exports of raw materials to China. Valuations presently are notably less for foreign markets compared to the US stock market, and this is particularly true of emerging markets. During the year, we expect to see additional stock and fund allocations to the non-domestic markets and there likely will be some shifts in your individual portfolios to reflect this thinking.

Quick Look at Taxes

There is much talk about Tax "Reform" in the US. Much of this talk includes something called a "Border Tax" which would be collected on imported goods. The money collected through the Border Tax would offset the money not collected by a reduction in corporate income taxes. Is this really a restraint of trade as it is called by many nations? To answer that question, we must look at the overall tax structure of the US and the other nations of the world.

There are about 200 countries in the world. About 160 of these collect a substantial portion of their national budget through what is called a Value Added Tax or VAT. In Germany and France, for instance, the VAT is about 20%. The US has no VAT. However, most states charge the end consumer a sales tax of about 5%. To make sure that the end price to a consumer is the same for imported and domestically produced goods, countries with a VAT exempt the tax on exports, but charge the full VAT for imported goods. This practice may seem a bit unfair, but when you work through all the numbers, for a country that charges the VAT, exempting that tax on exported goods and charging the VAT on imported goods does have the "desired" effect of making the end price to the consumer the same whether a good is produced within the country that charges the VAT or the good is imported, assuming the cost to manufacture that good is the same in both countries. So when looking at just the impact of the VAT, everything seems "fair" and no one country has an advantage. (For a detailed explanation of how the VAT works, Google "Value Added Tax, Wikipedia" and look at the section entitled "Imports and Exports".)

However, just a bit below the surface, there does lurk another dimension. With a VAT in place, the national government has a substantial source of income. In Germany and France, that source of income is about 20% of the GDP. On the other hand, the US sales tax gives the states about 5% of the GDP as income, but the US federal government has no source of VAT income. So the US federal government charges corporations a rather hefty corporate income tax. State governments also get in on the act, resulting in a top corporate income tax rate of about 40%. This is one of the highest tax rates on corporate profits in the world, exceeded only by a few small countries, like Chad. For comparison, the top corporate income tax rate in Germany and France is just 29% - substantially less than a 40% rate here in the States.

We think you can now see the rub. With a VAT, the consumer price of a good is the same regardless of the country of manufacture, but the government has collected 20% already and can afford to keep corporate income taxes low. The US cannot afford a low corporate income tax rate, since the corporate income tax is a primary source of income. As a net result of the tax structures, the consumer pays the same price for domestic and imported goods, but the US corporation pays a substantially higher income tax.

You will need to figure out what you think is "fair" to the US corporations but the result of high domestic income tax is fairly predictable. That result is having the US corporations go overseas with their productive resources, sell their goods at a competitive price and pay lower corporate taxes in foreign countries. Then, those corporations choose not bring the profits back to the US where they face a substantial income tax. To do anything else, the corporations would not be upholding the best interest of their shareholders.

Our trading partners will also have to figure out what is "unfair". There is much talk about repercussions to a "Border Tax". But we will need to leave the conjecture and posturing to the media and to the politicians. We can be certain, however, that changes to the income tax system in the US will engender tremendous political posturing, particularly from those who will wind up paying more than they do today. Any change to the tax system will certainly leave some parties aggrieved.

Watching China

There are three issues facing China that bear watching. None of these have emerged as problematic due to the strict management of the economy in that country. However, any of the three could become very troublesome.

1) First is the $9 trillion in quasi backed government deposits in less than risk free bank investments. Chinese depositors regard their bank deposits as backed by the central government, although they are not formally backed. The quality of the banks is not sufficient to consider their loan portfolios to be "risk free". About $9 trillion of funds are so invested, so there is a potential to get out of hand here. The government has taken steps to alert customers that these deposits are subject to risk and are not backed by the government. At the same time, the government is strongly encouraging banks to upgrade their loan quality. So far, the balance is being maintained.
2) The overall housing vacancy rate is now about 15%. There are pockets of demand where supply lags behind demand, but that is not the case overall. In areas with high demand and low supply, such as in Beijing, housing is extremely expensive, so much so that young Chinese are leaving the country and are considering not moving back home because they could never be able to afford to purchase living quarters. In other parts of the country, there is an overhang of unsold units with construction continuing. There is a movement to rebalance the housing stock, but there is a potential problem in this area that could be similar to our housing/financial crisis that started back in 2007.

3) The wealth to poverty ratio in China roughly equals that of the US. In both countries the top 1% of the population owns about one-third of the wealth. The wealth inequality in the US was one of the driving forces to the populist tilt of the last election. There is the potential for political upheaval in China for a similar reason. However, very much in contrast to the situation here in the US, in China the bottom 20% of the population has seen its income rising dramatically over the past two decades. So unlike the situation in this country, the wealth equality in China does not seem to be a driver for political change. The situation does, however bear watching.

Conclusion

We remain encouraged by both the economy as well as by the markets. Corporate earnings are up so far this year and we see an increase of 9%. The S&P 500, including dividends, is up over 6% so far for the year. We would not be surprised to see a 6% total increase in the S&P 500 for the year, which would indicate a flat overall market for the balance of the year. At the same time, the consensus earnings forecast is up 9% and an earnings increase from energy companies is virtually assured. So there is some upside potential beyond a flat forecast for the balance of the year.

Even though we do not see an economic downturn either domestically or internationally, a correction in the stock market at most anytime is always a possibility so that would not surprise us either. In any event, we conclude by saying that there is way more political turmoil than there is economic turmoil so our overall recommendation is to stay the course and we will continue to monitor the domestic and the international markets, as well as the economic picture in both places.

As always, we thank you for being clients and appreciate your continued support.