Monthly Outlook for January 2018: "Turning the page…"

"After midnight, we gonna let it all hang down. After midnight, we gonna chugalug and shout. Gonna stimulate some action. We gonna get some satisfaction. We gonna find out what it is all about. After midnight, we gonna let it all hang down…"
(Eric Clapton, CBE, British Rock and Blues Singer, Songwriter and Guitarist, born March 30, 1945).

These lyrics always remind me of what my mother used to say to me when I was a teenager: ***"Nothing good ever happens after Midnight, young man!"*** True to form, battling Democrats and Republicans in Congress decided to let the US Federal Government shutdown after midnight on Saturday, January 20th - as they could not agree on a spending bill. Congress agreed to, and did pass, a short-term spending extension until early February late on Monday, January 22nd, effectively providing a few days of paid vacation time to Federal Government employees.

Congress busily engaged in a ***"blame game,"*** and discovered that the American populace might actually get used to the idea of not needing a Federal Government at all! Regardless of one's opinions on the size of the Federal Government (yes, we believe it is way too bloated and large!), it comes as no surprise to us that financial markets ***completely ignored*** the goings on in Washington D.C. and rose with aplomb.

Now that the Holidays are over (and we try to remain faithful to our New Year Resolutions), equity markets rang in the New Year with a fresh batch of record highs. Indeed, ***2017 was perfect***: It was the first ever year where the S&P 500 index did not see a single down month! Since a predecessor to the S&P 500 was first published in 1923, we have never had a calendar year in which all twelve months posted a positive return!

The US economy added ***148,000 jobs*** during December. Private sector payrolls added 252k jobs. Among sectors, Construction (+30k), Leisure & Hospitality (+29k), and Manufacturing (+25k),) led the way, while Trade, transportation, and utilities (-10k), Mining and Logging (0k), and Financial Activities (+6k) lagged. December's job gains were below the twelve-month average of 171.25k jobs per month and well below the peak gain of 260.75k per month witnessed for the twelve months ending in February 2015.

The politically sensitive ***unemployment rate*** stayed at ***4.1%.*** The ***U-6 measure of underemployment*** (in our opinion, a more realistic picture of the labor market as it takes into account disaffected workers as well) rose one-tenths to ***8.1%.*** A closely watched wage inflation indicator, average hourly earnings rose 0.3% (m/m; y/y: 2.5%). A similar measure of average weekly earnings also rose 0.3% (m/m; y/y: 2.80%) for the period.

The Bureau of Economic Analysis of the Department of Commerce pegged ***GDP growth for 4Q2017 at a slightly slower 2.6%*** (Seasonally Adjusted Annual Rate), down from 3Q2017's pace of 3.2% (also SAAR). Personal Consumption Expenditures (the vaunted strength in the US economy) rose 3.8%, gross private domestic investment increased 3.6%, exports gained 6.9% while imports rose a whopping 13.9% and government expenditures also rose 3.0% (all SAAR).

It appears that the US economy might finally be ***accelerating***, spurred on by the ***tax cuts passed by Congress*** in late December 2017. The lifting of regulatory burdens might also be responsible: Corporations now have an incentive to increase spending on plant and equipment given changes in the tax legislation and pent-up demand for new equipment (especially as more robots are used in manufacturing) are all positive for the economy.

Another highlight of tax reform is the ***repatriation tax*** which provides incentives to US companies that do business abroad to bring their profits back at a much lower tax rate. Recent headlines about the amount of money moving back into the US are not as important because most multinational corporations' monies are already in dollar denominated markets. How companies choose to spend the monies they bring back will likely determine the true benefits for the economy. The shift from a global to a territorial tax system forces multinational companies to clean up their balance sheets in terms of inter-company loans.

A ***territorial tax system*** ought to favor manufacturing and financial industries as well as small and medium-sized businesses. With simplification of the tax code, we expect small and mid-capitalization companies to outperform. Furthermore, the reduction in stifling regulations put in place by previous business unfriendly Administrations, also tends to spur growth and allows business owners to pay their workers higher wages as well. The string of bonus and salary increases from companies like AT&T, Apple and Walmart does make even a skeptic like us take notice!

Equity markets continue to ***make merry at a pace that worries us:*** Indeed, the Dow Jones Industrial Average (yes, a mere price weighted index of 30 stocks) has risen over 2000 points in the shortest number of days and the move from 25,000 to 26,000 occurred in a mere seven trading days (the fastest such pace!). Clearly, the bulls are out and about and equity markets appear to be in a "blow-off" phase – rising on both good news (of which there has been plenty) and bad news (of which there has been a little).

Interest rates have also risen – displaying greater volatility this year than we have seen in quite a while. With the ten year US Treasury poised at a ***yield of 2.71%,*** we suspect that higher interest rates might indeed be the story of 2018. While market participants believe that the FOMC will likely raise interest rates three times this year, our fear is that given the stronger GDP growth and deteriorating inflation, the FOMC might need to be more vigilant and raise rates four times in 2018. In addition, all of the rate hikes currently priced in are for 25bp a piece – a 50bp increase thrown in for good measure could easily create a witches brew for markets.

The ***US Dollar*** for its part has ***declined ominously***, particularly after statements attributed to Treasury Secretary Steven Mnuchin in Davos, Switzerland, where is he is reputed to have said that a "weaker US Dollar is good for the US". While this statement is partially true, we worry about the longer term implications of a weakening currency – that too for a country that has consistently run large ***current account deficits*** (expecting the rest of the world to continue to finance our profligate consumption!)

Corporate earnings for 4Q2017 have come in better than expected: With about 133 companies of the S&P500 having reported earnings so far (=26.6% of the total), the average market capitalization weighted earnings gain has been 14.1%. Of these, 113 (or 85%) have announced earnings increases relative to the same quarter last year, 15 (or 11%) have had earnings declines and 4 have had the same level of earnings. Also, 103 (= 77.4%) companies have reported earnings that have beaten consensus expectations – a high percentage.

From a portfolio standpoint, we have ***taken profits in your energy holdings*** ("XLE") – selling a third of the current position – since energy might finally be coming out of its shell (no pun intended!). We still believe that given the higher demand for crude oil and natural gas, fundamentals do augur well for continued outperformance. We just felt it was prudent to trim the size of the holdings given the better performance we have seen in this sector since we first put the position on almost two full years ago. We have deployed the proceeds from the sale into emerging market equities – adding to the existing position there.

In conclusion, we believe financial markets are likely ***to continue their merry making*** despite the ***"blow-off"*** (and perhaps unsustainable) nature of the increase this year. While the list of worries is legion, like rising interest rates, a flattening yield curve and global policy tightening (as the European Central Bank and the Bank of Japan start to tighten later this year), fundamentals and technicals (including momentum and sentiment - "one of the most hated bull markets") do point to ***further gains ahead***.

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