MORNING BRIEFING
March 9, 2017

Guns & Butter

See the collection of the individual charts linked below.

(1) Entrepreneurial vs. crony capitalism. (2) Capitalism vs. corruption. (3) Adam Smith's huge marketing mistake. (4) Are capitalists selfish or just insecure? (5) The customer is always right. (6) The butcher, the brewer, and the baker all faced cut-throat competition, until they joined a trade association. (7) Small business owners create jobs, not Washington's politicians. (8) ADP data tell all. (9) Republican plans on spending and taxes add up to guns-and-butter. (10) Jackie discusses defense with Rick Whittington.

US Economy: Make Small Businesses Great Again! My favorite show on TV is "Shark Tank." It is all about "entrepreneurial" capitalism. I add the adjective to distinguish it from "crony" capitalism, which isn't capitalism at all but rather corruption. It has long been my view that there are only two alternative economic systems, namely capitalism and corruption. Sadly, capitalism has gotten a bad rap ever since 1776. Perversely, that's when Adam Smith, the great proponent of capitalism, published *The Wealth of Nations*. He made a huge mistake when he argued that capitalism is driven by "self-interest." Marketing capitalism as a system based on selfishness wasn't smart. Then again, Smith was a professor, with no actual experience as an entrepreneur.

My experience as the owner of a small business is that entrepreneurs are actually driven by insecurity, not selfishness. Our number one worry is that we won't satisfy our customers so they will go elsewhere, putting us out of business. That's why we strive so hard to grow our business because that confirms that we are doing right by our customers in the competitive market. To do so, we have to put our customers first, not ourselves. Our business model has always been based on going viral: "If you like our products and services, tell your friends about us."

Smith famously wrote: "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own self-interest. We address ourselves not to their humanity but to their self-love, and never talk to them of our own necessities, but of their advantages." This statement is totally wrong, with all due respect to the professor. The butcher, the brewer, and the baker get up early in the morning and work all day long trying to give their customers the best meat, ale, and bread at the lowest possible prices. If they don't, their competitors will, and put them out of business. Entrepreneurial capitalism is therefore the most moral, honest, altruist economic system of them all. Among its mottos are: "The customer is always right," "Everyday low prices," and "Satisfaction guaranteed or your money back."

The problems start when the butchers, brewers, and bakers form trade associations to stifle competition. The associations hire lobbyists to pay off politicians to regulate their industry, requiring government inspection and licensing. In other words, capitalism starts to morph into corruption when "special interest groups" try to rig the market with political influence. These groups are totally selfish in promoting the interests of their members rather than their members' customers. At least Smith got that concept right when he famously wrote, "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices."

The best way to make America great is to allow small businesses to grow in a competitive market. That means lower taxes and fewer regulations on these businesses. The best way to see how important small businesses are to the vitality and growth of the US is to slice and dice the ADP private-sector employment data available since 2005. Here are some key findings:

(1) *February*. Let's start with the latest monthly ADP report for February. It is yet another data set confirming that Trump's victory has unleashed the economy's animal spirits, especially among small business owners. Total payrolls jumped 298,000, the most since April 2014 (*Fig. 1*). The increase was led by a 193,000 increase in service-providing industries, which has been par for the course for a while.

What really stands out is the 106,000 increase in goods-producing employment, which is the most on record! Trump can take some credit for the 32,000 job increase in manufacturing in February (*Fig. 2*). Maybe construction companies are jumping the gun on Trump's infrastructure spending plans (including the "Great Wall") with a 66,000 hiring gain last month, the most since February 2006.

February's total gain in payrolls (298,000) was led by small (104,000) and medium-sized (122,000) companies, with large ones (72,000) lagging behind. The outsized gain in goods-producing payrolls was led by medium- (52,000) and small-sized (39,000) companies (*Fig. 3*).

(2) *Size.* According to ADP, small companies have accounted for roughly 41% of total employment in the US since the start of the data in 2005 (*Fig. 4*). Medium-sized companies have steadily accounted for roughly 36% of employment, while large companies have accounted for the remaining 22%-24%. The percentages are quite similar for service-providing firms by size (*Fig. 5*). Among goods-producers, medium-sized companies lead with 38% of employment, followed by small companies around 33% and large ones at 29% (*Fig. 6*).

(3) *Jobs.* Since January 2005, ADP payrolls have increased 12.4 million through February (*Fig. 7*). This series closely tracks the official data on private-sector payrolls released by the Bureau of Labor Statistics in the monthly Employment Report, which is up 12.2 million since 2005 through January.

The key point is that since 2005, small companies have created 6.5 million jobs, medium-sized companies have created 5.1 million jobs, while large companies have expanded their payrolls by only 700,000 (*Fig. 8*)! Employment is created by small and medium-size companies that are growing their business. Over the past two years, we've expanded our staff by hiring Melissa Tagg as Director of Research Projects and Jackie Doherty as Contributing Editor. We didn't get any help from Washington. If our taxes are cut, we might expand some more.

US Fiscal Policy: Fist Full of Dollars. In his first months as the CEO of the USA, President Donald Trump along with the Republican-controlled Congress have proposed a handful of policies that are causing deficit hawks to have a canary. It's early days, but initial plans to boost defense spending, cut corporate and personal taxes, and revise Obamacare look like they'll result in a large increase in government spending and a large reduction in government revenue, based on "static budget scoring." Welcome to Trump's guns-and-butter economy.

No doubt, these policies should provide a jolt to the economy and should result in higher tax receipts that will offset some of the new spending, based on "dynamic budget scoring." But the proposed spending boost and tax cuts are so large that unless a major cost-cutting program is enacted, deficits are sure to swell. Here's a look at how tax cuts, the replacement of Obamacare, and the new defense budget could affect the USA's bottom line:

(1) *Tax cuts.* One of President Trump's and congressional Republicans' highest priorities is cutting taxes. As Melissa laid out in the 2/23 *Morning Briefing*, candidate Trump proposed lowering corporate income taxes to 15% and cutting personal income taxes. The proposal would cost roughly $6.2 trillion over 10 years: $2.6 trillion for the corporate tax cut and another $3.3 trillion for the personal income tax cuts, according to the Tax Policy Center. The House Republican's tax cut proposal is half as expensive at $3.1 trillion. The GOP's corporate tax cut proposal, which includes a border adjustment tax, would cost $891 billion, while the personal income tax cuts would cost $2.0 trillion.

These estimates are just the revenue lost from reduced taxes, offset by any new revenue from the elimination of tax deductions. These estimates don't include the higher tax revenue that President Trump and Republicans would likely anticipate from a pickup in economic activity.

(2) *Health care*. House Republicans released on Monday their proposal to repeal the Affordable Care Act, better known as "Obamacare," and replace it with the American Health Care Act, which will likely become known as "Trumpcare." Republicans did not estimate how much their proposal would cost or save, nor did they estimate the number of folks who would gain or lose health insurance. A naysayer might say the lack of an estimate implies that the plan will be more expensive than Obamacare and insure fewer Americans. To quote Nancy Pelosi (D-CA), "[W]e have to pass the bill so that you can find out what is in it."

The American Health Care Act may be expensive because it eliminates many of the taxes created to pay for Obamacare. It also offers new tax breaks. For example, gone are the penalties that individuals pay under Obamacare if they go uninsured and the "Cadillac tax" Obamacare imposed on expensive employer health plans. In addition, "the bill repeals a 3.8% tax on investment income and a 0.9% tax on wages. Both levies affect only the highest-earning households, those individuals making at least $200,000 and married couples making more than $250,000," states a 3/7 *WSJ* article. In all, the GOP bill cuts almost $600 billion in taxes over 10 years, according to estimates by the nonpartisan congressional Joint Committee on Taxation.

The GOP's plan could also reduce tax revenues because it increases the amount that individuals can put away for health care expenses in flexible spending accounts and it lowers the amount above which individuals can itemize and deduct medical expenses on their taxes. The plan repeals the health care industry taxes in Obamacare, including a 2.3% tax on medical devices and fees on pharmaceuticals and health insurance.

The new Republican plan also has some new expenses, the largest of which may be a new tax credit of $2,000-$4,000 being offered to individuals who opt to buy their own insurance when it's not provided by an employer. "The measure would also provide states with $100 billion to create programs for patient populations, possibly including high-risk pools to provide insurance to the sickest patients," according to a 3/8 Reuters analysis.

There are some areas of savings. The Republican proposal would end the income-based subsidies for purchasing insurance under Obamacare. The growth of Medicaid is also limited in future years. It's estimated that about half of the 20 million people who gained insurance under Obamacare did so through the expansion of Medicaid. Future savings could come if Republicans can successfully end the expansion of Medicaid in 2020, and cap Medicaid funding after that date. Also, states would receive a set amount of money each year tied to their Medicaid population, which is expected to save the federal government money.

Reaction to the plan was decidedly mixed. Trump called the plan "wonderful," but members of Congress from both sides of the aisle were less than enthused. Senate Minority Leader Chuck

Schumer (D-NY) said the plan would force millions to "pay more for less care." Conversely, the fiscally conservative House Freedom Caucus didn't think that the repeal went far enough, according to a 3/7 report on Foxnews.com. They'd prefer to completely repeal Obamacare, reversing any Medicaid expansion and all related taxes. Instead, they plan to propose a new, market-based insurance program and would require insurance companies to insure those with preexisting conditions.

Political commentator Charles Krauthammer had perhaps the most honest assessment of the situation: "You cannot retract an entitlement once it's been granted," he said. Post-war Republicans tried to overhaul FDR's "New Deal," which included the then-new Social Security entitlement, but failed despite gaining control of both houses of Congress and the White House with President Ike Eisenhower. That's the "genius" of the left, he told Fox News. His suggestion: Republicans should take what they can while they can get it. And that presumably will mean compromise and accepting "Obamacare lite."

(3) *Defense.* President Trump has proposed a $54 billion increase in defense spending to $603 billion for fiscal 2018 in an effort "to rebuild the depleted military." He's expected to offset that increased spending by cutting the budgets for the State Department and the Environmental Protection Agency.

Our good friend Rick Whittington, who has been covering defense stocks for more than 30 years, laid out the bullish case in a recent interview with Jackie. You can access a transcript of our conversation with him or listen to a podcast. Rick, who now buys defense stocks for his own account, believes the boost in defense spending may end up being larger than Trump's proposal for fiscal 2018, and he expects robust spending increases will continue over the next few years. Consider that Senator John McCain (R-AZ) and Rep. Mac Thornberry (R-TX), chairs of the Senate and House Armed Services Committees, said last month that Trump's proposed spending bump isn't enough. They prefer a $640 billion military budget. "The Obama-era spending 'left our military underfunded, undersized, and unready to confront threats to our national security,'" said McCain, according to a 2/28 Military.com article.

Defense spending in fiscal 2019 could increase at rates anywhere from the mid-single digits to low double digits, Rick projects. After that, he anticipates that spending increases will taper off in fiscal 2020 and 2021.

To get such large increases in defense spending enacted, Rick expects that the Republicans will eliminate sequestration, i.e., across-the-board cuts to government spending that only spared entitlement programs. Sequestration was enacted in 2011 as part of the grand compromise that resolved the debt-ceiling crisis by agreeing to cut the deficit by $1.2 trillion over 10 years. But now Republicans control both chambers of Congress and the Executive branch, and they look ready to open the purse strings.

Industry Focus: More on Defense. To understand where defense spending is headed, Rick suggested reading Defense Secretary James Mattis' statement before the Senate Armed Services Committee in 2015. Certain themes shine through, including the importance Mattis places on allies and on good intelligence, the need for a strong Navy, and his opinion that sequestration should be repealed. Let's take a look at where Mattis may be leading the military and how Rick is investing based on his read of the situation:

(1) *Keep your friends close*. Mattis has a reputation for being a defense intellectual and a keen student of military history. As such, he makes clear how important it is for the US to have strong alliances and good intelligence. "The need for stronger alliances comes more sharply into focus as we shrink the military. No nation can do on its own all that is necessary for its security. Further, history reminds us that countries with allies generally defeat those without," he told the Senate committee.

So it should come as no surprise that among his first actions as Defense Secretary, Mattis went to Asia to meet with the leaders of Japan and South Korea, and then he went to NATO, where he met with the leaders in Brussels. Because he places such importance on allies, Rick is skeptical that the State Department's budget will be slashed to pay for the increase in defense spending.

And while President Trump may be feuding with the intelligence community, Mattis seems to see them as the country's first line of defense. He told the Senate committee: "Today we have less of a military shock absorber to take surprise in stride, and fewer forward-deployed military forces overseas to act as sentinels. Accordingly, we need more early warning. Working with the intel committee you should question if we are adequately funding the intel agencies to reduce the chance of our defenses being caught flat-footed."

(2) *Anchors aweigh*. If less is to be spent on the Marines and the Air Force, Mattis suggests that more will need to be spent on the Navy. "Because we will need to swiftly move ready forces to act against nascent threats, nipping them in the bud, the agility to reassure friends and temper adversary activities will be critical to America's effectiveness for keeping a stable and prosperous world. Today I question if our shipbuilding budget is sufficient, especially in light of the situation in the South China Sea," he said in 2015.

With this in mind, Rick expects a "material acceleration" in spending on ship-building and maintenance and owns the stock of shipbuilder Huntington Ingalls Industries, which has rallied 44.8% from the night of the election through Tuesday's close. President Trump has called for a naval fleet of 350 ships, up from roughly 270-290 in recent years, and he recently made a high-profile visit to a Huntington Ingalls shipyard.

Rick also owns shares of General Dynamics, which is leading the effort to build 12 Columbia Class ballistic missile subs, and Orbital Sciences, which produces spacecraft, satellites, rocket propulsion systems, missiles and other high-tech armaments. Orbital, his top pick, produces "high-impact, high-tech munitions, as opposed to the sort that have been utilized in these counter-insurgency wars in Afghanistan and Iraq. I think the focus of Mattis and the National Security community is turned now to China and Russia, as opposed to Iraq and Afghanistan."

(3) *Defense bull.* Aerospace & Defense has been among the top-performing industries since President Trump was elected. It has gained 16.2%, compared to the S&P 500's 10.7% return since Election Day (*Fig. 9*). The sector's forward P/E has increased to 19.2, near the top of its 20-year range (*Fig. 10*).

Analysts expect revenue growth of 1.4% this year and 3.7% in 2018, while they're looking for earnings growth of 5.3% this year and 10.2% in 2018 (*Fig. 11* and *Fig. 12*). Rick is even more bullish. Defense companies have managed to boost their margins from 5% to 12% during the past eight years even though most of them have had flat revenues. Despite the President's bargain-shopping tweets, Rick believes margins can continue to improve.

He explains: "Ships are very expensive items. Aircraft carriers are now up in the $15 billion range. It takes about seven years to build an aircraft carrier. If you can give a shipyard some visibility that you might pull in or accelerate the production of the carrier, or start a new one in the place of one that's perhaps a third or halfway through the production process, that allows the shipyard to operate much more efficiently. Unit costs can come down on each carrier, but the profit margin could actually go up for the contractor, and that'd be a win-win both for the country as well as private industry. I think the same thing holds true for aircraft like the F-35, or possibly an alternative, the F-18 from Boeing, which has been bandied as a possible alternate."

For the group of contractors he follows, Rick is penciling in 7%-8% revenue growth annually for the next five years, a slight increase in margins, continued stock buybacks, and a decline in the corporate tax rate to 18%. It adds up to annual earnings per share growth of 15%-17% annually for each of the next five years.

What could derail his hypothesis? If the Democrats regain control of Congress, they could put the brakes on defense spending, as could the Republican's budget hawks. But defense contractors do have a political tailwind right now.

"Don't forget, all these companies produce the preponderance of their product and generate the vast bulk of their revenues in the United States, through the employ of US workers. If you start speeding up and enhancing the funding in the ship-building industry and in the aircraft industry, it's going to have a direct impact on wage earners, on the purchase of SUVs and pickup trucks. So I think that there's a trickle-down effect here—which some people in the administration, Secretary Ross for example, have already highlighted—that could stimulate the economy even beyond what we've seen thus far." If Rick is correct, defense stocks are about to become growth stocks for the next few years.

CALENDARS

US. Thurs: Jobless Claims 238k, Import & Export Prices 0.2%/0.2%, Weekly Consumer Comfort Index, Challenger Job-Cut Report. **Fri:** Total & Private Nonfarm Payroll Employment 195k/190k, Unemployment Rate 4.7%, Average Hourly Earnings 0.3%, Average Workweek 34.4hrs, Treasury Budget -$181.5b, Baker-Hughes Rig Count. (Bloomberg estimates)

Global. Thurs: China CPI & PPI 1.8%/7.5% y/y, OECD Economic Outlook, ECB Rate Decision 0.00%, Marginal Lending Facility & Deposit Facility Rate 0.25%/-0.40%, ECB Asset Target (euros) 80b. **Fri:** UK Headline & Manufacturing Industrial Production 3.2%/2.9% y/y, China New Yuan Loans 950b, China M2 11.4% y/y, Canada Employment Change & Unemployment Rate -15.5k/6.8%.(DailyFX estimates)

STRATEGY INDICATORS

Stock Market Sentiment Indicators (*link*): The Investors Intelligence Bull/Bear Ratio (BBR) fell to 3.34 this week after rebounding to 3.82 last week, which was the highest reading since April 2015. It's the thirteenth straight week above 3.00. Bullish sentiment pulled back to 57.7% from 63.1% last week, which was the most bulls since 1987! The retreat this week ends seven consecutive readings above 60%. Bearish sentiment edged up to 17.3% after falling to 16.5% last week, which was the fewest bears since July 2015. The correction count jumped 4.6ppts this week to a four-month high of 25.0%. The AAII Bull Ratio dropped from 54.3% to 51.6% last week as bullish sentiment fell from 38.5% to 37.9% and bearish sentiment rose from 32.3% to 35.6%.

S&P 500 Earnings, Revenues & Valuation (*link*): S&P 500 consensus forward revenues and earnings rose slightly w/w to fresh record highs. The forward profit margin forecast was steady at a 16-month high of 10.8%, nearing the record high of 10.9% in September 2015 and up from its 24-month low of 10.4% in late March. Forward revenue growth for the S&P 500 fell to 5.5% from 5.6%. That compares to 5.8% in late January, which was the highest since May 2012 and up from a seven-month low of 2.7% in late February 2016. Forward earnings growth was steady at 10.6%, but is down from 11.7% in early January; that was the highest since October 2011 and compares to an 11-month low of 4.8% in February 2016. Valuation rose to a 13-year high of 18.0 from 17.9, which compares to a 15-month low of 14.9 in January 2016. S&P 500 forward revenues and forward earnings are enjoying a tailwind now from easier y/y comparisons for Energy and improving prospects for Financials, but currency translation looks likely to remain a challenge. Looking at last week's results ex-Energy, the forward revenue and earnings growth rates are lower at 4.2% and 7.6%, respectively. The ex-Energy forward profit margin improves to 11.4%, which is close to its record high of 11.5% in August 2007.

S&P 500 Sectors Earnings, Revenues & Valuation (*link*): Consensus forward revenue forecasts rose last week for 9/11 sectors, and forward earnings rose for 10/11. Telecommunication Services saw forward revenues fall w/w and Health Care had both measures decline. Forward revenues and earnings are at or around record highs for 5/11 sectors: Consumer Discretionary, Consumer Staples, Health Care, Industrials, and Tech. Energy's forward revenues and earnings are at or near 15-month highs. Most sectors had their forward P/S and P/E ratios rise w/w. Energy's earnings-depressed P/E fell to a 14-month low of 27.7, and both measures moved lower for Consumer Discretionary. Industrials' P/E of 18.4 is at a 12-year high, and Tech's 17.9 is the highest since 2007. Excluding Real Estate, Financials' P/E is up from 12.0 before the election to a seven-year high of 14.7. Consumer Discretionary's P/E of 19.1 is up from a three-year low of 15.7 a year ago and slightly below February 2015's six-year high of 19.3. Health Care's P/E of 15.9 and P/S of 1.69 have been rising recently, but remain well below their 2015 highs of 17.9 and 1.88, respectively. With Energy's forward revenues and earnings improving, its valuation is beginning to come back to Earth; its P/S ratio of 1.38 compares to a record high of 1.56 in May 2016, and its P/E of 27.7 is down from a record high of 57.5 then. Higher y/y margins occurred for only 7/11 sectors in 2016 and are expected to improve for all but Health Care, Real Estate, and Utilities in 2017. However, Real Estate's forecasted margin should improve as the year progresses when gains on property sales are included in the forecasts. Here's how the 11 sectors rank based on their current 2017 forecasts: Information Technology (to 19.9% in 2017 from 19.4% in 2016), Real Estate (16.2, 25.8), Financials (15.9, 14.5), Telecom (10.9, 10.8), Utilities (10.7, 11.4), S&P 500 (10.6, 10.2), Health Care (10.5, 10.5), Materials (10.1, 9.4), Industrials (9.0, 8.9), Consumer Discretionary (7.4, 7.3), Consumer Staples (6.8, 6.6), and Energy (4.5, 1.1).

US ECONOMIC INDICATORS

ADP Employment (*link*): Private industries blew past estimates, adding 298,000 to February payrolls—the most since April 2014—and 115,000 above the expected 183,000 gain. There were upward revisions to both January (to 261,000 from 246,000) and December (201,000 from 151,000) payrolls, for a net gain of 65,000. Once again, service-providing industries (193,000) accounted for most of the growth; but the big news was the 106,000 surge in goods-producing jobs, with jobs added in construction (66,000), manufacturing (32,000), and natural resources/mining (8,000, reflecting steady recovery from energy-related losses). Within service-providing, the biggest job gains were recorded in professional & technical services (42,000), leisure & hospitality (40,000), health care & social assistance (38,000), and information services (25,000) industries. Medium-sized companies were at the top of the leader board for the third month, adding 122,000 jobs—70,000 service-providing and 52,000 goods-producing. Small businesses (104,000) moved up to the number two slot, with service-providing and goods-producing industries adding 65,000 and 39,000, respectively, to February payrolls. Large companies (72,000) moved to the bottom slot, with service-providing (58,000) jobs once again accounting for most of the gain, while goods-producing (14,000) companies added to payrolls for the third straight month.

Consumer Credit (*link*): Consumer credit in January expanded at its slowest pace since July 2012 as consumers reduced credit card debt. Overall consumer credit rose only $8.8 billion, less than half the average monthly gain of $19.1 billion recorded during the final quarter of last year. Revolving credit dropped $3.8 billion—the first decline in nearly a year and the largest since December 2012. Nonrevolving credit, which includes student and auto loans, expanded $12.6 billion in January, in line with the average monthly gain recorded during 2016.

GLOBAL ECONOMIC INDICATORS

Germany Industrial Production (*link*): German output in January bounced back after seasonal factors caused a big drop in December. January's headline production, which includes construction, rebounded 2.8% after a 2.4% drop in December, which was the steepest since August 2014. Output remains in a volatile flat trend around recent highs, with January's gain moving it back to the top of the range. January's advance was driven by a 3.7% jump in manufacturing; construction (-1.3) and energy (-0.7) output moved lower. Excluding construction, production rose 3.3%. In January, output of investment (6.2), consumer durable (2.9), consumer nondurable (2.1), and intermediate (1.7) goods all posted robust gains. Looking forward, Germany's M-PMI (56.8) for February climbed to a 69-month high as growth rates for output, new orders, and exports all accelerated, with output the strongest since January 2014.

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