MORNING BRIEFING
October 24, 2017

Halloween Is Coming

See the collection of the individual charts linked below.

(1) Gee, the year is almost over! (2) September and October haven't been scary this year. (3) Will Republicans deliver tricks or treats? (4) Nothing to fear but nothing from the Republicans on tax reform. (5) Market says: The correct question is "What if tax reforms happens?" (6) The way is cleared for the bulls. (7) Best tax code money can buy. (8) Supply-siders offer self-financing tax cuts. (9) Ratio of federal government revenues to GDP is very procyclical in a flat trend. (10) Government spending relative to GDP is countercyclical, with an upward bias since the Great Society entitlements extravaganza. (11) Two Fed districts are really hot this month.

Strategy: Whistling Along. This is the time of the year when most of us—especially the older folks among us—express amazement at how fast the year has gone. Halloween is next Tuesday. Less than three weeks later is Thanksgiving. Shortly thereafter come Hanukah and Christmas celebrations. Before you know it: Happy New Year, 2018!

September is long gone. It is supposed to be the scariest month of the year for stock investors, perhaps in anticipation of Halloween. During the Septembers from 1928-2017, the S&P 500 has managed to lose 1.0% on average (*Fig. 1*). October has a history of some harrowing selloffs too, though on average it's been up 0.5%. This year, the S&P 500 rose 1.9% during September, and October is up 2.2% through the end of last week. So now we can look past Halloween to November and December, which tend to be among the best months of the year on average, with gains of 0.7% and 1.4%, respectively.

In recent meetings with some of our accounts in NYC, I've been asked whether the stock market might take a dive if the Republicans fail to pass tax reform. This admittedly very small survey of investors' psyches suggests to me that there's still plenty of fear that the Republicans will screw it up despite their majority status in Congress. The fear is that the Republicans will deliver more tricks than treats.

Meantime, the stock market has continued to forge ahead to new highs ever since the Trump administration presented its 9/27 *Unified Framework for Fixing Our Broken Tax Code*. The S&P 500 is up 3.1% since the day before it was released through the end of last week. On 10/4, Melissa and I noted that the framework is an outline that "is leaving it up to Congress to fill in the details that will make it a plan. The Republicans need to make tax reform the law of the land to hold onto their slim majorities in both houses of Congress come next year's mid-term elections. They might fail as miserably on this challenge as they did on repealing and reforming Obamacare, when their majority splintered and not one Democrat in either the House or the Senate supported their effort."

As we noted yesterday: "Also driving the market higher recently are rising expectations that there will be tax reform by early next year that will include a cut in the corporate tax rate. On Thursday, the Senate passed a budget resolution that may expedite tax legislation. The budget proposal includes $1.5 trillion in tax reductions over the next 10 years. It might be possible to pass it with a simple 51-vote majority in the Senate, without a conference committee with the House of Representatives."

So the question now may be: “What if tax reform happens?” rather than “What if it doesn’t happen?”!

The Republicans might actually deliver a treat rather than another lame trick. There’s increasing chatter that this might happen by the end of this year or early next year. That provides an upbeat path for the stock market bulls to continue charging ahead. If it turns into a stampede, then the resulting meltup could set the stage for a correction when tax reform is actually enacted. Of course, the selloff would be more severe if the Republicans screw it all up. Let’s review the recent chatter, as provided by a 10/13 CNBC article on the subject:

(1) President Donald Trump, top White House officials, and House Speaker Paul Ryan all aim to approve a tax bill before the end of this year. Ryan said on Thursday, October 12 that he would keep the House in session through Christmas if necessary.

(2) Texas Republican Senator Ted Cruz told CNBC on Friday, October 13 that it will take “at least a couple months” to iron out differences within the GOP, which has a narrow majority in the Senate. “I do think virtually every Republican wants to get to yes” on overhauling the tax system he said. He expects tax reform to get done “late this year or early next year.”

(3) The GOP is running into political dissent within the party. Some GOP lawmakers, such as Senator Bob Corker, have expressed concerns about the potential budget deficits the tax cuts would generate. Republican lawmakers in high-tax blue states have started to push back on a proposal to get rid of state and local tax deductions.

US Economy I: Faith-Based Economics. There are lots of good reasons for overhauling our tax system. However, while the Republicans might succeed in pushing for some tax cuts, I doubt that the tax code will be shorter or much simpler than before their reforms. I wish I was kidding, but the reality is that we have the best tax code money can buy. Billions of dollars have been spent on lobbyists and by lobbyists to fashion the tax code to meet the special interests of special interest groups. It’s hard to imagine that Trump will be signing a tax reform package that will significantly reduce the complexity of the tax code. I hope I am wrong, but I’ll believe it when I see it.

I would love to believe that reducing marginal personal income tax rates and cutting the corporate tax rate will boost economic growth sufficiently so that the reforms “will pay for themselves,” as is the mantra of supply-side economists. To prove their point, they often point to the pickup in US economic growth following the tax cuts implemented by the Kennedy, Reagan, and Bush administrations. Reagan cut the top marginal income tax rate from 70% to 28%. He reduced the top corporate tax rate from 46% to 40%. That helped boost the economy out of severe recession at the start of the 1980s. President Bush also used supply-side economics to cut taxes in 2001 and again in 2003. The economy grew, and revenues increased. Supply-siders give tax cuts all the credit for better growth. The problem is that it’s hard to separate out the impact of other variables such as easy monetary policies and bubbles in stocks and real estate.

Supply-siders favor “dynamic scoring” of their tax-cutting proposals over the coming 10 years. The exercise requires using an econometric model that allows for a feedback loop from lower tax rates to better economic growth, which generates more tax revenues, which “pay” for the tax cut. They might be right. I hope they are. But lots can happen over a 10-year period. I would feel better about it all if there were more efforts made to slow the growth of government spending on entitlements at the same time. The problem is that progressives can counter that if the supply-siders can have tax cuts, they should get to keep their entitlements. If the tax cuts can pay for themselves, maybe they can also pay for more entitlements. It’s all faith-based economics to me. Let’s review what the facts show:

(1) *Federal government receipts* as a percentage of nominal GDP has tended to fluctuate in a flat trend ([*Fig. 2*]). Since 1948, it has ranged between a high of 20.4% and a low of 13.4%, averaging 17.6%. It is very procyclical, rising during economic expansions and falling sharply during recessions.

According to supply-side theory, cutting tax rates will boost the growth rate of nominal GDP. On a static scoring basis, the Revenues-to-GDP Ratio (RGR) should fall initially, especially if GDP growth responds rapidly to the tax cut. But in time, better GDP growth will generate more revenues.

The extreme procyclicality of the RGR since 1948 suggests that no matter what the individual tax rate might be, revenues outpace GDP during expansions. The ratio has almost always risen to a new cyclical high during expansions, peaking just before recessions.

This suggests that the best fiscal and monetary policies for the RGR are the ones that prolong the business cycle.

(2) *Federal government outlays* as a percentage of nominal GDP is countercyclical (*Fig. 3*). It tends to rise during recessions, peaking at the end of these downturns. It then falls during expansions, tending to trough just as the economy falls back into another recession.

This ratio has had an upward drift since the mid-1960s, when the Johnson administration expanded the New Deal entitlements programs through the Great Society social welfare programs.

(3) *Don't get me wrong:* As an entrepreneur running a small business, I certainly would be happy to see lower tax rates. They might boost economic growth, and at least partly pay for themselves. But I'm skeptical that faster growth can be achieved given the demographic outlook for the US. There is room for growth in productivity, which might get a boost if lower taxes boost final demand. After all, productivity has a demand side in addition to a supply side. You can have the most efficient widgets factory in the world, but if no one wants widgets, your productivity will be zero. Ironically, supply-side tax cuts might work by stimulating demand, boosting productivity and GDP growth.

US Economy II: Chugging Along. While we are all waiting to see whether tax cuts are coming, the economy continues to grow at a slow but steady pace. The Atlanta Fed's GDPNow model is currently forecasting 2.7% real GDP growth for Q3. The data are hard to interpret for September and October as a result of the direct impacts on the economy of hurricanes Harvey and Irma and their consequences. September's auto sales rose sharply, perhaps reflecting demand to replace flooded vehicles (*Fig. 4* and *Fig 5*).

The October regional surveys conducted by the New York and Philly Feds showed quite a bit of strength. The average of their composite indexes jumped from 24.1 during September to 29.1 this month, just shy of February's 31.0—which was the highest reading since July 2004 (*Fig. 6*). The average of their new orders dipped, from 27.2 to 18.8, but remains high. The big surprise was the big jump in the average employment index from 8.6 to 23.1, the highest since May 2011.

CALENDARS

US. Tues: Composite, Manufacturing, and Nonmanufacturing PMI Flash Estimates 54.8/53.4/55.2, Richmond Fed Manufacturing Index 20. **Wed:** Durable Goods Orders Total, Ex Transportation, and Core Capital Goods 1.0%/0.5%/0.5%, New Home Sales 555k, FHFA Price Index 0.4%, MBA Mortgage Applications, EIA Petroleum Status Report. (*Wall Street Journal* estimates)

Global. Tues: Eurozone, Germany, and France Composite PMI Flash Estimates 56.5/57.5/57.0, Eurozone, Germany, and France Manufacturing PMI Flash Estimates 57.8/60.0/56.0, Eurozone, Germany, and France Nonmanufacturing PMI Flash Estimates 55.6/55.5/56.9, Japan Manufacturing Flash PMI, ECB Bank Lending Survey. **Wed:** Germany Ifo Business Climate, Current Assessment, and Expectations Indexes 115.0/123.5/107.3, UK GDP 0.3%q/q/1.5%y/y, Australia CPI 2.0% y/y, BOC Rate Decision 1.00%. (DailyFX estimates)

STRATEGY INDICATORS

YRI Weekly Leading Index (*link*): Our Weekly Leading Index (WLI)—a good coincident indicator that can confirm or raise doubts about stock market swings—climbed 5.7% during the three weeks ending October 14 after sinking 8.6% the prior four weeks on a hurricane-related jump in jobless claims. Before the recent downturn, the WLI had posted a seven-week surge of 5.0% to a new record high. Our WLI is the average of our Boom-Bust Barometer (BBB) and Bloomberg's Weekly Consumer Comfort Index (WCCI). Our BBB jumped 10.6% over the three-week period, after tumbling 13.7% the prior four weeks, as jobless claims fell to 248,250 (4-wa) from a 19-month high of 277,000 three weeks ago. Claims were as low as 236,750 seven weeks ago, not far from late May's 235,500—which was the lowest since April 1973. Meanwhile, the CRB raw industrial spot price index—another BBB component—is sinking. The WCCI rebounded 3.2% after falling five of the prior six weeks by a total of 7.1%.

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose to a yet another record high last week for all three indexes as SmallCap posted a fourth straight high for the first time since mid-July. Momentum remains strong as the yearly change in forward earnings is up from six-year lows in early 2016, but the easy y/y comparisons may be waning. In the latest week, LargeCap's forward earnings improved to a three-month high of 9.9% y/y from 9.6%, which compares to a 64-month high of 10.2% in mid-May and a six-year low of -1.8% in October 2015; MidCap's rose to a 69-month high of 14.0% from 13.8%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's rose to a seven-week high of 9.9% from 8.9%, which compares to a 39-month high of 13.0% in mid-July and a six-year low of 0.3% in December 2015. LargeCap's consensus growth rates expected for 2017 have remained strong throughout this year instead of falling. Furthermore, the growth rates for 2018 should remain strong for all three indexes if the corporate tax rate changes sooner rather than later. Here are the latest consensus earnings growth rates: LargeCap 10.7% and 11.6%, MidCap 9.6% and 15.2%, and SmallCap 4.8% and 22.2%.

S&P 500/400/600 Forward Valuation (*link*): Forward P/E ratios mostly edged higher for the three indexes last week. Looking at the weekly valuation, LargeCap's forward P/E of 18.0 is up w/w from 17.9 and at the highest level since March 2004. That's up from a 15-month low of 14.9 in January 2016 and the post-Lehman-meltdown P/E of 9.3 in October 2008, but remains well below the Tech bubble's record high of 25.7 in July 1999. SmidCap P/Es had stalled for most of 2017 following the post-election melt-up, but are rising again now. MidCap's forward P/E rose to a 19-week high of 18.3 from 18.2, and is higher than LargeCap's P/E again after being below during August and September for only the second time since 2009. MidCap's P/E remains below its 15-year high of 19.2 in late February and the record high of 20.6 in January 2002, but is up from a three-year low of 15.0 in January 2016. SmallCap's was steady at 19.9, which compares to a 15-year high of 20.5 in early December when Energy's earnings were depressed. That's up from a three-year low of 15.5 in February 2016, and only 0.7ppt below SmallCap's record-high P/E of 20.9 in April 2002. Prices remain near record highs for all three indexes, but their "E" still remains low as analysts await the passage of legislative changes to the tax rate and its positive impact on corporate earnings. Looking at their daily forward price/sales (P/S) ratios, valuations last week were similarly higher for the three indexes: LargeCap's P/S of 2.02 was at a record high, MidCap's 1.30 was down from a record high of 1.39 in early March, and SmallCap's 1.04 was down from 1.08 in early March and its record high of 1.17 in November 2013.

S&P 500 Q3 Earnings Season Monitor (*link*): With over 19% of S&P 500 companies finished reporting Q3-2017 earnings and revenue results through midday Monday, their surprise and y/y growth results are mixed compared to the same point during the Q2 earnings season, but more companies are reporting a positive surprise. Of the 97 companies in the S&P 500 that have reported, 75% exceeded industry analysts' earnings estimates, by an average of 3.6%; they have averaged a y/y earnings gain of 12.2%. At the same point during the Q2-2017 reporting period, the same percentage of S&P 500 companies (75%) had beaten consensus earnings estimates by a higher 7.0%, and earnings were up a higher 17.2% y/y. On the revenue side, 73% beat sales estimates so far, with results coming in 1.1% above forecast and 6.9% higher than a year earlier. At this point in the Q2 season, a similar 73% had exceeded revenue forecasts by a slightly higher 1.3%, and sales rose a lower 4.2% y/y. Q3 earnings results are higher for 77% of companies, vs 64% at the same point in Q2, and revenues also are higher for 85%, vs 84% a quarter ago. Although these figures will change markedly as more Q3-2017 results are reported in the coming weeks, particularly for the insurers, the early results are encouraging. Q3-2017 should mark the fifth straight quarter of positive y/y earnings growth despite the negative impact of the three hurricanes. However, growth is likely to fall back into the low single digits following double-digit percentage growth in Q1 and Q2, which was the first double-digit growth seen since Q3-2011.

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