



MORNING BRIEFING

January 22, 2018

Many Happy Returns

See the [collection](#) of the individual charts linked below.

(1) The longest Santa Claus rally on record. (2) Trump vs FDR. (3) Market says: “Love him or hate him, don’t bet against him.” (4) Lots of happy returns as stock market soars. (5) Biggest corporate tax-cut winners are spreading the love to their workers. (6) US Treasury projected to collect more than \$300 billion from more than \$2 trillion of repatriated earnings. (7) Great Rotation beginning as money leaves bonds for stocks. (8) Political turmoil in Germany. (9) Germany’s economy booming. (9) Movie Review: “The Shape of Water” (+ +).

Strategy: Merry Christmas! Someone forgot to tell Santa Claus that Christmas is over. The Santa Claus rally, which started the day after November 8, 2016 (Election Day), kept going through Christmas 2016, through all of last year including last Christmas, and is still going strong so far this year. It just keeps giving many happy returns to stock investors. The S&P 500 is up 31.3% since Election Day ([Fig. 1](#) and [Fig. 2](#)). It is up 23.7% since President Donald Trump moved into the White House. Only President Franklin D. Roosevelt’s first year beat President Donald J. Trump’s first year. However, FDR had an advantage since the stock market had crashed under his predecessor. Trump’s Santa Claus rally comes on top of a bull market that had been going strong during President Barack Obama’s eight years in office.

A few weeks after Donald Trump was elected—the Republican party having won majorities in both the Senate and the House of Representatives—Joe and I raised our 2017 outlook for the S&P 500, expecting that a combination of deregulation and tax cuts would boost earnings. In a *Barron’s* [interview](#) on February 4, 2017, I said:

“It would be a mistake to bet against what President Trump might accomplish on the policy side. I’m giving him the benefit of the doubt, hoping good policies get implemented and bad ones forgotten. We could get substantial tax cuts. All his proposals don’t need to be implemented for the Trump rally to be validated. If you got \$1 trillion to \$2 trillion coming back from overseas because of a lower tax on repatriated corporate earnings, that would be very powerful in terms of keeping the market up.”

I anticipated that Trump would move quickly to push Congress to enact his tax reform plan. Instead, he pressed for the repeal of Obamacare, which ran into fierce opposition even from a few congressional Republicans. I argued that it didn’t much matter whether the tax-cutting plan was implemented in 2017 or 2018. At the start of 2018, after Trump had signed the Tax Cut and Jobs Act (TCJA) at the end of 2017, the stock market continued to climb to new highs. Joe and I remained bullish and lifted our odds of a meltup from 55% to 70%. However, we also observed in our 1/16 [Morning Briefing](#): “We may be experiencing an extremely unusual earnings-led meltup. If so, it is more likely to be sustainable than the run-of-the-mill P/E-led meltup, as long as it doesn’t morph into one. We’ll let you know if it does. For now, sit back and enjoy the show.”

The happy returns for equity investors continue to mount. As we expected, analysts are raising their 2018 and 2019 earnings estimates significantly following the passage of the TCJA. In addition,

companies are starting to repatriate their overseas earnings. The corporate windfalls from the TCJA are trickling down to workers, who are receiving bonuses and pay raises. Undoubtedly, corporations also will use some of their windfalls to boost share buybacks and dividends. Capital spending may also get a boost. The US Treasury stands to cash in “HUGE” —to the tune of hundreds of billions of dollars— during the current fiscal year. Here are some specifics:

(1) *Trump bonuses.* Love him or hate him, Trump delivered on his promise to cut taxes and his promise that the cuts would benefit individuals, not just corporations. Lots of middle-income taxpayers will have a lower tax rate this year. In addition, some of them may receive bonuses and wage increases from employers that are benefitting from the corporate tax-rate cut.

Fox Business compiled a [list](#) of big corporations that have announced bonuses and pay hikes following the passage of the TCJA. They are Apple, Wal-Mart, AT&T, BNY Mellon, Boeing, Comcast, Fifth Third Bancorp, JetBlue, Southwest Airlines, US Bank, and Wells Fargo. The list suggests that among the big winners from the TCJA are airlines, banks, and retailers.

(2) *Performance derby.* The performance derby for the S&P 500 sectors since December 22, when Trump signed the TCJA, shows lots of winners to varying degrees: Consumer Discretionary (6.7%), Health Care (6.6), Energy (6.1), Tech (5.6), Industrials (5.4), Financials (5.1), Materials (4.8), S&P 500 (4.7), Consumer Staples (1.9), Real Estate (-3.3), Telecom (-3.3), and Utilities (-4.8).

(3) *Treasuries windfall.* Last week, Apple announced that it will be paying \$38 billion in taxes from profits made overseas. That implies that Apple will be repatriating \$253 billion in profits, assuming they are all taxed at the new 15.5% tax rate (if they were held in liquid assets). Debbie and I have added up the quarterly data reported by the Fed for foreign earnings retained abroad by nonfinancial corporations (NFCs) since 1986, when the data start ([Fig. 3](#)). They added up to \$3.5 trillion during Q3-2017. Applying a 15.5% tax rate (under the TCJA) on that total would produce a \$540 billion revenue windfall for the US Treasury. The actual windfall is likely to be closer to \$300 billion, and won't offset the deficit-widening impact of the cut in the corporate tax rate over the next 10 years.

By the way, the Fed's data can be used to calculate a global effective tax rate (GETR) for NFCs, by dividing taxes on corporate income by profits before taxes ([Fig. 4](#)). This measure is misleading because foreign profits retained abroad (which were not taxed in the US) are included in the denominator. Subtracting them from profits shows a domestic ETR of roughly 26% over the past few years, well below the statutory rate of 35%. However, it too may be misleadingly high because it includes taxes paid to other foreign and domestic taxing bodies. Then again, it may understate the federal ETR because it includes the profits of sole proprietor corporations, but not the taxes they pay on dividend income to their owners as individual taxpayers. As we've concluded before: It's hard to use the macro data to come up with a clean ETR paid by corporations just to the federal government.

(4) *Permanent tax holiday for overseas earnings.* The TCJA moves the US from a worldwide to a territorial tax system, which means that corporations will no longer be required to pay domestic taxes on dividends received from foreign affiliates. The Joint Committee on Taxation (JCT) has estimated that the repatriation will raise \$338.8 billion over 10 years by taxing the previously sheltered trillions in overseas profits, a one-time transition tax payable over eight years, with the proceeds heavily concentrated in the first year, 2018. The JCT [tables](#) show that by 2027, this provision actually starts to lose money.

(5) *Great Rotation.* The bad news is that bond yields are rising. For now, that isn't a problem for the stock rally, which may actually be getting some fuel from funds rotating out of bonds and into stocks. The 10-year Treasury bond yield is up from last year's low of 2.05% on September 7, when Trump's

agenda seemed to be sinking into Washington's swamp, to 2.64% on Friday ([Fig. 5](#)). Expected inflation, as implied by the 10-year TIPS yield, rose from 1.79% to 2.06% over this period ([Fig. 6](#)).

Germany I: Real Politik. Germany's economy is the most robust it's been in many years. Too bad the same can't be said for its political leadership, which moved a step closer Sunday to giving longtime Chancellor Angela Merkel a fourth term following a close and contentious vote by the Social Democrats to proceed with negotiations on joining her Christian Democratic Union in a new coalition government, according to a 1/21 Bloomberg [report](#). The vote comes four months after September's federal election resulted in no clear majority. Chancellor Merkel has been struggling to form a coalition since, reluctant to lead under a minority government.

With the EU facing a call for post-Brexit reforms, as most of its member states are financially stable for the first time since the global financial crisis, this is a critical time for Germany. Which parties make up the ruling coalition will matter greatly to the direction of the negotiations and the shape of the outcomes. And the future of Germany matters much to the future of the EU, as Germany is Europe's largest economy and has a dominant share, 29.2%, of the 19 EU member states' combined GDP. I asked Sandra Ward, our contributing editor, to review the German election and its aftermath and get up to date on the current state of affairs for a sense of what to expect ahead:

(1) *It's the refugee crisis, dummkopf!* The far-right, anti-immigration party, Alternative for Germany, or AfD, won 13.5% of the vote and 87 seats in last September's national election, the first time in 60 years that an openly nationalist group won seats in the Bundestag, a 9/24 [report](#) in *The Guardian* has noted. The AfD's success was a response to Chancellor Merkel's 2015 humanitarian response to the war in Syria and the open-door policy on asylum seekers she instituted that welcomed 1.2 million mostly Middle Eastern refugees. Recent polls have shown Germans consider immigration to be the biggest issue facing the next government, according to the 9/21 Bloomberg article.

(2) *Shifting balance of power.* The inroads made by the AfD shifted the balance of power in the Bundestag by diminishing support for the two mainstream parties that have long dominated German politics. Merkel and her conservative Christian Democratic Union won a fourth term, but the 33% of the vote represented a far slimmer margin of victory than the 41% of votes garnered in the 2013 elections. Merkel's grip on power weakened further as the "grand coalition" she forged with Martin Schulz's progressive Social Democratic Party, or SPD, collapsed in the election's wake.

The SPD ended its uneasy alliance with the CDU and declared itself an opposition party following its worst electoral showing in the postwar period—winning slightly more than 20% of the vote—as left-wing and younger supporters rejected the grand coalition and the positions of the CDU.

(3) *A new coalition, not.* Seeking to form a new coalition government, Merkel turned to the pro-business Free Democratic Party and the pro-environment Green Party for a return to the so-called Jamaica coalition that governed Germany prior to 2013. The name refers to the fact the colors of the parties match the colors of the Jamaican flag. Talks broke down in late November as the Free Democratic Party walked out, unable to reach a compromise on energy and immigration issues.

(4) *Grand coalition II.* No sooner did the three-way coalition fail than German President and Social Democrat Frank-Walter Steinmeier urged SPD leader Schulz to reconsider reviving the grand coalition with Merkel's Christian Democrats to break the political deadlock and avoid fresh elections. According to an 11/23 [report](#) in *The Guardian*, there is growing concern that new elections will erode the SPD's finances further and put more of its seats at risk of going to the AfD. By initially resisting calls to revive the coalition and welcoming new elections, Schulz alienated many party delegates and put his position as party leader in jeopardy. That speculation was fanned further when, in a speech in early December

to party members, he floated the notion of a “United States of Europe” by 2025, proposing a constitutional treaty to create a federal Europe. That created an uproar among party members and revised a long-contentious issue that threatens the sovereignty of European nations, according to a 12/7 Bloomberg [article](#).

(5) *Pas de deux*. Talks between Merkel and Schulz on reviving the grand coalition resumed last week, and after a marathon 25-hour session, the two sides reached agreement on a 28-page blueprint outlining the goals of their alliance. The euro rallied sharply on the news ([Fig. 7](#)). Terms of the alliance include a cap on the number of refugees and limits on the number of family members allowed to rejoin refugees in Germany, according to a 1/12 CNN [piece](#). Also on the list: a pledge not to increase the tax burden on citizens; increased contributions to the EU budget; fair taxation for Internet companies such as Google, Apple, and Amazon; and more cooperation with France, among other items highlighted in a 1/12 Bloomberg [report](#).

(6) *Sturm und Drang*. Many SPD members, mostly the party’s youth wing, remain wary of resuming the coalition, saying the blueprint doesn’t adequately represent their positions, according to a 1/14 Reuters [piece](#). A tax increase on the wealthy, for instance, and a push for parity between public and private healthcare aren’t included in the plan. The party rift showed in Sunday’s narrow margin of victory: 362 out of 645 votes cast.

(7) *A new dawn*. In the end, Schulz’s impassioned plea that Germany and the SPD were central to a “new dawn for Europe,” won out, according to a 1/21 *Financial Times* [piece](#). Coalition talks could resume as soon as Monday.

Germany II: Whirling Wirtschaft. In sharp contrast to the shambolic political scene, Germany’s economy is going full throttle. Official data released last week reported a new high in industrial output in November. The strong economy supports pledges in the proposed blueprint offered by the coalition that provide for tax relief of up to €10 billion through 2021 and extra spending on home-building, education, and research, according to a 1/12 Reuters’ [article](#).

(1) *Industrial production*. Germany’s headline industrial output, which excludes construction, rebounded 3.4% m/m in November, the strongest rate of growth since September 2009, on broad-based expansion in all sectors but energy. The growth was nearly double the expected increase of 1.8%. The strength follows October’s decline of 1.2% m/m due to holidays and bad weather. On a y/y basis, total November output expanded 5.6%, up from a revised 2.8% y/y in October, the best gain since August 2011 ([Fig. 8](#)).

(2) *Manufacturing output*. Manufacturing grew at a 4.3% m/m clip in November, led by a 5.7% surge in capital goods production. Consumer goods output also posted sharp gains ([Fig. 9](#)).

(3) *Exports and imports*. Exports expanded by 4.1% m/m in November, while the pace of imports quickened to 2.3% m/m. The trade surplus rose to €22.3 billion in November from €19.9 billion in October ([Fig. 10](#)).

(4) *German M-PMI and business confidence*. December’s manufacturing PMI rose to an all-time high of 63.3, as output, new orders, and exports showed accelerated growth. Business confidence fell slightly to 117.2 points in December from a revised 117.6 points in November, perhaps due to uncertainty in the political climate. Still, business confidence remains well above the critical 100-point mark and near an all-time high, suggesting optimism abounds ([Fig. 11](#)).

(5) *Valuation*. Up 4.2% ytd (local currency) and 6.1% ytd (dollars) through Friday, the performance of

Germany's MSCI stock price index trails that of its EMU counterparts. With a P/E of 13.9, it also trades well below its historical midrange of 18. The consensus projection calls for 2018 earnings growth of 10.7%, above the 9.4% growth estimate for the MSCI EMU index. Still, forward estimates for the MSCI German share price index are rising, and valuation is trending higher ([Fig. 12](#)). Germany's benchmark DAX has rallied recently on hopes that a new grand coalition with SPD can be attained. Yesterday's vote should stoke new enthusiasm toward investing in Germany.

Movie. "The Shape of Water" (+ +) ([link](#)) is a very unusual movie that harkens back to lots of previous unusual movies such as "Beauty and the Beast" and "E.T. the Extra-Terrestrial." Nevertheless, it fits in a fairly conventional way into the genre of films that show how love conquers all. During the Cold War, while Americans were watching *Dobie Gillis* on TV, evil-doers in the American army had captured an intelligent reptilian alien from the sea. Evil Russian spies aimed to kill the life form before the Americans learned his secrets. Good American and Russian folks aimed to toss him back into the sea.

CALENDARS

US. Mon: Chicago Fed National Activity Index 0.25. **Tues:** Richmond Fed Manufacturing Index 18. (*Wall Street Journal* estimates)

Global. Mon: None. **Tues:** Eurozone Consumer Confidence 0.6, Germany ZEW Survey Expectations 17.9, Japan Trade Balance (yen) 520b, BOJ Rate Decision & 10-Year Yield Target -0.10%/0.00%, BOJ Outlook Report. (DailyFX estimates)

STRATEGY INDICATORS

Global Stock Markets Performance ([link](#)): The US MSCI index rose 0.9% last week for its eighth gain in nine weeks. The index ranked 31st out of the 49 markets in a week all but three countries rose in US dollar terms. That compares to 15th a week earlier, when it rose 1.6% as 33 countries moved higher. The AC World ex-US index rose 1.4% and outperformed the US MSCI for the fourth time in five weeks and has risen for six weeks in a row. That the best winning streak for the AC World ex-US index since it rose for seven weeks through June 2017. All regions rose last week for a second week as EM Latin America performed the best with a gain of 2.9%, followed by BRIC (1.9), EM Asia (1.8), EMU (1.7), and EM Eastern Europe (1.5). EMEA (1.1) and EAFE (1.2) also rose, but were the worst-performing regions. Taiwan was the best-performing country, with a gain of 4.4%, followed by South Africa (4.1), Mexico (3.6), Pakistan (3.5), and Poland (3.3). Egypt was the worst performer among countries, falling 1.5%, followed by slight declines for Israel (-0.5) and Turkey (-0.4). On a ytd basis, the 5.1% gain for the US MSCI ranks 28/33, which matches the gain for the AC World ex-US as all regions and 47/49 countries are higher. EM Eastern Europe (9.3) leads EM Latin America (8.7), BRIC (8.5), EMEA (7.4), EMU (6.3), and EM Asia (6.3). EAFE (5.0) is the only laggard relative to the AC World ex-US's performance, but barely so.

S&P 1500/500/400/600 Performance ([link](#)): All three market-cap indexes ended the week at record highs. LargeCap rose 0.9% and edged out SmallCap (0.7%) and MidCap (0.7). Twenty-four of the 33 sectors rose w/w, compared to 23 a week earlier. Last week's biggest gainers: LargeCap Consumer Staples (2.4%), LargeCap Health Care (1.9), SmallCap Health Care (1.7), and MidCap Tech (1.6). Energy and Telecom dominated last week's worst performers: MidCap Energy (-3.2), SmallCap Energy (-2.8), SmallCap Telecom (-2.0), LargeCap Energy (-1.3), and MidCap Telecom (-1.1). LargeCap has risen 5.1% so far in 2018, ahead of SmallCap (4.3) and MidCap (4.1). The best performers to date in 2018: SmallCap Health Care (8.5), SmallCap Energy (8.1), and MidCap Tech (8.0). The Utilities and Real Estate sectors dominate the worst performers: MidCap Utilities (-5.2), LargeCap Utilities (-5.0), LargeCap Real Estate (-4.5), and SmallCap Utilities (-4.4), MidCap Real Estate (-4.2), and SmallCap

Real Estate (-3.7).

S&P 500 Sectors and Industries Performance ([link](#)): Seven of the 11 sectors rose last week, and five outperformed the S&P 500's 0.9% gain. That compares to seven sectors rising a week earlier when five outperformed the S&P 500's 1.6% gain. Consumer Staples was the best-performing sector as its 2.4% gain beat out the advances of Health Care (1.9%), Tech (1.5), and Financials (1.0). Energy (-1.3) was the biggest underperformer followed by Industrials (-0.9), Utilities (-0.5), Materials (-0.2), Telecom (0.4), Consumer Discretionary (0.6), and Real Estate (0.8). Eight sectors are higher so far in 2018 and six are ahead of the S&P 500's 5.1% ytd gain. The best performers to date in 2018: Consumer Discretionary (7.1), Health Care (7.0), Tech (6.7), Energy (5.9), Financials (5.7), and Industrials (5.2). These sectors have underperformed: Utilities (-5.0), Real Estate (-4.5), Telecom (-2.9), Consumer Staples (1.9), and Materials (4.7).

Commodities Performance ([link](#)): The commodities markets cooled off last week: Twelve of the 24 commodities we follow rose for the week as the S&P GSCI commodities index fell 0.6% for its first decline in five weeks. That compares to a 2.1% gain in the prior week, when 15/24 commodities rose. Last week's strongest performers: Live Cattle (2.7%), Cotton (2.1), Feeder Cattle (2.1), and Lead (2.0). Last week's biggest laggards: Sugar (-6.6), Natural Gas (-1.7), Brent Crude (-1.6), Crude Oil (-1.4), and Heating Oil (-1.1). The best performers so far in 2018: Cotton (6.1), Lean Hogs (5.2), Crude Oil (4.8), and Lead (4.0). 2018's laggards: Sugar (-12.6), Coffee (-3.9), Copper (-2.8), and Aluminum (-2.1).

Assets Sorted by Spread w/ 200-dmas ([link](#)): Spreads between prices and 200-day moving averages (200-dmas) rose last week for 11/24 commodities, 7/9 global stock indexes, and 21/33 US stock indexes, compared to 14/24 commodities, 3/9 global stock indexes, and 23/33 US stock indexes rising a week earlier. Commodities' average spread dropped w/w to 6.7% from 6.9%. However, more commodities trade above their 200-dmas now, 16 compared to 15 a week earlier. Crude Oil leads all commodities and all assets at 22.9% above its 200-dma, but Live Cattle (4.2%) rose 2.6ppts w/w for the best performance of all commodities and all assets. Crude Oil is followed closely by Brent Crude (22.3), GasOil (20.1), Heating Oil (19.8), and Nickel (18.9). Sugar (-8.6) trades at the lowest of all commodities relative to their 200-dmas as it fell 5.9ppts last week for the worst performance of all commodities and indeed all assets. The global indexes trade at an average of 9.5% above their 200-dmas, up from 8.7% in the prior week. All nine global indexes still trade above their 200-dmas, the same as a week earlier. Brazil (15.8) now leads the global indexes as it rose 2.0ppts for the best performance among global indexes. The UK (3.9) trades the lowest among its country peers and dropped 0.8ppt for the worst performance among global indexes. The US indexes trade at an average of 8.0% above their 200-dmas, with 26 of the 33 sectors above, up from an average of 7.9% a week earlier, when 26 sectors were above. SmallCap Health Care (19.0) now leads all US stock indexes relative to their 200 dmas, followed by SmallCap Energy (17.4), MidCap Energy (17.2), LargeCap Financials (15.8), and LargeCap Tech (15.4). MidCap Energy fell 4.0ppts w/w for the worst performance among the US indexes last week. LargeCap Consumer Staples (5.1) improved 2.3ppts w/w for the best performance of the US stock indexes. MidCap Telecom trades at a sharp discount relative to its 200-dma of 13.9%, the lowest among not just the US stock indexes but all assets.

S&P 500 Technical Indicators ([link](#)): The S&P 500 index remained in a Golden Cross last week for a 90th week (after 17 weeks in a Death Cross) as both the short-term and long-term trends improved for a second straight week. The index's 50-day moving average (50-dma) relative to its 200-dma rose to a four-year high of 6.2% from 5.9% a week earlier. That compares to a 39-week low of 3.4% in early October and a 52-month low of -4.5% in March 2016. The S&P 500's 50-dma and 200-dma both rose together for a 21st straight week, after failing to rise together in mid-August for the first time in 36 weeks. The index closed above its 50-dma for a 20th week after three weeks below, which was its worst streak since it closed below its 50-dma for 10 straight weeks from September 2016 until the

November election. The S&P 500 rose to a 21-month high of 5.1% above its rising 50-dma from 5.0% a week earlier. These 50-dma readings compare to a four-month low of 1.0% below the index's falling 50-dma in mid-August and a 52-month high of 6.2% in March 2016. The S&P 500 surged to 11.7% above its rising 200-dma from 11.2% a week earlier. That's the highest it has traded above its 200-dma since May 2013, which compares to a post-election low of 3.0% in mid-August and a four-year low of -10.1% in August 2015.

S&P 500 Sectors Technical Indicators ([link](#)): Among the 11 sectors, last week saw five improve w/w relative to their 50-dmas and seven to their 200-dmas. These four improved relative to both dmas: Consumer Staples, Health Care, Tech, and Real Estate. Nine of the 11 sectors traded above their 50-dmas for a fifth week, unchanged from a week earlier. Utilities was below its 50-dma for a sixth week and Real Estate for a fifth week. Still, that's up sharply from six at the end of November and contrasts real favorably with the week before the 2016 election, when all 11 were below (for the first time since December 11, 2015). The longer-term picture—i.e., relative to 200-dmas—shows nine sectors trading above, also unchanged from a week earlier as Real Estate was below for a third week and Utilities for a fifth week. All 11 had been above in mid-December for the first time since mid-February. All sectors are in a Golden Cross (50-dmas higher than 200-dmas) for the first time since a 26-week streak ended in October 2016. That's up from 10 sectors a week earlier as Telecom joined the club for the first time in 46 weeks. Nine sectors have rising 50-dmas, unchanged from a week earlier as Real Estate fell for a third time in five weeks and Utilities dropped for a fifth straight week. Eight sectors have rising 200-dmas, unchanged from a week earlier, as Real Estate and Utilities fell for a second week. Telecom's 200-dma fell for a 21st straight week, and Energy's 200-dma rose for a fifth week after falling for 34 weeks.

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