MID-CONTINENT CAPITAL

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Will Worry Give Way to Euphoria?

On numerous occasions during an eventful 2017, investors seemed unusually preoccupied with geopolitical events -- not the least of them being the drama of a new and unpredictable administration. This is understandable, if for no other reason than the fact that the United States has never had a president quite like Donald Trump. Judging from media coverage of Washington and Wall Street, the equity market was nearly always on the verge of a price collapse owing to conflict with North Korea, high level indictments from a special prosecutor, or the failure of Republican tax reform efforts.

One year ago in *Consilium*, we noted the following:

> *There is good reason for increased optimism about the economy, corporate profits, and stock prices in 2017. Mr. Trump's fiscal agenda is dominated by ideas and proposals that, all else being equal, should be helpful to growth over the next few years:*
>
> - *corporate tax reform featuring incentives to repatriate overseas cash*
> - *large (but undefined) infrastructure spending plans*
> - *lower individual tax rates, including lower capital gains rates*
> - *reducing regulatory burdens on business*
> - *reforming the Affordable Care Act*
> - *encouraging even more aggressive development of domestic energy resources*
>
> *The incoming Trump administration offers reason to be openly optimistic about the economy and the stock market.*

In hindsight, if an investor had known with certainty that four of the six agenda items above would indeed come to pass, he or she would have expected the market to ignore the headlines, continue to "climb a wall of worry", and march steadily higher -- and this is precisely what happened. The global economy gathered strength throughout the year, corporate profit growth accelerated, and even minor market dips were quickly reversed. A positive feedback loop of higher business, consumer, and investor confidence now has all but erased memories of the nervousness that prevailed a year ago and at various times throughout the year. Even prominent long time pessimists are openly speculating that the equity market may be heading for a "melt up".[1]

Is the market's more exuberant, confident tone reason alone to be concerned? After all, over very long periods, the best market returns tend to be earned when investor enthusiasm is low, not high. But this undisputable fact does not provide a sufficient basis for a 2018 market forecast -- it merely reminds us that the market simply may be more vulnerable to the kinds of geopolitically-driven "shocks" we described in our last issue of *Consilium*. These sudden market declines are inevitable but random, and generally serve as good buying opportunities. To repeat, **investors are much better served by focusing on economic and business fundamentals than by attempting to predict the unpredictable**.

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So, do the current fundamental factors offer reason to be concerned? At the moment, we are confident that the answer is "no". Meaningful bear markets, over the last 50 years, have nearly always been associated with recessions and sharp declines in corporate profits. But economic downturns do not simply happen -- they inevitably result from overly tight financial conditions created by the Federal Reserve. This process of shifting from a virtuous to a vicious cycle seems to repeat itself unfailingly, as follows:

1. In response to strong economic growth, low unemployment, and the risk such conditions may pose for higher inflation, the Fed raises short term interest rates.
2. Having risen sufficiently, higher interest rates put pressure on heavily indebted firms, particularly those that have borrowed money for aggressive expansion purposes.
3. Lenders -- bondholders and bankers -- become concerned about the creditworthiness of borrowers, and credit "spreads" (the incrementally higher interest rates private borrowers must pay) widen.
4. Seeing reduced access to capital, firms cut back on investment spending and hiring, creating ripple effects across the broader economy.
5. As consumers perceive less robust job market conditions, they rein in their spending plans.
6. With profits coming under pressure, companies in turn further reduce inventories, investment and hiring, until the Fed relents and financial conditions ease materially.

As we enter 2018, all eyes are on the Fed and "step one" of the paradigm outlined above. The Fed began to back away from its ultra-low interest rate policy in late 2015 and has moved gingerly since then due to persistently low inflation. If higher inflation finally does arrive, the Fed would of course be justified in tightening: it may come to pass that the economy has simply reached the limits of its natural capacity to grow, and a Fed-induced downturn is inevitable.

Whether higher inflation materializes, and how quickly the Fed moves in response, therefore holds the key to sustaining the current economic expansion and equity bull market. We are not convinced that meaningfully higher inflation is imminent; for example, there is still a large reservoir of labor available to fuel growth even at 4% unemployment. If the Fed can "wait 'til it sees the whites of their eyes", and not act prematurely to repel non-existent inflation, then good corporate profit growth and higher stock prices can follow.

In summary, aside from all-important (and currently solid) fundamentals driving stock prices, it is investor confidence that will determine whether the equity market has indeed entered a "dangerous" euphoric period that will leave it more exposed to disappointment. But if healthy market skepticism dominates again in 2018, stock prices can advance at a sustainable pace that leaves room for error.

[1] *https://www.marketwatch.com/amp/story/guid/655382BE-F0C2-11E7-805B-FD54EDBA88C0?__twitter_impression=true*