StraightTalk

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What is Going On?

It is a well-known fact for most investors that the "stock market" is always forward looking; the short term direction is driven by investors anticipating declines or improvement in our economy. In other words, the market doesn't care whether things are good or bad, it cares whether thing are getting better or worse on a relative basis. Clearly, since the election in November, it appears that the U.S. stock market is thinking things are going to be getting better. But are we all, collectively, getting ahead of ourselves and bidding up prices too much, too soon?

On one hand, conditions on the ground appear poised for economic improvement. We have a new President who is following through on his campaign promises of less regulation, lower corporate taxes, and a pro-business environment that has been lacking in Washington for many years. These changes in policy, if they are enacted, will improve corporate profits immediately, and could add as much as 1% to our economic rate of growth, according to numerous analysts. This possibility has caused a surge in stock prices, pushing the market to new highs almost every week since early November last year.

On the other hand, we have a new President who is following through on his campaign promises of limiting immigration, and favoring protectionist behavior regarding trade. These policies, if enacted, will shrink the labor pool for many manual labor industries, and could create significant friction in trade, making the import and export markets out of balance, drive prices up, and perhaps start trade wars with other nations. The combination of these policies could negatively impact the strength of the dollar, and slow down the economy's rate of growth in the future. Clearly, the market appears to be discounting the potential impact of these policies.

And that, my friends, is the clearest sign of all that we are in the midst of a secular bull market. Celebrating good news, and ignoring weak economic data (or even bad news) is a classic sign that investors are optimistic and are voting with their dollars. Remember, it is not "the stock market," it is a market of stocks, bought and sold by people who make daily judgements on their relative merits. In other words, emotion is always and everywhere part of the stock market dynamic. How else can you explain why the stock market declined almost 40% in 2008-2009, when the economy only declined about 6%? Markets get overbought and oversold because emotion clouds the facts on the ground, and only when the selling or buying is exhausted do people once again make decisions based on facts. In the example of the bear market of 2008-2009, it was very clear that the stock market was severely oversold and was due to rebound, but most investors remained nervous, paralyzed by fear and thus missed a chance to add significant money to accounts at levels that today look unbelievably low.

So, the question now is have stock prices moved too far, too fast - in expectation of economic improvement, or has this move up been justified, and there is more to come? In an attempt to answer that question, I canvassed a wide range of investment managers to gauge their relative range of enthusiasm for the near term. One common thread emerged in doing so, which is not directly attributable to the election results, but is somewhat related to it.

There is a growing consensus that across the globe, populist politics is on the rise. While populism is not good policy in every category (protectionism and tariffs are two distinct negatives,) one positive effect that often emerges from populist politics is governments loosening purse strings and directing spending towards local or domestic markets. The investment manager, Clarion Partners wrote in a recent report, *"We could see government fiscal* *spending taking over from central bank's monetary policy. Given that government spending is a lot easier to understand and predict than monetary policy, this could be a very good thing for markets."* Another manager, Brandywine Global concurs, saying in an interview, *"We believe the world is moving from an investment regime dependent on developed markets' monetary policy to one based on real growth."* In other words, the Federal Reserve will begin to take a back seat, and allow the fundamental driver of stock prices to once again be mostly about corporations and their earnings. Given that earnings are expected to move up sharply in the next year or two, this could indicate upside for the markets from here.

Another common thread amongst many investment managers is the enormous horde of cash that is on the sidelines. In a report from January, Legg Mason Global Asset Management stated, "*There is approximately $70 trillion of cash currently sitting on the sidelines. To be sure, in a low interest rate environment, the opportunity cost of holding cash is low. However, a massive stimulus program underway in Washington, including infrastructure spending and tax cuts, has already boosted inflation expectations, and some of that cash may be "forced" to jump into the market for higher return opportunities, benefitting many asset classes."* A similar report from the Investment Company Institute, which tracks flows of investor's dollars into various asset classes, echoed this theme. Their report indicates a significant amount of money has rotated into stocks from bonds since election night. Their conclusion was that as interest rates rise over the next couple of years, cash will become a less and less attractive place to be, and that cash will be looking for more attractive inflation beating returns, which should continue to push the markets higher in the intermediate term.

The final area with a consensus of opinion from many portfolio managers is that the cycle of business investment is about to improve. Referred to as capital expenditures (Capex), or research and development spending (R&D), this has been conspicuously absent in recent years, as companies have been cutting their bottom line, buying back their own stock, and hoarding cash on their balance sheets.

According to Clarion Partners, *"Business investment, which has been a key missing component in the current recovery and expansion cycle, could finally break out of its slump."* A report from CNBC last week analyzed fourth quarter earnings conference calls from almost half of the companies in the S&P 500. These calls, conducted between January 1 and February 2, had more mentions of Capex spending than any other topic. The report concludes, *"Phrases related to capital spending had 1,027 mentions, while tax related terms appeared 639 times, interest rates were discussed 353 times, trade policy had 108 mentions, and deregulation had just 59 mentions."* In other words, it appears that CEOs are aware of the specific policy proposals being floated by Washington, but are more focused on spending inside of their companies to gain or maintain competitiveness as we enter a stronger period of economic growth.

The most concise explanation of why we should remain optimistic came from JP Morgan CEO, Jamie Dimon, in a recent interview He said *"America has the best hand ever dealt to any country on this planet today, and ever. And Americans don't fully appreciate what I'm about to say. We have peaceful, wonderful neighbors in Canada and Mexico. We have the biggest military barriers ever built, called the Atlantic and the Pacific. We have all of the food, water and energy we will ever need. We have the best military on the planet and we will for as long as we have the best economy. And if you're a liberal, listen closely to me on that one, okay. Because the Chinese would love to have our economy. We have the best universities on the planet. There are great ones elsewhere, but these are the best. We still educate most of the kids who start businesses around the world. We have the rule of law, which is exceptional. If you don't believe me, we can talk about Brazil, Russia, Venezuela, Argentina, China, India. Believe me, it's not quite there. We have a magnificent work ethic. We have innovation from the cores of our bones. You can ask anyone in the room…it's not just Steve Jobs. We're the widest, deepest financial markets the world has ever seen. I just made a list of these things. It's extraordinary. It's extraordinary. And we have it today."* That sounds like a case for the bulls rather than the bears, don't you think?

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