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How do you reconcile the chaos and dysfunction in Washington with the so-called Trump Rally in the stock market?

How do you square President Trump's record low approval rating and civil unrest over his policies with recent surveys showing a surge in optimism among American consumers and business?

Is the country headed in the right or wrong direction? A recent Rasmussen poll shows only 38% of Americans say we are on the right track. But that's actually a big improvement from 30% of those surveyed just prior to the election and 24% at this time last year.

I have pondered these questions ad nauseam, trying to divine their relevance to the outlook for stock and bonds.

A psychologist might conclude that our "body politic" is suffering from both schizophrenia and multiple personality disorder. As most people know, schizophrenia is an affliction that causes people to lose touch with reality, become unreasonably suspicious of others, feel persecuted, and become fearful and sometimes violent. MPD is characterized by a person having two or more distinct identities and personalities. It is often caused by extreme stress and childhood trauma. (Quick! Hide the kids from Rush Limbaugh, Rachel Maddow and C-SPAN.)

Economics has a foundation in hard numbers–employment, inflation, spending–that has largely allowed it to sidestep the competing partisan narratives that have afflicted American politics and culture. But not anymore. Since Donald J. Trump's victory consumer sentiment has diverged in an unprecedented way, the Republicans convinced that a boom is at hand, and Democrats foreseeing an imminent recession.

~ New York Times
April 9, 2017

The "Circus Maximus" of American politics

The conclusion that much of the country is going crazy may be a useful, if not entirely accurate, way of explaining some of the contradictions that confront investors. My view is that the US media—broadly defined as print, radio, TV and particularly social media—has helped fuel our collective psychosis. The media is too focused on the noisy and vitriolic "Circus Maximus" of American politics. Too little attention is paid to events outside Washington and inside the private sector. Amplified by a 24 hour news cycle, the media's devotion to politics creates the false impression that government is the primary determinant of our economic well-being. In a nutshell, the media makes it hard for investors to separate the signal from the noise.

Since the November election, the US stock market gained 11% as of March 31st. This so-called Trump Rally was initially led by market sectors deemed to benefit most from the new administration's policies: namely, Energy, Materials, Industrials and Financials. What's more, US stocks with low foreign exposure outperformed those with high foreign exposure throughout 2016.

The outperformance of the Trump beneficiaries began to falter in the waning days of 2016 and new leadership emerged in the first quarter. The Information Technology, Health Care and Consumer Discretionary sectors led the market during the first three months of 2017. Stocks with high foreign exposure outperformed more

> *Gloomy projections for Europe reflect a classic forecasting mistake, which is to extrapolate from recent trends and miss the big shifts. Predictions of an impending takeover by destabilizing populists overstate their momentum.*
>
> ~The Economic Winds are at Europe's Back, Ruchir Sharma
> Wall Street Journal
> March 31, 2017

Exhibit 1: Five Key Warning Signs that the End is Near. Four of five indicators are still positive.

Indicator	Commentary	Current Reading
❶ Short-term vs. long-term interest rates	When short-term interest rates rise to meet or exceed long-term rates, monetary policy is usually tight enough to eventually cause a recession.	Fed funds rate is far below 10-year T note.
❷ High-quality vs. low-quality bond yields	A widening gap between junk bond yields and Treasuries indicates deteriorating credit market conditions.	Credit Spreads are still narrow
❸ Wage inflation	When wages rise at a 4% annual rate, it is difficult for the Fed to keep core inflation near its 2% goal. So the Fed usually tightens policy aggressively.	Wage growth is 3% and beginning to accelerate
❹ S&P 500 P/E ratio	Price earnings ratios over 20 times makes stocks vulnerable to rising interest rates and inflation.	P/E is 20.1 times
❺ The leading economic indicators	The Conference Board's LEI has peaked and turned down in advance of each recession since 1960.	Strong uptrend

domestic-oriented names. And it's worth noting that the best performing stocks within the Consumer Discretionary sector were internet retailing and media stocks. Like technology and health care, internet retailing and media are US industries which are globally competitive in their own right and not generally viewed as Trump beneficiaries or in need of government help.

Synchronized global economic expansion

So what's going on with the Trump Rally? It appears there's more to it than just Donald Trump and his policies. Indeed there is. What's going on is a synchronized global economic expansion the likes of which we haven't seen in almost a decade.

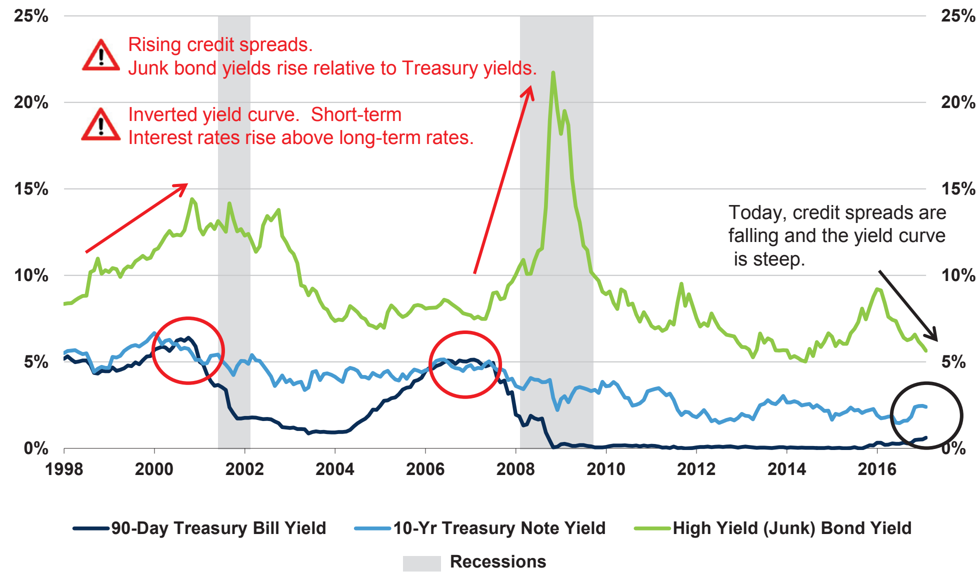
In 2008-09 the US and Europe were mired in recession while China and many emerging market economies enjoyed modest growth. Just as a tepid recovery got underway in the West, a sovereign debt crisis hit Europe and the Eurozone "double-dipped" into a second recession in 2012. As Europe regained its footing in 2013-14, China experienced a financial crisis in its real estate markets. This together with a plunge in commodity prices in late-2014 caused many emerging market economies to weaken or enter recession (think Brazil and Russia).

> *The final Markit Eurozone Manufacturing PMI rose to 56.2 in March 2017 . . . It was the highest reading since April 2011, as output and new orders expanded the most in nearly six years, amid stronger inflows of new work from domestic and export clients. On the price front, manufacturers' purchasing costs rose at a rate close to February's 69 month high.*
>
> ~Trading Economics
> April 6, 2017

The disjointed, out-of-sync nature of the global economy in 2008-2015 gave rise to a deflationary environment which undermined credit markets and caused many central banks to pursue zero interest rate policies. Finally in 2016, commodity prices began to firm and China and other emerging market economies began to exhibit improved performance. As a result, all major areas of the world economy are now growing in unison—even the lethargic Eurozone. Unemployment there recently hit an eight-year low and the region's closely watched PMI index signaled robust first quarter 2017 economic activity. So, in the Eurozone and around the world, inflation is back. And interest rates are beginning to rise.

With almost 30% of our GDP dependent on international trade and almost 40% of S&P 500 revenues derived from foreign sources, the synchronized global expansion is having a positive impact on the US equity market. Earnings are beginning to grow

Exhibit 2: Mind the Gap! The gap between short-term/long-term interest rates and high-quality /low-quality bond yields are important signals for equity investors.



Sources: Bloomberg, Bank of America Merrill Lynch, Atlanta Capital as of 3/31/17

again. From 2014 to 2016, S&P 500 earnings per share flatlined around $117 as global growth slowed and commodity prices remained under pressure. In the fourth quarter of last year, however, US corporate earnings growth began to accelerate with the pick-up in global economic activity. Estimates for S&P 500 earnings in 2017 are in the range of $125 to $130, a gain of 7-10% over the prior year.

In my view, the emergence of a synchronized global expansion is a more significant signal for investors than any that may be gleaned from examining the entrails of our political process. Now what? Despite strong gains in stock prices over the past nine years, I believe the US market can still trend higher over the balance of 2017.

Exhibit 1 shows five indicators that I've found useful in providing an early warning signal that the end of a bull market is near. These indicators are not useful in signaling a correction in stock prices—the 5% to 15% dips in the market averages which have pockmarked bull markets throughout history. As a rule of thumb, I would turn more negative on the market when three of the five indicators turn negative.

Currently only one indicator is negative: the S&P 500 index closed the first quarter at 2393 putting its price/earnings ratio slightly over 20 times trailing four quarter earnings. The market's P/E ratio (or most any other valuation metric) is generally a poor indicator of future market trends. P/E ratios can stay high or low for extended periods. In fact, economic environments with low interest rates and inflation, like the current one, are conducive to sustaining higher than average P/E ratios.

Over the long-term, P/E ratios for the market have generally fluctuated between about 10 and 20 times, with 15 being the long-term average. The reason we include P/E among our five indicators is that "expensive" markets can fall a lot once the other indicators turn negative. For example, in the year 2000, the S&P 500 index traded at a record 30 times earnings. Between the March 2000 high and the October 2002 low the market plunged almost 50% despite only a brief, mild recession in 2001. Rich valuations limit the upside potential for the stock market and can create the potential for big declines if the economy turns sour.

In 2015, two Princeton University economists published a landmark paper showing that mortality was rising for white middle-aged Americans after decades of decline, a startling development for an economically advanced nation. Now a new analysis . . . paints an even bleaker picture of the nation's largest population group . . . Driving the uptick are increases in "deaths of despair" –from drugs, alcohol-related liver disease and suicide.

~ Wall Street Journal
March 28, 2017

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In the United States today, we have more than our share of the nattering nabobs of negativism. They have formed their own 4-H Club– the hopeless, hysterical hypochondriacs of history.

~Vice President Spiro Agnew
referring to the media in a speech
September 11, 1970

A computer lets you make more mistakes faster than any other invention with the possible exceptions of handguns and Tequila.

~Mitch Ratcliffe
Journalist and digital media executive

I don't see much potential for the US economy to turn down in 2017. US leading economic indicators remain in a strong uptrend and an LEI downturn typically leads a recession by about three quarters. Wage inflation is not yet strong enough to cause the Federal Reserve to hit the panic button, i.e., jack up interest rates aggressively to rein in inflation pressures.

What's more, our two credit market indicators are signaling that monetary policy is still relatively easy and there's sufficient credit availability to finance economic growth. Exhibit 2 depicts the two indicators over the past 20 years. We compare short-term interest rates to long-term interest rates (Indicator 1) by showing the trends in yields for the 90-day Treasury bill and the 10-year Treasury note. As you can see, the gap between short and long rates is still relatively wide. Thus the yield curve is positively sloped—an indicator of healthy credit markets. Note the red circles around years 2000 and 2006-2007. These were periods right before recessions when the yield curve was flat or inverted, i.e., short-term rates equaled or exceeded long rates. This is an abnormal condition and signals trouble ahead.

To determine Indicator 2, I compare yields for high yield (junk) bonds to those of 10-year Treasuries. A widening spread signals that lenders are becoming more quality conscious and credit conditions are tightening. Conversely, when spreads are narrow, like now, credit conditions are healthy and accommodative to borrowers.

Tax reform and stock prices

A few days ago I attended a tax seminar at the University of North Carolina at Chapel Hill. After hearing from a number of tax experts in government, industry and academia, I left the seminar with the conclusion that there is little hope for significant tax reform this year. It's just too difficult an undertaking in today's fractious political environment.

More than a few market pundits opine that corporate tax reform is an important precondition for higher US stock prices given the lofty valuations of our market. I don't agree. This nation has long endured with a globally uncompetitive corporate tax code and an expensive and dysfunctional health care delivery system. While both need reform, the fortunes of investors over the next 12 months are more likely to be influenced by trends in global economic data than the vagaries of US politics. So put down your *Washington Post*, turn off *Fox News* and pick up a copy of *The Economist*. It's the London-based weekly that does a credible job of putting us Yanks into a proper global perspective and helping us separate the signal from the noise. ☘