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2018 Outlook

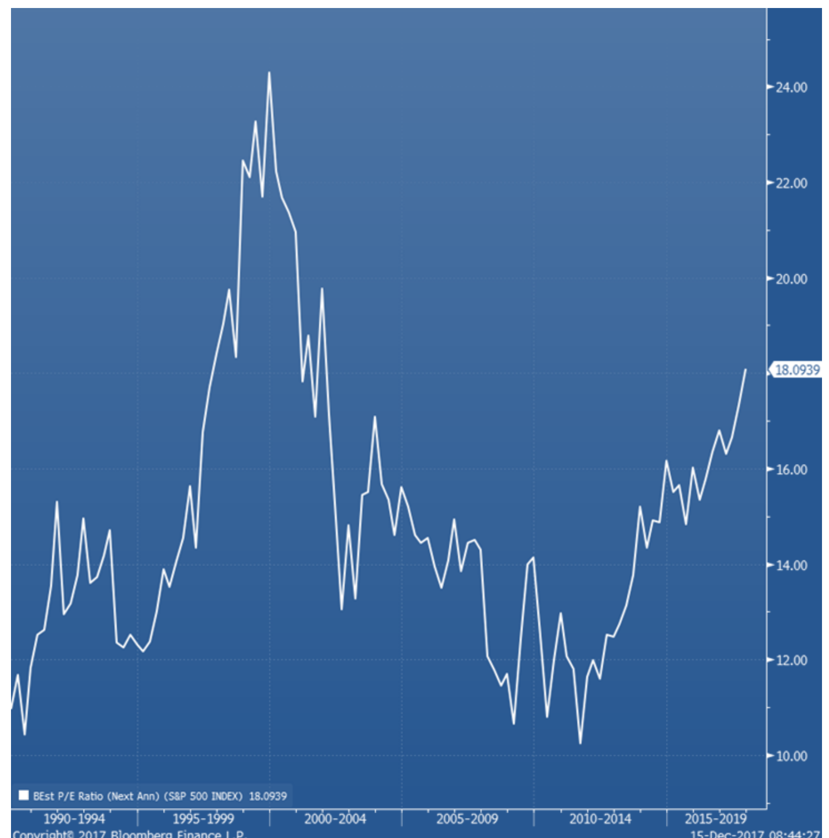
Not Everything Is Expensive

After a surprising 2017 for markets, a relevant question is whether there is anything left for equity markets to give. The potential of tax reform to provide new life to the U.S. economy and corporate earnings should not be underestimated. But is it already priced into markets?

On the surface, it would appear that tax reform and a booming U.S. economy (yes, 3% is a booming economy) are fully priced in. But that belies a more complex market underlying the most popular indices. For example, the S&P 500 is trading at more than 18x its forward earnings number. However, this is not indicative of how "expensive" the overall market is now.

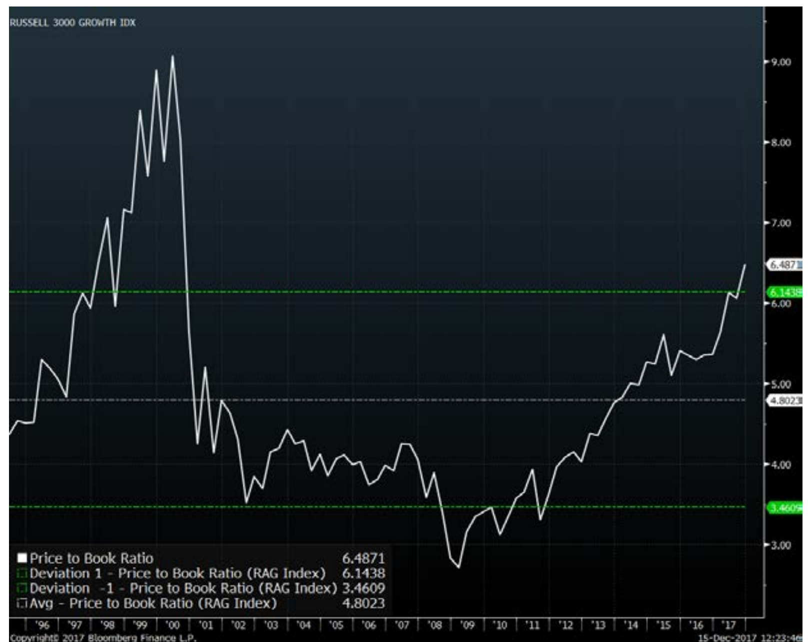
Taking a closer look at the market reveals significant valuation disparities between parts of the market. Growth stocks (Facebook, Google, and the like) are relatively expensive, while Value stocks (such as banks) valuations are consistent with historical norms. The Russell 3000 Growth Index, a broad index covering both large and small cap U.S. growth stocks, is trading well above its average historical levels. The Russell 3000 Value is near its average levels.

The differential between the two indices' valuations is at an extreme not seen since the dot-com bubble. It is worth noting that value had a relatively good decade following the dot-com bubble, while growth lagged.



Source:
Bloomberg

This creates an interesting outlook for U.S. equities. While the overall valuations of the indices are expensive, not everything is expensive. And the places where the valuations are not extreme have a tendency to be the ones that benefit from tax reform as well. This creates the potential to lean into the tailwinds of tax reform while simultaneously lessening the "expensiveness" of investments.



Source: Bloomberg

Also of note in positioning for 2018 is the positive economic outlook. The U.S. economy should continue to accelerate through the first half of 2018, and continue its strong growth for the remainder of 2018. This type of economic environment tends to favor value over growth equities.

As previously mentioned, the tax reform will favor value, but it will also favor smaller companies as well. The acceleration in earnings growth for companies could be extreme in some cases. According to Jefferies, accounting for the tax package increases 2018's earnings growth in value from 8.3% to more than 23%. That type of change in earnings growth is substantial and a reason to pay attention.

Source: Bloomberg

Source: Bloomberg

What Could Rock the Boat?

At its final meeting of the Yellen era, the Federal Reserve raised rates to the range of 1.25% to 1.5%. But that does not really matter. Everyone expected the Fed to raise interest rates, and it delivered. What made people nervous was future moves by the Fed. Specifically, how would the Fed react to tax reform? The Fed answered by suggesting it would not attempt to counteract it.

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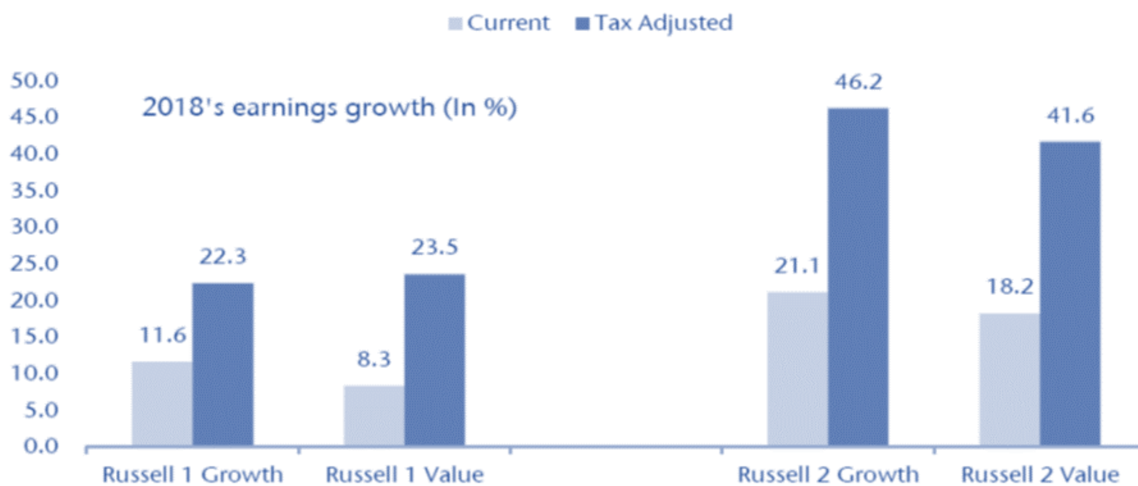
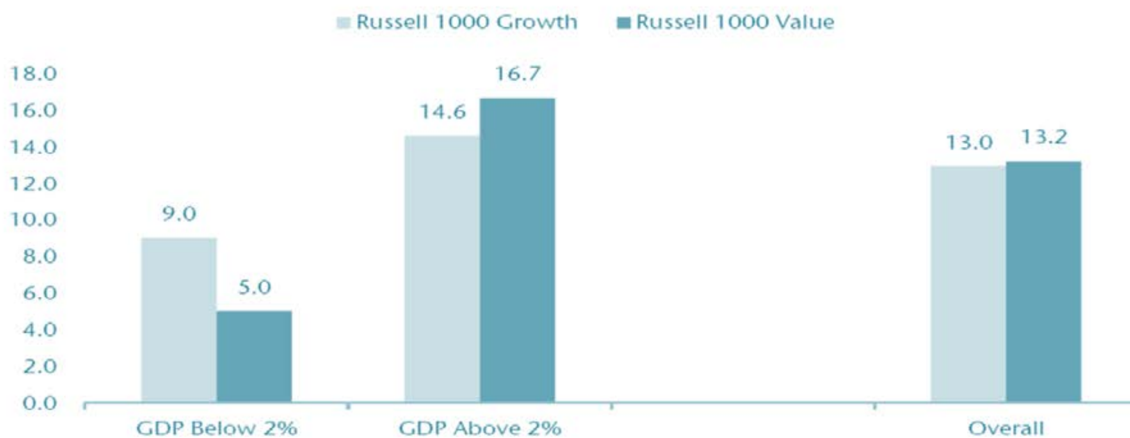


Note: Excludes nonearners and Real Estate
Source: FactSet; FTSE Russell; Jefferies

Chart 14: When GDP breaks 2%, value does tend to outperform in large



Source: FactSet; FTSE Russell; Jefferies

The Fed's willingness to avoid counteracting the potential economic tailwind from Trumponomics is an important step in understanding the dynamics of 2018. With the tax reform package, the U.S. economy should accelerate in 2018. That is quite the statement given that the U.S. economy is nearing a decade long expansion.

Source: Bloomberg

One of the more pressing questions heading into the Fed meeting this week was how the Fed would react to this possibility. There were two possibilities. First, the Fed could see tax reform as coming too late in the cycle, the potential for overheating the economy, and therefore hint at an accelerated path of tightening to counter it. Alternatively, it could sit back and take the inflation and growth as a welcome reprieve from the past few years.

The answer was clear: take the inflation and growth from the tax reform, interfering little. Taking this route made sense for the Fed.

It is already guiding markets toward three hikes in 2018, and the market already has two priced in. Without imminent tax reform, three was likely to be overly aggressive. But with tax reform passed, sticking to its previous guidance was not a shock to the system.

With "most" of the participants accounting for tax reform in their projections for growth and inflation, the Fed raised estimates for growth in 2018 by 0.4%, but the estimate for inflation remained flat. This "growth without the inflation" prediction is one of the more interesting takeaways. The Fed's mandate revolves around full employment and a stable price level. With the unemployment rate at 4.1%, the critical piece of the puzzle is inflation. Even with the tax reform kicker, the Fed does not see accelerating inflation pressures, and therefore there is no reason to accelerate interest rate hikes. It is not a difficult calculus.

To a degree, this view of a growth surge without additional inflation pressure is unrealistic. It goes against many of the orthodox economic lessons and theories. Then again, those do not always play well in the real world, and there are reasons to believe that growth without much inflation could be the case. After all, wage pressures remain lackluster, and the latest Consumer Price Index (CPI) report showed nascent weakness in services pricing. Services (less energy) have been the sole driver of inflation over the past several years. Maybe the Fed's projection on inflation is more realistic than it appears on the surface.

Source: Bloomberg

To its credit, the Federal Reserve is not alone. While announcing no change to its policy stance, the European Central Bank (ECB) did a victory lap of sorts at its latest meeting. They too expect inflation pressures to be modest and upgraded their growth forecasts. Further, ECB President Draghi made clear: Monetary policy would remain loose for the near future, the EU has much farther to go in its recovery, and the ECB would only slowly withdraw policy stimulus when the time was right.

The result of the announcement of the Fed and ECB was a sigh of relief. An overreaction by the Fed to the possibility of inflation pressures was a major risk to the current economic expansion. By suggesting that it is willing to allow inflation to pick-up before accelerating its tightening, the Fed is giving the global economy room to run in 2018.

For its part, the ECB is not leaving the party early either. Instead, Draghi made it clear that the U.S. and Europe were at different points in their recoveries with Europe having much further to go.

For the ECB, the question becomes when to stop pouring gasoline on the fire. Ben Bernanke began to scale back quantitative easing nearly four years ago. The ECB appears poised to end 2018 with a similar announcement.

The Fed and ECB could not have been clearer about their willingness to keep this expansion going. All in all, the central banks told markets to "have your growth, and don't worry about the tightening". There are few things more bullish for markets than stimulative fiscal and monetary policy. In 2018, markets get both.

Not Another 2017. Actually…

What really makes the 2018 economy so intriguing is how similar it appears to 2017. Few, if any, observers anticipated the acceleration in Europe. Oil prices have slowly climbed all year. The United States is poised to grow at a similar rate of 2.5% with a Fed that is tightening slowly. China's growth rate is slowly slowing. That sounds remarkably like 2017.

Europe's growth has been an unexpected, but welcome, addition to the case for persistent global growth. German growth has proven resilient, and France is undergoing reforms that should strengthen its economy for years to come.

Oil prices have been volatile, and this should continue. But U.S. stockpiles are beginning to move lower, and OPEC has extended cuts. That stabilizes an important geopolitical flash point, and reinvigorates an important aspect of the United States' near-term growth potential.

The United States should grow at around 2.5% next year, possibly a bit faster. The growth rate is nothing spectacular, but enough to keep the global growth story alive. China's growth rate will slow, and the Chinese leadership will begin to tackle some economic reforms. Of particular concern is how quickly and sharply Beijing reigns in the property market. Another possible issue is a reversal in its rampant debt expansion. Slowing credit expansion is akin to slowing growth, and Chinese authorities are unlikely to want to restrict it too much.

This makes 2018 dull. Without tax reform (or some other catalyst) to keep the economy in growth mode, there was a decent chance that an exhausted consumer and tepid business investment would tip the U.S. economy toward a recession. Tax reform reverses many of those potential headwinds in 2018. Business investment is likely to pick up, if only on the margin. The consumer will get a bit of a tax break, though not much. It may not fully reverse the spending exhaustion, but it will at least slow the consumption decline.

Critically, it is not because of the expectation of lower tax rates. The leaders of the market rally were U.S. technology companies with low tax rates generally known for their defensive characteristics. These companies may see their tax bills go higher under the proposed tax package. The highly taxed sectors that would benefit the most are severe laggards.

This is part of the problem for finding something dramatic to write about in regard to 2018. There really does not seem to be anything too interesting about 2018. It looks a lot like 2017. Stable global growth and tax reform should be positive for global equity markets. There are always headwinds and headlines, but the fundamentals of the U.S. economy and markets remain strong.

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