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ON OUR MINDS

Welcome Back My Friends To the Show That Never Ends

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Not that the summer wasn't without its intrigues and its spectacles (and its horrors, for our friends on the Gulf Coast), but investors could be forgiven for having taken the past two months in Truro or Kennebunk; the economy and the markets are pretty much where they were eight weeks ago. As the year's *entr'acte* closes and the curtain rises on the second act, a quick glance at the Playbill can reset the scene for us.

First, a recap of Act One. The economy has been chugging along quite nicely, the very definition of a Goldilocks year: Second-quarter GDP growth finally hit 3%; inflation remains subdued below 2%; employers are adding about 180,000 jobs per month while unemployment remains close to generational lows; and business investment is again on the rise. The Fed has been steady and cautious in its very gradual tightening moves.

Investors have noticed, and bid up securities markets: The S&P 500 is up almost 11% so far this year, and now sits just 0.4% below its all-time high. The bond market has also done well, up 4% year-to-date; most interest rates (which act inversely to bond prices) are within one percentage point of their all-time lows. It's been a good year in the markets.

On the other hand, it hasn't been a good year in Washington; eight months into the Trump Administration, Congress has enacted not a single major element of the President's agenda. When last we saw them, legislators were slinking away for intermission with nothing but a Supreme Court appointment to show for their time on stage.

> *Welcome back my friends to the show that never ends*
> *We're so glad you could attend, come inside, come inside*
> *Come inside, the show's about to start*
> *Guaranteed to blow your head apart.*[1]

And now, Act Two: The Playbill outlines several interrelated plot lines that theatergoers can expect to be resolved as the players return to the stage: Will the debt ceiling be raised? Can the dramatis personae agree on a fiscal 2018 budget? What about infrastructure spending? Is tax reform a dream or a reality? Will corporate earnings grow into current valuations? Will the Fed keep the economy in its groove? *You've got to see the show, it's a dynamo! You've got to see the show, it's rock and roll!*

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[1] Emerson, Lake & Palmer had much more to say about the political spectacle currently playing out in Washington, but most of *Karn Evil 9, First Impression* was more inciting than insightful. Besides, some of the imagery was quite bizarre and some of the puns and rhymes were really awful.

Let’s look briefly at each of these plot lines:

The debt ceiling. The Treasury is still operating under an agreement that suspended the federal debt ceiling until last March. Since then, the Treasury has been using so-called emergency measures to stay under the approximately $20 billion cap. But there’s only so many ways the Treasury can shift cash around before it runs out of options; Treasury Secretary Steven Mnuchin has said the Treasury will run out of cash around the end of September.[2]

President Trump has promised to shut down the government if debt ceiling legislation doesn’t include funds for a Mexican border wall, but he is unlikely to prevail. Mr. Mnuchin, along with Congressional leaders of both parties, are seeking a “clean” bill with no strings attached. This legislation should be Congress’s highest priority, to ensure that there is no risk of the U.S. defaulting on any of its debt obligations.[3]

Fiscal 2018 budget. The media tend to highlight the budget as a critical legislative need, but history shows that the federal government can function for a long time on continuing resolutions that provide funding for short periods without setting new priorities. Even so, it would still give investors (and the public) some comfort to know that the Congress and President could agree on a plan for how the federal government wants to spend its money in the coming fiscal year, which begins October 1. Expect plenty of dramatic fireworks as legislators and the White House negotiate publicly over the budget – but the denouement won’t be a tragedy even if this plot line remains unresolved at year-end; call it instead a missed opportunity.

Infrastructure and tax reform. Perhaps the biggest opportunity presented by the 2018 budget process is a fiscal stimulus package that could extend and perhaps accelerate the current economic expansion. Both infrastructure investment and tax reform are popular in concept on Capitol Hill, but translating those concepts into concrete legislation is likely to be exceptionally difficult. The problem, as was shown with health care in Act One, is that too many cast members have conflicting and mutually exclusive priorities. After watching the health care farce, investors seem to have concluded that infrastructure investment and tax reform are unlikely to be enacted this year.[4] This, too, could be a missed opportunity, one that neither the President nor Congress can easily afford.

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[2] That date is still approximate. Treasury might be able to extend its leeway a bit further by prioritizing debt service payments over other government obligations such as payroll and vendor payments, but missing payroll or stiffing vendors would come at a significant political and economic cost. Conversely, use of non-FEMA funds to aid in the cleanup from Hurricane Harvey could advance the critical date forward. (FEMA’s Disaster Recovery Fund has its own money, separate from the Treasury’s funds; but a new Congressional appropriation would come from Treasury cash.) What’s clear, however, is that Congress must act quickly to give Treasury more headroom.

[3] Some pundits have speculated that a special Harvey clean-up appropriation could spur Congress to act quickly to raise the debt ceiling at the same time.

[4] One way to assess investor attitudes is to look at the performance of smaller U.S. companies that typically have higher tax rates and might benefit most from tax reform. These small-cap stocks rocketed ahead following President Trump’s election, and have subsequently given up all of their post-election gains. Similarly, industrial companies that might have benefited most from a major infrastructure investment program have languished in recent weeks.

Corporate earnings. When all the "thrills and shocks"[5] have subsided, the less dramatic through-line of the year's narrative drive remains corporate earnings growth. S&P 500 profits jumped sharply this year after two years of torpor, and the trend is likely to continue. The stagnation from mid-2014 through mid-2016 was largely due to collapsing oil prices and a historic surge in the value of the dollar; the sharp rebound in the past four quarters has been fueled by a rebound and stabilization in oil prices.

Cutting through those factors, underlying demand and profit growth have both been rising at a mid-single-digit pace for a long time. With the dollar's recent weakness (down 9.3% this year, as investors worldwide have embraced Europe's revival while also taking a dim view of the Trump presidency), reported corporate earnings are likely to maintain their 9% growth rate through year-end and beyond. While the stock market is currently trading at a relatively pricey 18.8 times year-ahead earnings, this growth rate suggests that earnings can indeed catch up to valuations relatively quickly; the P/E ratio looking out two years is only 16.9.

The Federal Reserve. Although Fed Chair Janet Yellen has had a starring role this year, she hasn't contributed much to the drama. The Fed has been quietly consistent, gently raising short-term interest rates four times since it began a tightening cycle almost two years ago. Yellen is likely to orchestrate another hike in December (although futures contract pricing indicates that Wall Street doesn't believe it), and to begin shrinking the Fed's long-term asset holdings as soon as early October. Based on Yellen's testimony before Congress earlier this year, these tightening actions should be "as exciting as watching paint dry." If the economy continues in its steady groove, investors will be quite happy to have at least this one plot thread resolved without drama; but if inflation revives, the Fed may be perceived as being too slow to respond.

The orchestra is tuning up again, and the curtain is about to rise for Act Two.

> *Step inside! Hello! We've a most amazing show*
> *You'll enjoy it all we know, step inside! Step inside!*
> *We'd like it to be known the drama that we've shown*
> *Is exclusively our own, all our own.*
> *Come and see the show!*

[5] Lyricist Greg Lake rhymed this with "supersonic fighting cocks" and "leave your hammer at the box," evidence that his imagery is indeed quite bizarre and his rhymes indeed awful.