# 2017 Outlook: Wall of Hope

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Traditionally, bull markets climb a Wall of Worry. Anxieties about what could go wrong keep expectations low, valuations under control and cash on the sidelines. As the data comes in less-worse than forecast, the mountain of cash set aside due to the wall of worry gradually seeps into the market, fueling the advance. Since the lows in 2009, this secular bull has followed this classic market pattern. “We’re over-leveraged.” “Another bank blowup is probably out there, hidden!” “Greece! Greece!” “The Fed will tighten too soon!” “More regulations coming!” “More taxes!” “Another corporate scandal!” “Margins peaking, earnings declining!” “Brexit!” “The U.S. election!” “Trump? Trump!” …. Through it all, the market has ground higher, from the 666 low on the S&P 500 in March 2009 to 2,140 on Election Day.

*Election Day*. Since Nov. 8, something has palpably changed about the psychology of this market, and of corporate America. Collectively, investors seem to have dropped their worry beads and shifted instead to dreaming, hoping about a brighter future under the new administration. Tax cuts leaving more money in the hands of the private economy. Deregulation cutting the cost of doing business. Infrastructure spending improving economic efficiency. And most importantly, “tone at the top” encouraging the private sector to grow, take risks, to make money, to create jobs, to be capitalists. Indeed, capitalism is suddenly fashionable again.

## This time really could be different

For sure, the grizzled veteran in me is scarred from previous instances when my hope got in front of my worry, only to be dashed against the hard rocks of reality. So I have a natural skepticism when markets go straight up on no hard news, simply on hope. I know I don’t have the valuation protection that comes with a wall of worry. On the other hand, as I wrote in our post-election Nov. 10 piece, “Back to the secular bull; adding to equities,” this time could really be different. To start with, we need to place the promised policies of the new Trump administration and Republican Congress within the context of the last eight years. The apparent contrast is dramatic.

Since 2008, the private sector has taken a beating, almost literally. First, many businesses nearly lost everything in the systemic global meltdown of the real estate markets. Then, those same businesses often found themselves berated for causing it all, their CEOs routinely dragged down to Washington for questioning or worse, besieged by thousands of new regulations and overwhelmed by rising costs on nearly all fronts, including taxes, endless “fines,” health care and regulatory compliance. Under siege within this Orwellian nightmare, American capitalists laid low and tried not to make too much money, lest they be called out for “not building it” and having it all yanked away by an overreaching federal government.

Until late in the evening of Nov. 8, all of this was expected to continue as usual. No hope. No change. No growth. A “Five Ones” world, i.e., dollar-euro-pound parity, 10-year Treasury yields, a “One and done’’ Fed. Keep carving up an ever-shrinking pie. Keep living with subpar growth. Grind out a little earnings here and there. Keep

### Fiscal stimulus vs. structural reform

Over the last 20 years, dating to the second Clinton presidential term, the D.C. policy establishment has primarily shifted to a view that “fiscal policy” means stimulating economic growth by taking money from the private sector and spending it through the government. To this day, this notion remains the predominant view toward how fiscal policy works as economic stimulus. Hence, throughout the recent presidential campaign, we had one political analyst after another marching through our New York headquarters proclaiming confidently that “whether its Hillary or Trump, we are going to get a big fiscal package.” Even today, analysts are scrambling to guesstimate the size of the infrastructure bill, for instance, and from that, to project its impact on GDP next year. The tax cut bill is a similar exercise.

New flash: this is not the way the president-elect, a seasoned businessman, remotely thinks about the role of the federal government in the economy and/or what “fiscal policy” means. Try instead to read Trump’s fiscal plan as “structural reform”—stimulating growth by making the government more efficient and giving the private sector more room to grow. Thus, “infrastructure spending” is not about creating make-work for unemployed construction workers through more “shovel ready” projects, but rather is about making the bones of the economy, its roads, bridges and airports, more efficient, lowering logistics costs for individuals and businesses throughout the country.

“Deregulation” is not about cutting government payrolls for the sake of doing so and saving a

surviving. An uninspiring, no hope, just hang-on existence. Then, suddenly, literally overnight, everything changed. An apparent 180-degree reversal in government policy and attitudes toward the private sector.

## Confidence is a powerful thing

Back in the fall of 2008, we wrote a piece about animal spirits, the middle syllable of “E-con-o-my”—“Confidence.” President-elect Trump’s revolution, if I can use that term, is just this: restore confidence, restore hope. And see what happens.

For markets, what makes a wall of hope powerful is that it gives investors the patience to see their way through the inevitable speed bumps that will come. I don’t think that traditional political analysts (most of whom got the election wrong, by the way) get this. Trump’s corporate tax bill, for instance, is likely to flounder for some period of time in Congress, as the usual haggling starts about which tax exemptions get eliminated in return for a simpler code. But maybe the market won’t overreact to this delay this time, hoping instead that Trump the deal-doer will figure out a way to cajole, embarrass and/or reward stray congressmen into passing his bill.

Similarly, Trump’s attempts to wind back excessive regulations might stall as he works his way through the federal labyrinth. But maybe, just maybe, markets will hope that eventually he’ll get there, if through nothing more than a different “tone at the top” encouraging regulators to work with businesses instead of blocking them at every turn. Maybe Trump’s threats and tweets will start a trade war with China, or maybe, just maybe, the great dealmaker will figure out a way that gets a deal done on trade that both sides like.

few billion dollars, but rather designed to eliminate the productivity-killing rules and paperwork that have been gumming up the wheels of progress in the economy with no grounding in a legitimate cost-benefit analysis. And corporate tax cuts are not about a one-off cash gift to companies in the hopes they spend it on something, anything, but rather an attempt to improve the long-term after-tax return on investment for businesses large and small, leading to new projects and capital expenditures that otherwise would have been insufficiently profitable on an after-tax basis. So, fiscal stimulus should be viewed as “structural reform,” not simply “deficit spending.”

The reason this distinction is important is inflation and the bond market. Bond-market bears currently worry the Trump plan will lead to massive federal deficits, sparking inflation and causing a dramatic run-up in government bond yields. At some point, such a run-up could threaten equity market valuations and lead to a sell-off. If, on the other hand, the Trump policy mix can truly rekindle economic growth by making the economy more efficient, equity investors could be looking at rising earnings streams even while inflation, and the discount rate on those streams, remains relatively low. Although few have yet articulated this distinction in this way, we think the gradual realization that this could happen is part of the positive dynamic fueling the Wall of Hope.

## Climbing the Wall of Hope

We remain confident that a new phase of the great secular bull market has begun, one guided by hope, not worry. In this phase, we expect nominal GDP growth to accelerate by almost 2 percentage points to 5.5% by 2018, with earnings growth to follow.

For now, valuations have expanded in the hope of earnings to come, but over time, we believe our longstanding target valuation of 18 times earnings will hold up as government bond yields gradually expand in the new-growth environment. With $140 in earnings on the S&P likely by 2018, at some point over the next 12 to 18 months, that index likely will reach the 2,500 level we first targeted back in 2012. And while we think it’ll be 2018 before we finally get there, who knows? Hope might accelerate the process.

In the meantime, the dynamics of a market driven by a wall of hope are different. Dips tend to be shorter and shallower, as investors look through setbacks to the hope beyond. So, despite the quick, almost alarming run-up of the past few weeks, we remain committed to our long-term bullish call. We are not selling here. We’re buying the dips when they inevitably come. We’re climbing the Wall of Hope.

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Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

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