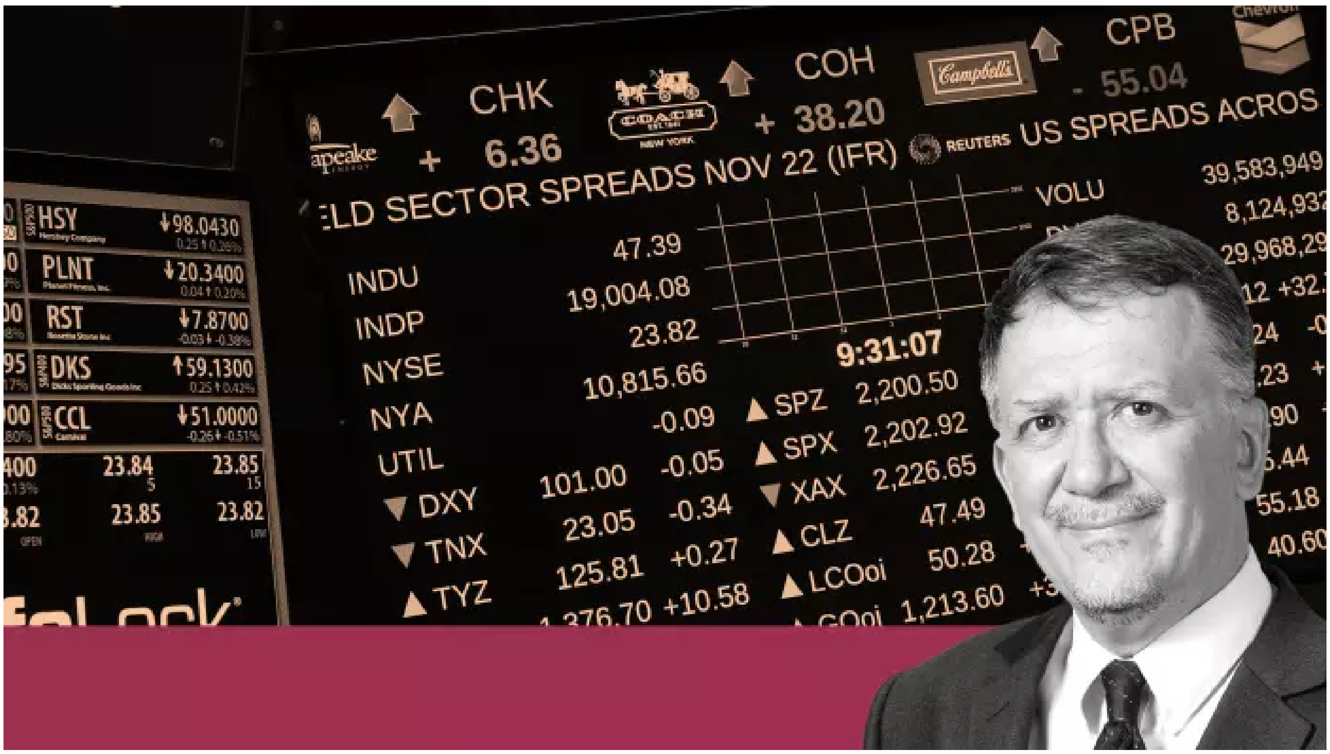
Investing under Trump

Authers' Note: Confidence Game

Premium

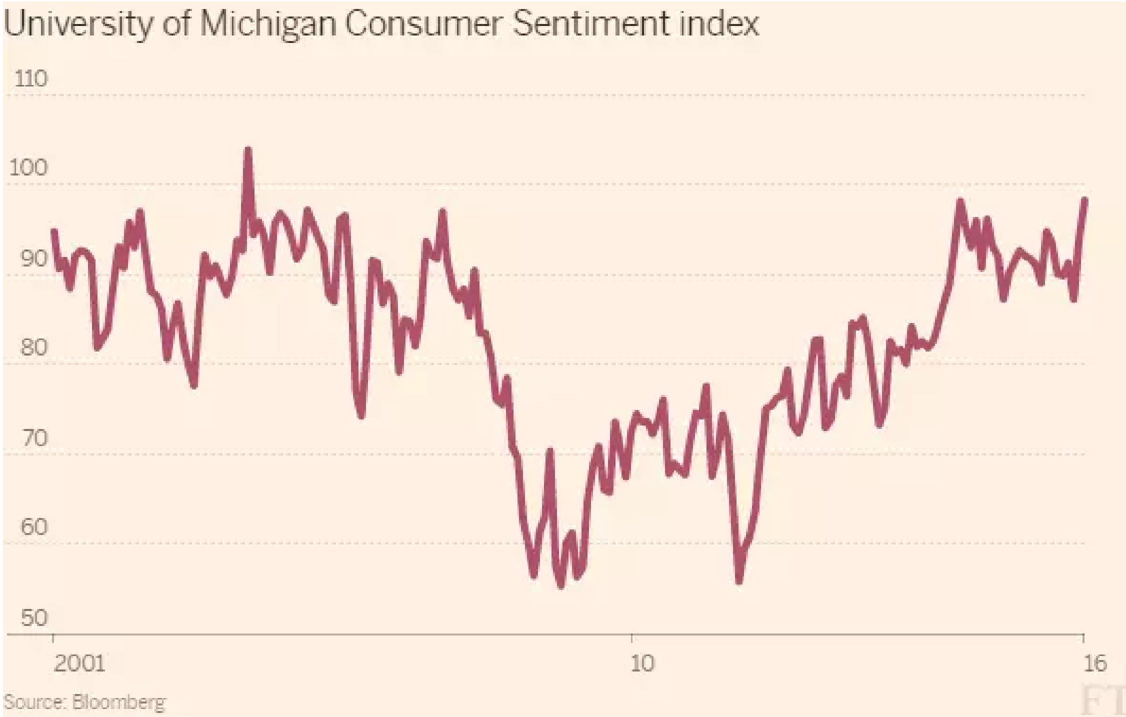
The FT's daily newsletter on the world of investment

John Authers



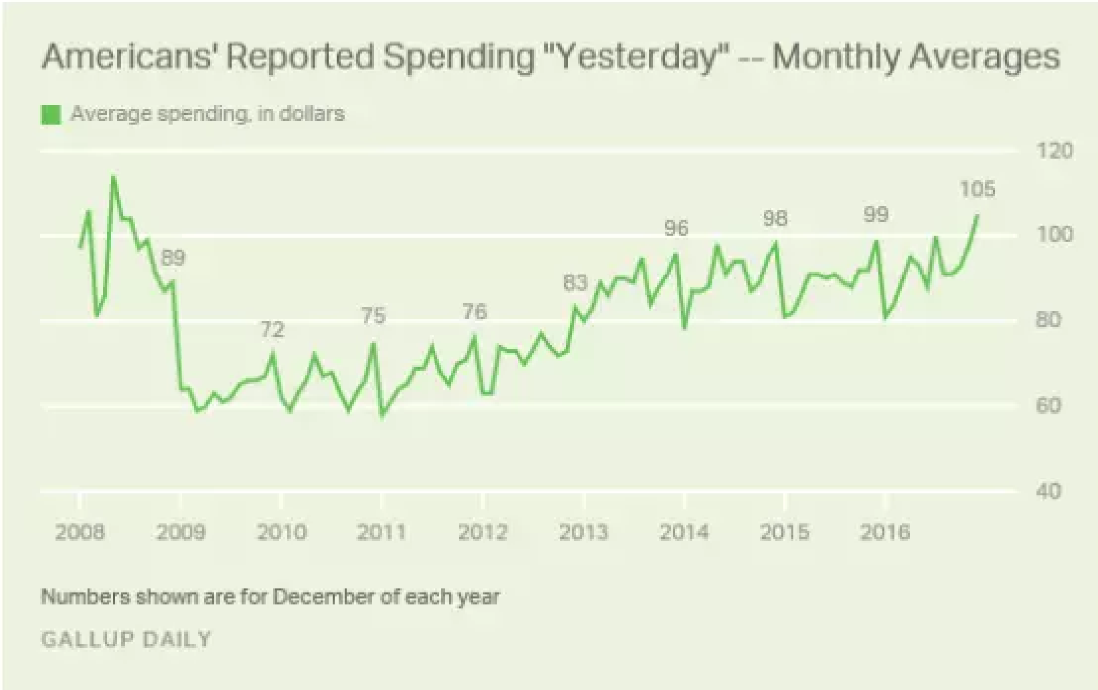
JANUARY 9, 2017 by: **John Authers**

Confidence is back, and it has the power to affect economic and market outcomes. In the US, as measured by the University of Michigan in a survey that goes back more than 50 years, consumer sentiment is as strong as it has been in a decade.



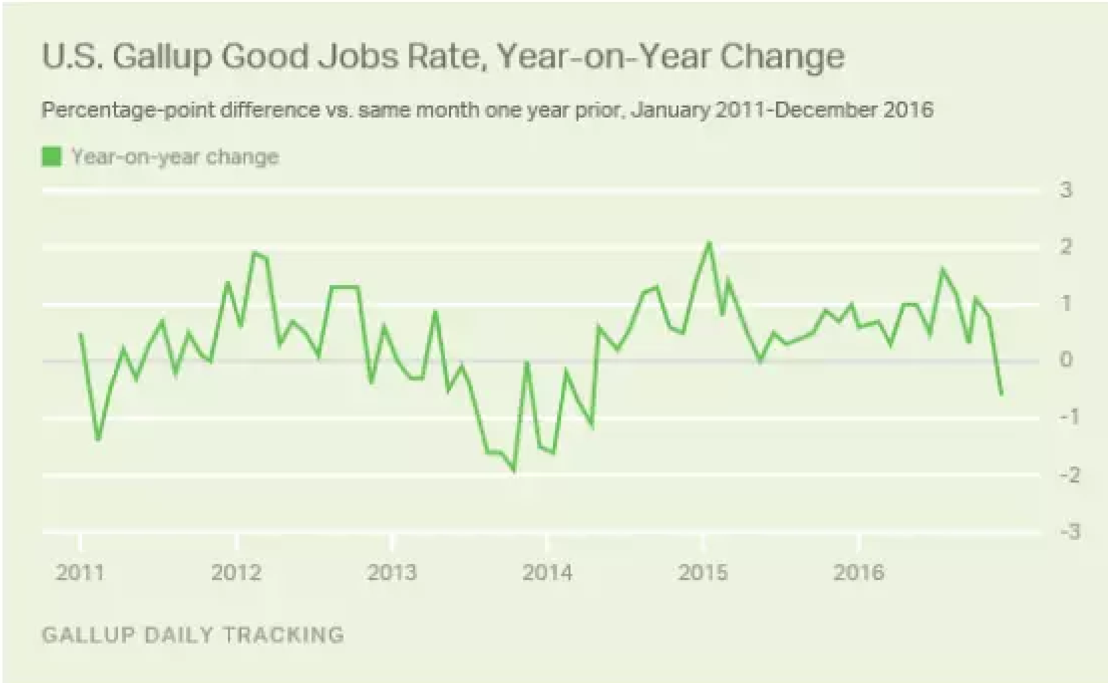
Where does this confidence come from, and how is it manifested? Those strong consumer confidence numbers came as the new year dawned with some horrific announcements from the biggest US department stores, traditionally the beneficiaries of consumer confidence and also big employers. The S&P 500 department store index — whose three members are Kohl's, Macy's and Nordstrom — has tanked, bringing with it fears of lay-offs and closures in retail land.

As the always interesting Peter Atwater of Financial Insyghts points out, using data from Gallup, the confidence does not show up unambiguously when looking at actual spending patterns. As is clear, the amount that people report spending recently is as high as it has been in 10 years:



The problem, as Peter analyses when digging into the numbers, is that when the data are broken down by income, poorer and middle-income families showed a sharp boost in spending from October to November, but no continued growth in December, a month which normally sees high spending. Confidence is higher but appears to need further confirmation.

He also uses Gallup data on the jobs market to suggest a problem for sentiment there. This is Gallup's index of "good jobs" (full-time jobs of 30 hours or more per week). It is showing a year-on-year decline for the first time in a while.

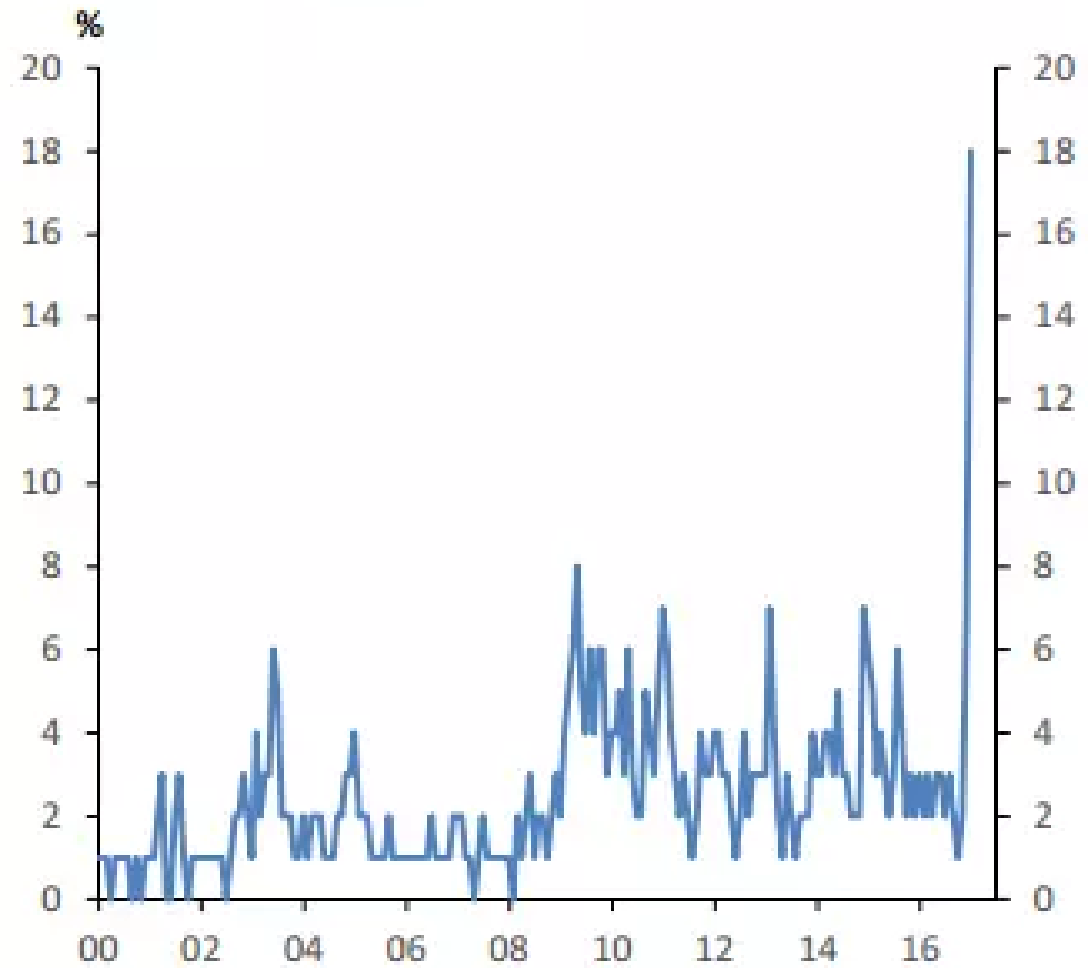


The problem, he suggests, may be that the fixed costs of living have risen too much. “While Detroit is now celebrating its record 2016 sales, auto-malls look even more vulnerable than fashion malls ahead. So, too, I am afraid do American college campuses. How American consumers choose to dishonour their supersized fixed expenses is the biggest, yet least appreciated, issue facing us. The financial tug of war between banks, landlords, hospitals and the government is going to be wild.”

While that strikes me as unduly negative, given the strength of retail and motor sales, there are plainly reasons for nerves. If Donald Trump can score a few quick wins to boost employment, there will be a strong bonus in terms of consumption. But the stakes are high.

One final critical point, from the Michigan survey, is that the overall confidence increase appears to be strongly driven by media coverage since the election. The proportion of those surveyed who said they had heard positive news on the economy recently went through the roof after the election:

Chart 8: Share of consumers who heard favorable news of changes in economic policies



Source: University of Michigan

We can derive from this that Mr Trump has so far done a great job of building optimism and excitement, and translating that into increased consumer activity, at least in November. Remembering FDR and “fear itself”, this is a significant achievement.

The problem is that that optimism is concentrated to a dramatic extent in Mr Trump’s own supporters. It sets up the significant risk of a disappointment. The gap in perceptions between Republicans and Democrats that shows up in the Michigan survey is horrifying in the way that it demonstrates the polarisation of perceptions in the US today. Look at the numbers in the final two lines on the proportion who expect unemployment to increase or decrease:

Change in Economic Assessments Among Identical Consumers From June to December 2016
By Political Party

	Political Party in June								
	Democrats			Independent			Republican		
	June 2016	Dec 2016	Diff	June 2016	Dec 2016	Diff	June 2016	Dec 2016	Diff
Index of Consumer Sentiment	101.2	88.4	-12.8	88.1	96.6	+8.5	82.6	122.8	+40.2
Index of Current Economic Conditions	115.7	120.3	+4.6	109.1	108.8	-0.3	100.9	124.8	+23.9
Index of Consumer Expectations	91.9	67.8	-24.1	74.6	88.7	+14.1	70.9	121.4	+50.5
Year-ahead Income Expectations (median %)	1.6%	0.3%	-1.3	1.2%	2.2%	+1.0	0.3%	2.6%	+2.3
Year-ahead Inflation Expectations (median %)	2.1%	2.4%	+0.3	3.0%	2.3%	-0.7	2.3%	1.6%	-0.7
Year-ahead unemployment									
More Unemployment (percentage)	17	46	+29	33	16	-17	41	3	-38
Less Unemployment (percentage)	28	10	-18	13	31	+18	4	57	+53

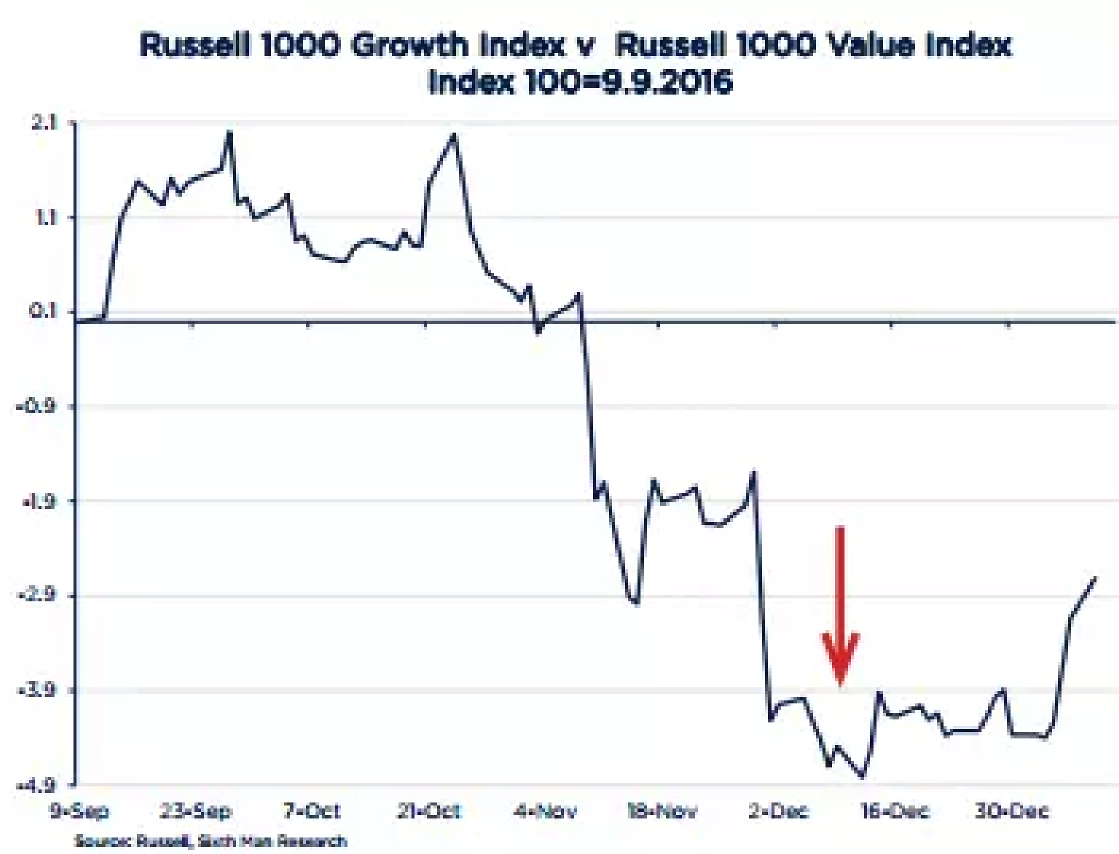
Note: Data differs from the official published data since these data were based on 200 cases that were interviewed in both June and December 2016.

That confidence can probably survive a while, given that Mr Trump's supporters are so obviously prepared to give him the benefit of the doubt, while sceptical Democrats can scarcely grow any less confident. Until Mr Trump breaks a significant promise or two, consumers' animal spirits should stay reasonably high. If Mr Trump starts to veer off course politically, consumer confidence could collapse quickly.

On Wall Street, it is interesting to note that the Dow Jones Industrials started its month-long sideways movement, just below the level of 20,000, in early December when Mr Trump's telephone conversation with the premier of Taiwan was announced. This may have been the point when the market professionals, if not as yet consumers at large, began to wonder whether they should factor in some of the possible negatives of a Trump presidency. It was widely thought at the time to be a gauche and unwise move, remember, that raised the risk of a trade war.

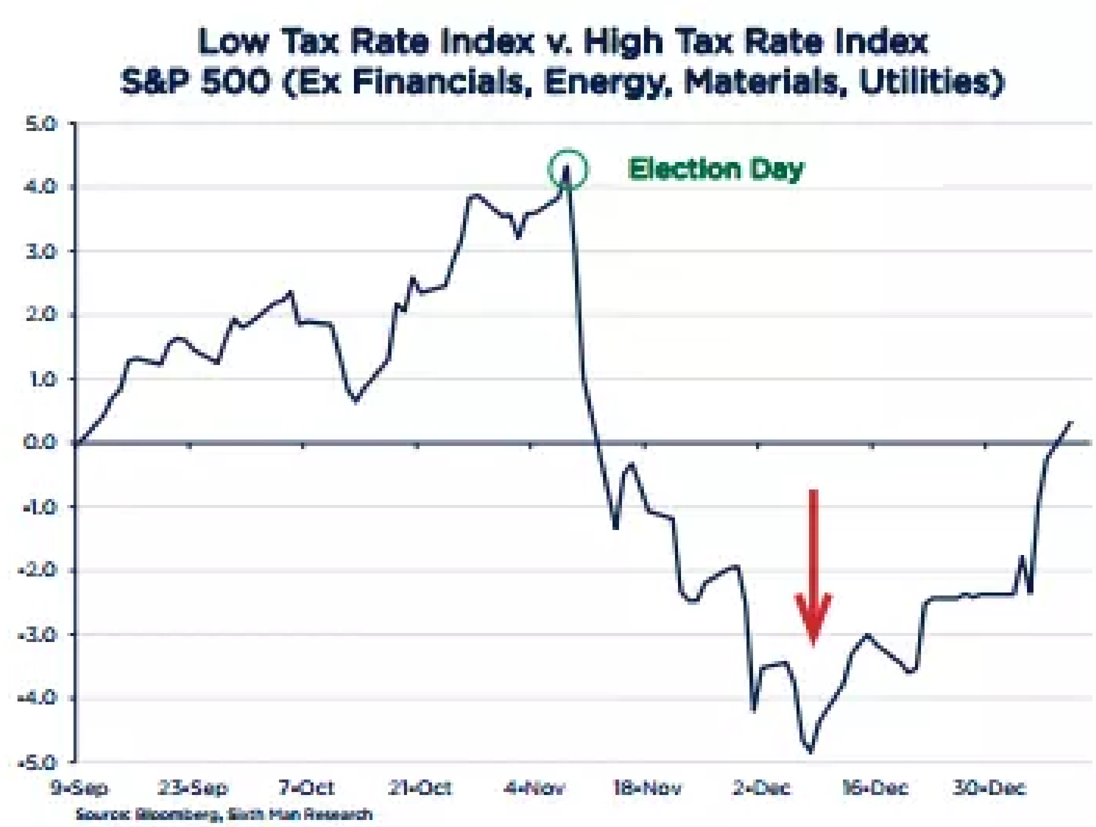
The internals of the market also fit this picture. This chart, by Mark Lapolla of Sixth Man Research, shows the relative performance of value and growth stocks. Value sharply outperformed in the immediate aftermath of the election. The logic behind this was that investors were more optimistic that growth would be widespread; it would no longer be a scarce commodity. Therefore investors looked for value, not for growth.

Value’s outperformance stopped at about the time of the Taiwan call, and it has sharply underperformed during the first week of this year. The arrow points to the day when his Taiwanese phone call was revealed.

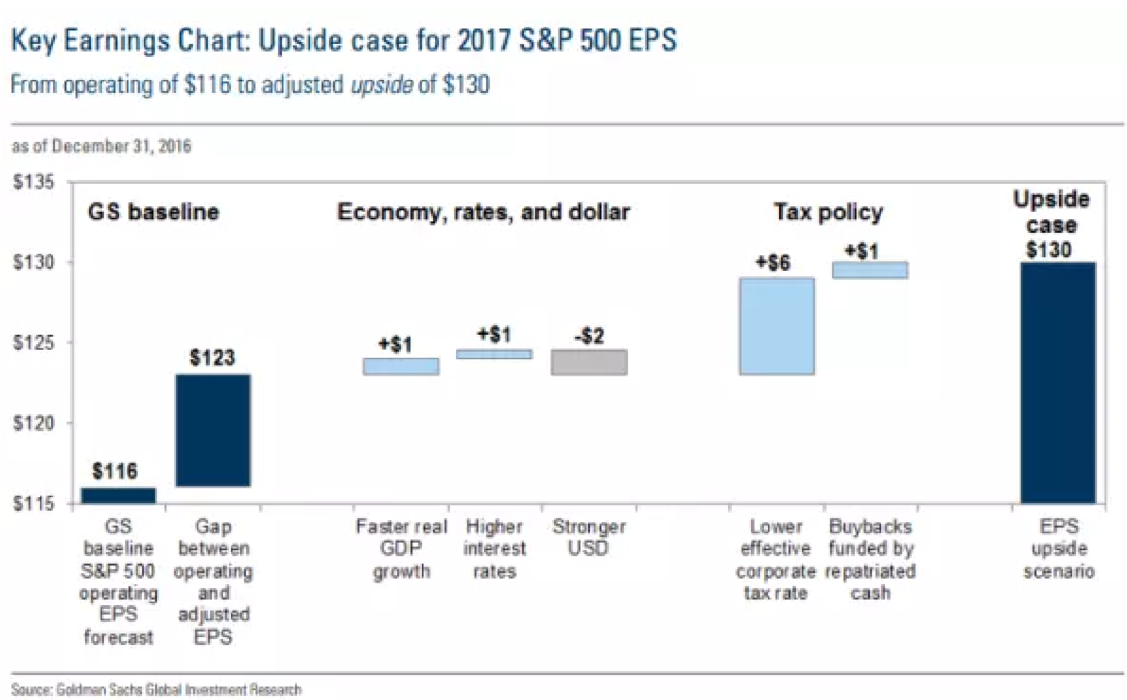


Trump and taxes

Taxes matter more than anything else, including event tariffs. The extent of corporate tax cuts, and the ambition and extent of tax reforms are still, even with the next presidency starting next week, largely unknown. What is clear is that the confidence in a straightforward tax cut took a knock at about the same time as Mr Trump’s Taiwanese chat. This chart, produced by Mr Lapolla at Sixth Man Research, shows how the S&P 500 companies with the lowest effective tax rate, which should thus benefit least from a big tax cut, have fared relative to those with the highest effective tax rate. There is quite a switchback in sentiment:



Goldman Sachs has also churned out some very interesting research on this. This breakdown of their upside bullish scenario for earnings this year shows clearly enough how much of the current optimism rests on a sweeping tax reform:



The issue is that Mr Trump, and many Republicans in Congress, may well aspire to a broader tax reform, rather than just a tax cut (https://www.ft.com/content/27079f4a-c157-11e6-9bca-2b93a

6856354?emailid=56cef8b84218200300714481&segmentId=e2b21419-1ad0-96bc-fb17-88413ea973e2), and aim to tax revenues according to their destination. This would reduce the incentives to use foreign-sourced goods, or to outsource labour, but would make life much harder for companies that rely on imports.

At the level of public policy, more or less all options remain open. It may yet prove to be the vital economic debate of the year. Larry Summers (https://www.ft.com/content/7e5900ec-d401-11e6-b06b-680c49b4b4c0?emailid=56cef8b84218200300714481&segmentId=e2b21419-1ad0-96bc-fb17-88413ea973e2) — not a fan of the president-elect — provided his own broadside on why the Trump plan is deficient in the Financial Times. Tyler Cowan, writing in Marginal Revolution (http://marginalrevolution.com/marginalrevolution/2017/01/larry-summers-new-republican-tax-plan.html), provides his own gloss on Larry's arguments, and suggests some further reading. The critical point, in his opinion, is Larry's contention that proposed border taxes will "capriciously redistribute income" and place "punitive burdens" on particular sectors — notably those that are particularly reliant on importers. These obviously include large retailers.

It is an important debate to follow. For other important entries in the debate, Tyler suggests looking at Jared Bernstein, a Democrat, in the Washington Post. He describes the border tax plan as another failed trickle-down tax cut experiment (https://www.washingtonpost.com/posteverything/wp/2016/12/30/my-take-on-the-republicans-new-interesting-corporate-tax-plan/?tid=ss_tw-bottom&utm_term=.f14b6f5a19a9). For a positive take, try Martin Feldstein, a veteran of Republican administrations, in the Wall Street Journal. He calls this a "good tax trade-off (http://www.wsj.com/articles/the-house-gops-good-tax-trade-off-1483660843)".

While the notion divides economists along predictable partisan lines, the political issue is that it divides the Republicans. Many business figures within the GOP (understandably led by retailers) are lobbying strongly against a border tax (https://www.ft.com/content/d80c483a-c18a-11e6-9bca-2b93a6856354?emailid=56cef8b84218200300714481&segmentId=e2b21419-1ad0-96bc-fb17-88413ea973e2).

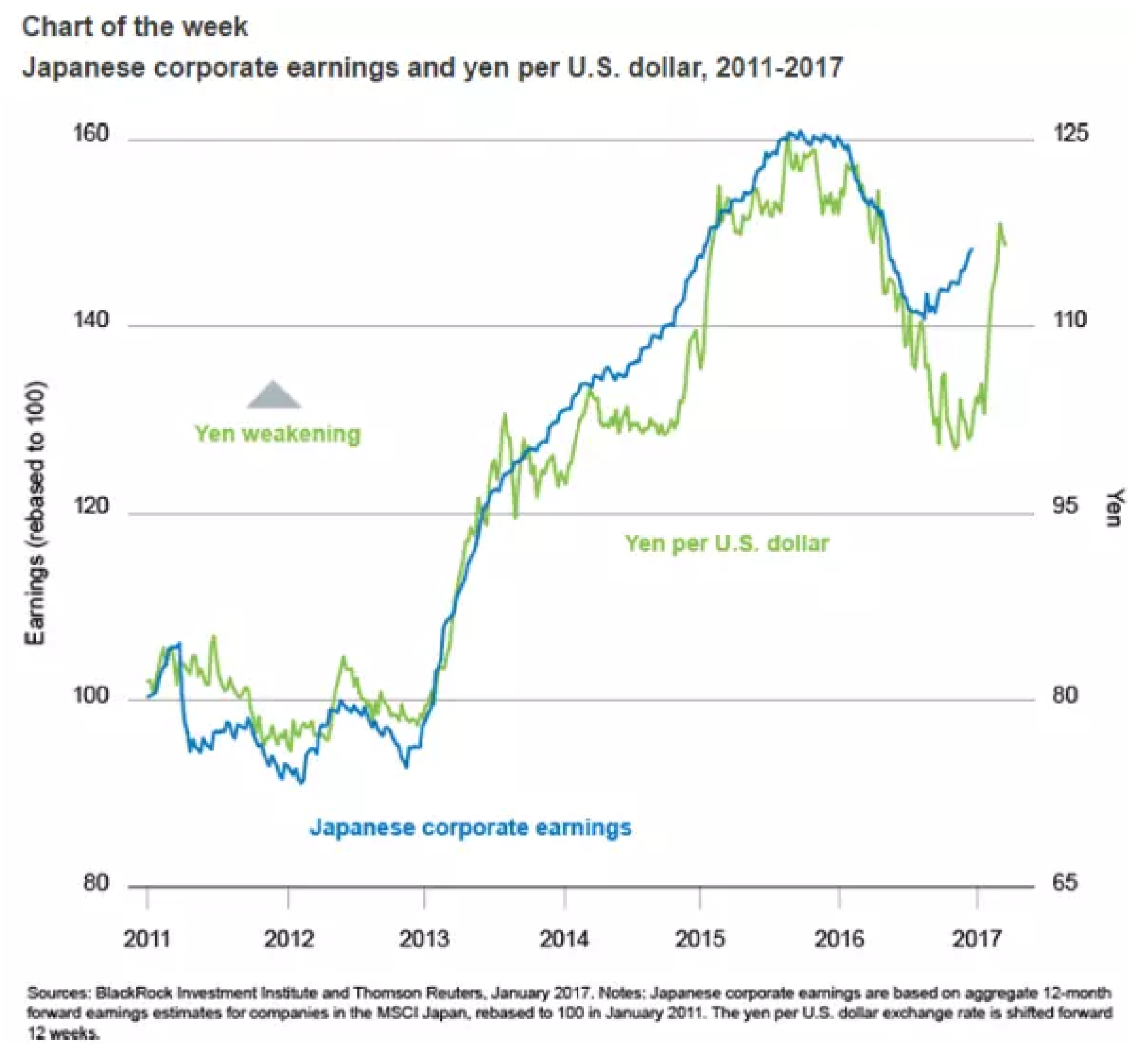
We could yet see a Keynesian deficit-boosting tax cut, or we could see a rather crude attempt to use the tax system to impose protectionism, or we could see a tax reform that levels the playing field for US companies in a meaningful way. It is hard to see how importers could fare well from the process, however — and this is another reason why department stores and malls are doing so badly. And there is no issue, horribly technical though it is, that investors should be following more closely.

One final point — look at John Dizard's essay on infrastructure financing (https://www.ft.com/content/5e063e20-d3fe-11e6-9341-7393bb2e1b51?emailid=56cef8b84218200300714481&segmentId=e2b21419-1ad0-96bc-fb17-88413ea973e2). The current plan for boosting infrastructure spending, authored by Wilbur Ross, calls to encourage private sector investment using tax credits. The problem is that most investors in infrastructure tend not to pay tax (because they are endowments or pension funds), and so the incentive will make no difference to them. Mr Summers has already made this point (https://www.ft.com/content/2673c232-a9b2-11e6-a0bb-97f42551dbf4?emailid=56cef8b84218200300714481&segmentId=e2b21419-1ad0-96bc-fb17-88413ea973e2), and it is important. Note that infrastructure stocks, as measured by MSCI, actually dropped significantly after the election:

Japan rising

Bullish voices around Japan continue to make themselves heard. A key reason for optimism is the weak yen, which enjoys an almost linear relationship with the Japanese stock market — a weaker yen leads to a stronger Japanese equity index.

This chart from BlackRock's Investment Institute (https://www.blackrock.com/investing/insights/weekly-commentary) suggests there is a fundamental basis for that relationship. Japanese corporate earnings also appear to be led very directly by the yen-dollar exchange rate:



If you are confident that the US dollar will stay strong this year, buoyed by raising rates, then little can go wrong with Japanese equities. The problem, as with so many other assets around the world, is that they are ultimately so exposed to a call on rates. If yields turn down, and deflationists are proven right, Japan will not be a place to be.

Dow 20,000

At some point, as we await this historic round number, I might feel obliged to post a link to a full performance of *Waiting for Godot*. For now, note that fellow Financial Times columnist Mohamed El-Erian, writing for Bloomberg View, is also of the opinion that Dow 20,000 doesn't matter much (https://www.bloomberg.com/view/articles/2017-01-09/does-dow-20-000-matter-mostly-no).

Meanwhile, this is my favourite Tweet on the issue so far. If the Dow keeps hovering just below 20,000 for much longer, it should be good for some great internet memes, but I fear the start of earnings season later this week should be enough to get us to the milestone.

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