NEAM VANTAGE POINT

Outlook

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EQUITY REVIEW

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Regime Change: Parallels to Reagan Era

The election of Donald Trump is reminiscent of the Reagan era in many regards, and a deeper comparative review provides valuable context.

The S&P 500 returned just shy of 12% for 2016, a feat hardly conceivable in early February after the market had fallen over 11% on global growth and deflationary undertones. From this low point, the market staged a remarkable comeback in the face of several notable surprises, specifically Brexit and the election of Donald Trump as the 45th President of the United States. By their very nature, surprises defy consensus views which, in these cases, dismissed any substantial probability of these scenarios occurring. However, rising populism, essentially the mobilization of an alienated element of the population, characterized these election outcomes.

Conventional wisdom would have concluded that such events would wreak havoc in equity markets. Yet, the opposite transpired. Initially lower, U.S. equity prices experienced a short lived pullback on Brexit before exceeding pre-vote levels less than two weeks after ballots closed. In the case of Trump's election, futures pointed to equities being down as much as 5% in the midnight hours, only to reverse resoundingly with the S&P 500 closing in positive territory the day following the election. Investors favorably discounted the potential of pro-growth elements of Trump's agenda, including tax rate reduction and regulatory reform, and the broad Republican gains in Congress increasing the odds of implementation. Improving economic data and the end of the earnings recession further supported the U.S. equity rally. The Federal Reserve raised rates for the second time since the Financial Crisis as the year drew to a close.

Suffice it to say, these unexpected political outcomes helped define the year. Interestingly, low volatility also reigned alongside these low likelihood but highly impactful events. The market held an almost nine week summer stretch during which the S&P 500 index closed within 1% of its previous day's close. Volatility, as measured by the Chicago Board Options Exchange SPX Volatility Index ("VIX"), likewise remained subdued. This placid period took place between Brexit and the U.S. Presidential election, a somewhat surprising juxtaposition in retrospect. With rising populism contributing to a wider possible range of outcomes, risk assets should plausibly require a higher risk premium and exhibit greater volatility. Instead, the lens focused on only the positives, specifically, the regime change in the White House and the possible cyclical recovery driven by potential policy initiatives. Consequently, the year was indeed a tale of two halves as sector performance for the S&P 500 followed a dramatically different script in the second half of the year relative to the first.

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Defensive sectors, such as utilities and telecom, commandingly led the market in the first half of the year when investors prioritized safety and income in the slow growth backdrop. Conversely, cyclical sectors drove the market in the latter half of the year on renewed optimism around accelerating economic growth and higher corporate earnings. Data gathered by Goldman Sachs dimensions the powerful differential as cyclical sectors *underperformed* defensive sectors by 400 basis points in the first half of the year and *outperformed* by 1800 basis points in the second half.[1] The Dow Jones Industrial Average ("Dow Jones"), designed to act as a proxy for the U.S. economy, best illustrates this level of optimism in its attempt to surpass 20,000 for the first time ever. While this milestone was not achieved in 2016, all three major indices, S&P 500, Dow Jones and Nasdaq Composite, recorded simultaneous highs in November for the first time since December 1999,[2] reflecting investor fervor behind the shift toward fiscal stimulus.

NEW REGIME – REAGAN VS. TRUMP

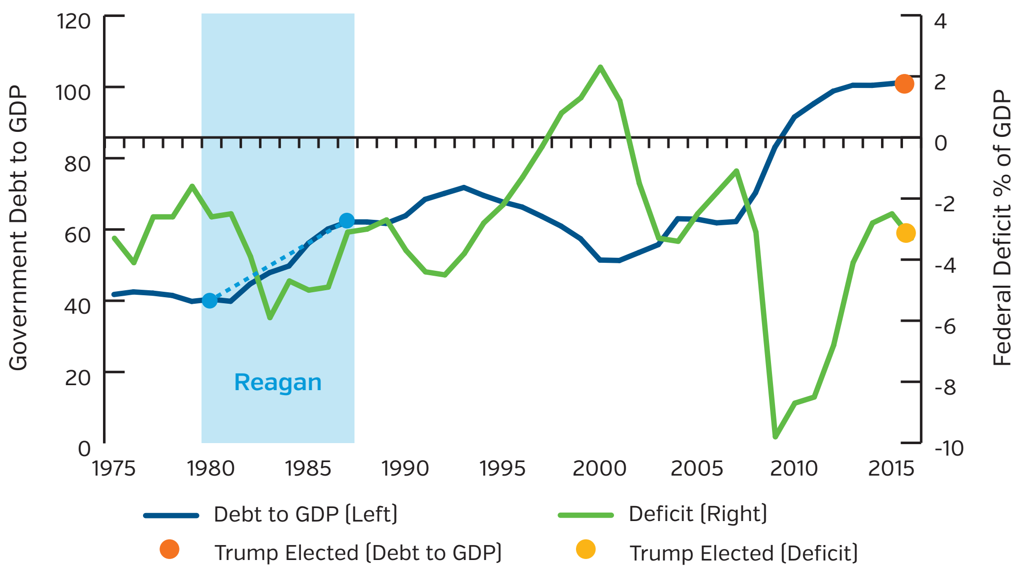
It is our practice to consult history to provide context for current developments, be it individual companies or the market in aggregate, as patterns, while not exact replicas, do repeat. As such, the election of Donald Trump is reminiscent of the Reagan era in many regards, and a deeper comparative review provides valuable context. Yes, optimism appears warranted as regulatory changes, tax reform and pro-growth policies are beneficial endeavors, but the launching point for Trump is vastly different than for Reagan, raising the potential for disappointment should divergence eventually exist between the hope embedded in market sentiment and the executed reality. Today's market sentiment discounts increasing conviction in the successful implementation of Trump's pro-growth policies, yet the timing and magnitude will likely exhibit variability. Likewise, possible negative consequences appear underappreciated, and linearity should not be presupposed. Our effort is dedicated to better understanding the parallels between Reagan and Trump in order to help calibrate the merited level of enthusiasm.

"…the launching point for Trump is vastly different than for Reagan, raising the potential for disappointment should divergence eventually exist between the hope embedded in market sentiment and the executed reality."

Stepping into a time machine, we revisit the early 1980s. Technology advances include a portable music player, named the Sony Walkman, and IBM introduces its first personal computer. 3M Corporation launches Post It Notes, helping millions with personal organization. Gas averages $1.25 per gallon, and suburban life had not yet been transformed by the advent of the minivan. Malls would soon become the social hub for teens, later showcasing fashion trends inspired by the launch of Music Television ("MTV"), the 24 hour music entertainment network. Fresh off a short recession, American voters cast their ballots in November 1980 to elect Ronald Reagan as the 40th President of the United States. While challenged by a more painful recession early in his first term, spanning July 1981 to November 1982, optimism around Reagan's presidential potential grew, premised on his pro-growth, supply side economic platform, coined "Reaganomics." His message of lower taxes, smaller government and strong U.S. military resonated with the American people over the course of his leadership.

Prior to his administration, the U.S. experienced a decade of stagflation, characterized by rising unemployment and rising inflation. The underlying principles applied under Reagan: lower marginal tax rates, less regulation, restrained government spending and non-inflationary monetary policy: resulted in economic expansion and higher productivity. Illustratively, the American economy accelerated from GDP growth of -0.2% in 1980 to 4.2% growth in 1988.[3] However, this was not achieved without a significant cost. National debt grew from $997 billion to $2.85 trillion[4] establishing the U.S. as the world's largest debtor nation and reversed its prior status as the largest international creditor. As shown in Chart 1, government debt to GDP stood at roughly 40% at the outset of Reagan's administration, leaving room to finance initiatives via external creditors. In tandem, the deficit almost doubled, averaging 4.2% of GDP during his time in office.[5] By contrast, Trump was sworn into the Oval Office with much higher debt levels and the deficit, while below the Reagan peak, roughly 25% higher than the comparable starting point.

Chart 1. Debt and Deficit

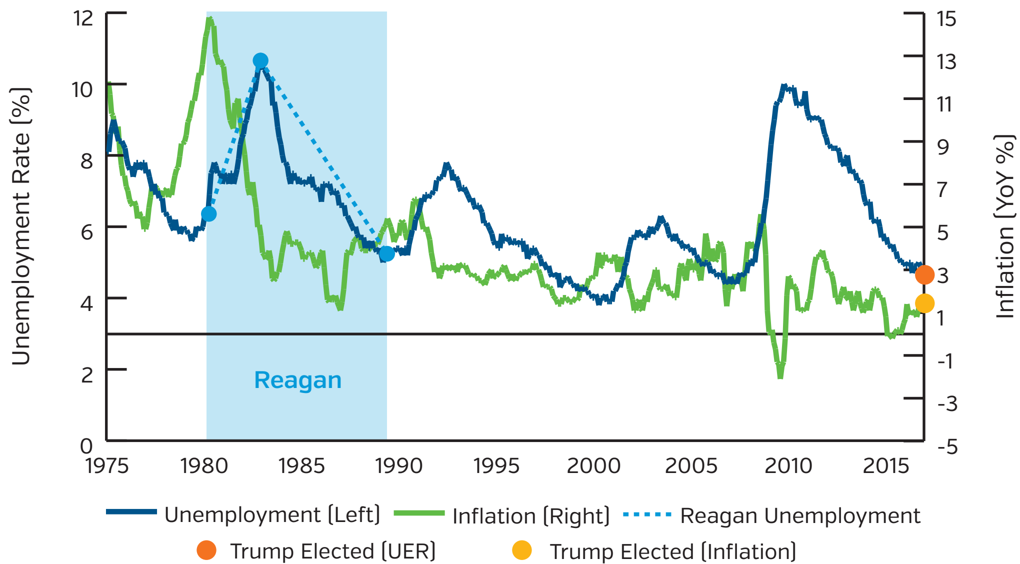


Source: Haver, NEAM

Likewise, Trump will implement his fiscal initiatives with the economy approaching full employment. As shown in Chart 2, unemployment under Reagan peaked at 10.8% in December 1982 and halved before his exit from the White House. The most recent December data shows the current unemployment rate stands below this level, implying there is much less comparative labor slack, and wages should rise. The capital to labor relationship sits at extremes given the aging business cycle, similarly arguing for a redistribution of corporate profits toward labor in the form of higher wages.

Logically, inflation should increase, albeit from very low levels given the disinflationary trends driven by technology and the global commodity unwind. Inflation stands sub 2% for Trump, a rather asymmetric level, while Reagan assumed office with inflation in the low double digits. Directionally, Trump faces rising inflation while Reagan benefited from inflation reverting downward following the stagflation of the 70s. Notably, the upward bias in inflation may pressure equity valuation, already at the high end of historical ranges, given the inverse relationship between inflation and price to earnings multiples. Equity volatility could likewise emerge should the inflation outlook prompt the Federal Reserve to normalize interest rates faster than expected. As such, the equity markets will be keenly focused on the rate of change for inflation as well as the absolute magnitude.

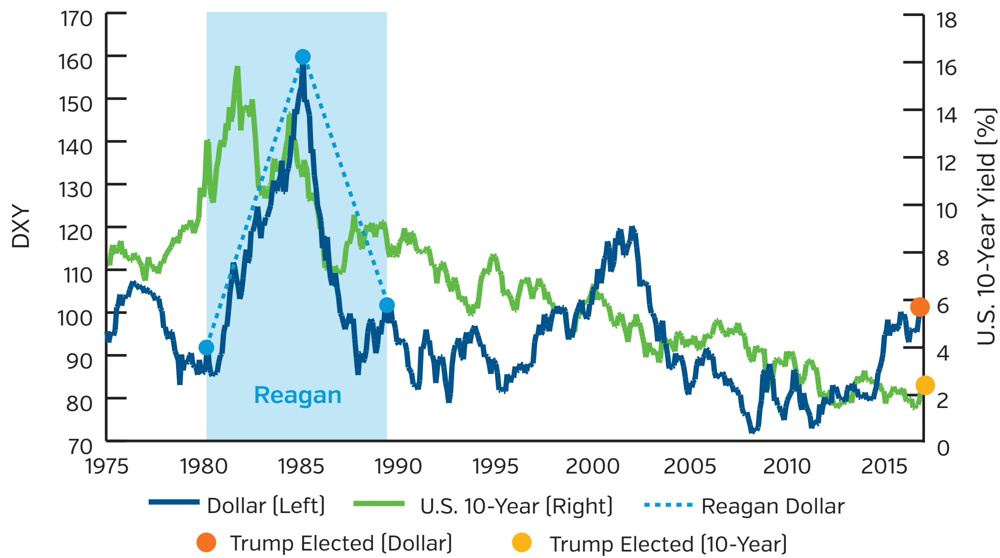
Chart 2. Unemployment and Inflation



Source: Haver, NEAM

The dollar strengthened materially into the mid-80s driven by Reagan's fiscal policies (Chart 3). Not surprisingly, the greenback reacted similarly to fiscal promise, rising over 7% in the 4Q of 2016, with roughly half of its ascent achieved post Trump's election. Comparatively, the dollar sits near a fourteen year high versus the near generational low when Reagan commenced his presidency. The strong dollar further expresses the favorable real yield differential for the U.S. versus other countries in the slow growth backdrop. By year end, U.S. Treasury yields had risen to reflect these higher real interest rate expectations driven by increasing economic growth, higher inflation and potential deficit spending. Fundamentally, reflation warrants higher equilibrium yields in the bond market. When higher real rates coincide with a stronger dollar, financial conditions tighten. As such, rising yields could constrain equity valuation expansion. Under Reagan, equity multiple expansion more closely coincided with the peak in yields rather than being positively correlated. This places more emphasis on absolute earnings levels to drive equities.

Chart 3. USD and Rates

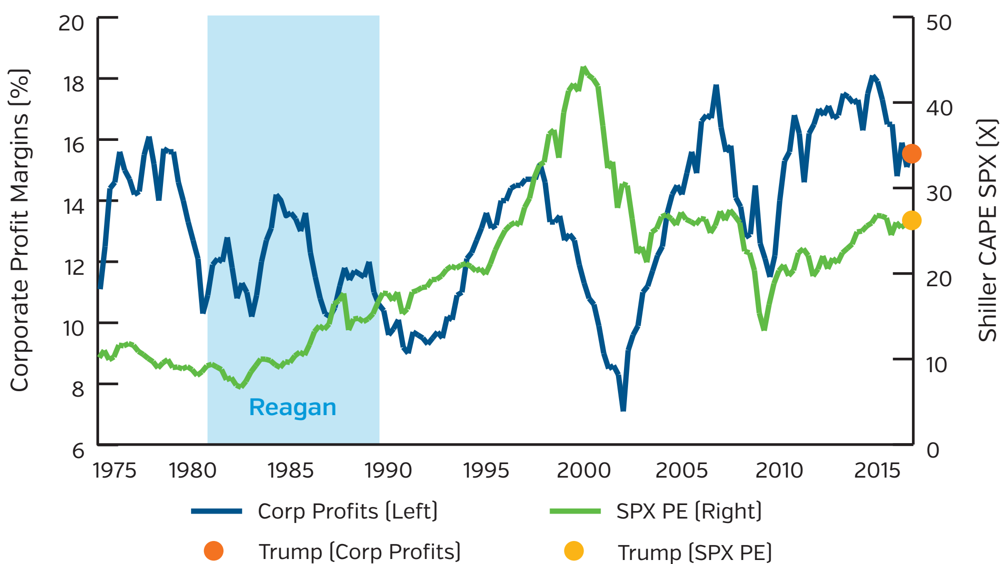


Source: Haver, NEAM

HIGH EXPECTATIONS

Tax and regulatory reform could enable higher investment and subsequent earnings growth for the companies within the U.S. economy. Earnings, the primary driver to equity values over the long term, would potentially drive stock price appreciation. Valuations are, however, much higher today than when Reagan took office (Chart 4), driven by years of monetary stimulus and quantitative easing as well as the long term structural benefits from the introduction of the 401k and the wider comparative base of equity ownership. The market commands a 27x Shiller cyclically adjusted price to earnings ratio ("CAPE") which is roughly 3x higher than the early 1980s. Equally, the pricing of equity risk assets incorporates higher margin levels driven by cost rationalization. While leaner companies stand to gain from higher incremental profit margins should revenue growth outpace reinvestment needs, valuations already imbed high expectations. Equity prices have advanced in excess of earnings growth for some time, effectively decoupling from fundamentals.

Chart 4. Equity Market Valuation and Profit Margins



Source: Haver, NEAM

CONCLUSION

For Trump, history suggests the U.S. dollar has an upward bias, inflation should rise and the budget deficit should widen based on his intended fiscal priorities. If implemented effectively, nominal GDP growth and earnings could also improve. While details are lacking, this argues for some guarded optimism. However, we must be cognizant of the starting point when calibrating this optimism into the equity capital markets. Reagan executed his agenda against a backdrop of falling inflation, falling interest rates, lower average profit margins, cheap equity valuations and a healthy credit creation mechanism. This empowered equities to return over 11% on a compound annual return from 1982-2016. For Trump, inflation sits at depressed levels, interest rates have been in a secular bull market for over 30 years, profit margins are already robust, and valuation is elevated. Future equity returns are likely more muted given the foundation from which Trump begins, and the possible constraints imposed by valuation.

Equity volatility could also rise as these inflationary pressures, somewhat cyclical in nature as global secular pressures remain, give the Federal Reserve the scope to conceivably normalize rates faster. The trajectory of the U.S. dollar and pace of wage growth also hold relevance in calibrating future earnings levels. Additional risks remain from policy ambiguity, political uncertainty and timing, and the potential for disappointment exists. As a result, promise may exceed reality. Optimism is the inherent bias in the equity market, but pragmatism may indeed be warranted to accompany the hope.

ENDNOTES

[1] Goldman Sachs, Portfolio Strategy Research, United States, January 2, 2017 - "U.S. Weekly Kickstart"

[2] LPL Financial Strategy

[3] Bureau of Economic Analysis, Gross Domestic Product Spreadsheet, December 22, 2016

[4] Public Debt Reports, "Historical Debt Outstanding Annual 1950-1999", U.S. Treasury Department

[5] CBO Historical Tables

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