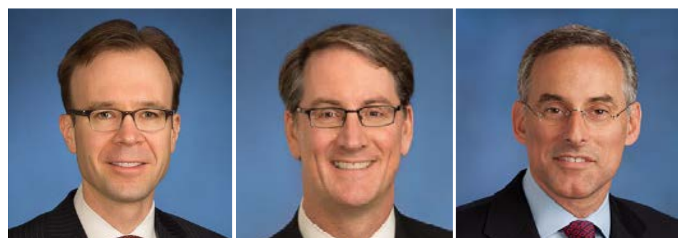
# A discussion on markets and growth

We sat down with Jan Hatzius, Charlie Himmelberg, and David Kostin to discuss the intersection of policy expectations, market sentiment, and underlying fundamentals in the US economy.



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**Allison Nathan: Given the reversal of key policy-related trades, has the market put "Trump euphoria" behind it?**

**David Kostin:** To a large extent, yes. For example, the outperformance of companies with high tax rates has indeed reversed now that it's clear that tax reform won't take effect until 2018, at the earliest. As reality has set in on policy delays and disappointments, there has been a reset in the market. Policy has been pushed to the side, and you're left looking at the fundamentals. Maybe the economy is growing a little faster, helping sales to grow. But that may come with higher operating and labor costs, which will erode margins. On net, this suggests a modest and gradual increase in profits and—given stretched valuations—modest return potential.

**Charlie Himmelberg:** The "micro" Trump trades, like the Mexican peso or the high-tax basket that David mentioned, have completely retraced. But judging by the level of bond yields and equities, I think the macro impact—the boost to aggregate demand—is still more than half priced relative to its peak in December. So I wouldn't say that policy disappointment for 2017 has been fully priced. The market is still embracing deregulation and a more pro-business, pro-growth narrative. Small business surveys have been through the roof, for example. Just being out there on the bully pulpit, railing against regulation, has a very powerful effect on sentiment.

**Allison Nathan: Despite the unwinding of "Trump trades," the S&P 500 is still up roughly 10% since the election. What's been supporting the market?**

**David Kostin:** Tech, which is somewhat independent from politics in that it is traditionally non-regulated, has been important. And Financials have done well as the presumed beneficiaries of higher interest rates and less aggressive regulation. But also consider the counterfactual: Is the market higher because Trump was elected or because Hillary Clinton was *not* elected? I would argue that some of the market action has been based on the notion that there would have been more regulation and higher taxes under a Clinton presidency. So in some sense we can think of this as a relief rally.

**Jan Hatzius:** Improvements in the economy are obviously not mutually exclusive to the points David and Charlie have raised, but they have also played a significant role. Better fundamentals were already in the pipeline prior to the election and continued to gain steam through Q4 and into this year.

**Allison Nathan: But Q1 GDP growth is tracking fairly low, and hasn't much of the improvement in our Current Activity Indicator (CAI) come from "soft" economic data?**

**Jan Hatzius:** We're tracking Q1 GDP growth at 1.2%, but due to a seasonal downward bias, the true number is probably somewhere between 2% and 3% in reality. The CAI is at 3.6%, and while soft data have played an important role, it's important to realize that soft data include more than pure sentiment surveys. Some so-called "soft" indicators, like ISM new orders, are quite a bit more concrete. These more objective surveys have also looked strong. So I would say we are already seeing a growth pickup.

**David Kostin:** What's interesting is that economic data are generally better, but earnings have not been revised higher. The CAI may be strong, but average GDP growth this year is still forecasted at 2.25%. Nominal GDP growth, which is the key driver of sales for most companies, will probably average around 4%. So you're looking at top-line revenue growth of around 4%, flattish margins, and rising labor costs. Roughly 1% accretion from buybacks will lift 2017 EPS growth to about 5%.

**Allison Nathan: The Trump administration has talked about achieving GDP growth of 4%. Is that possible? And would that create a more upbeat environment for equities?**

**Jan Hatzius:** I think it's possible for a few quarters, but not over a long period of time. A couple of years of 3% growth is at the top end of what I can imagine, and even that is very optimistic. Today's demographic environment is totally different from that in past cycles; for most of the post-war period, labor force growth was around 1.5%, whereas now it is 0.5%. That immediately takes 1pp off of any potential growth estimate. Then you have the issue of weak productivity. The last five years or so were likely just a very bad draw in terms of productivity growth, and there could certainly be some improvement from here. But unless that improvement were really significant—and accompanied by a reversal of the demographic slowdown—you still wouldn't get to 4%. Besides, we're basically at full employment, so if you did manage to sustain material above-trend growth, the cost would be upward pressure on inflation and thus on rates.

**David Kostin:** Right. And higher inflation and rates would be consistent with a falling P/E multiple. That in and of itself would be a drag on rather than a boost to equity returns. But you won't get much tailwind from higher earnings, either. Even if we assume growth of 3.25%, that additional 100bp would add $5/share on average to earnings for the year. But a 50bp swing in margins is also worth $5/share, and margins would likely deteriorate owing to higher prices and wages. Firms are already mentioning having less ability to pass through price increases.

**Allison Nathan: With that in mind, is now even the right time for fiscal stimulus, be it via tax cuts or spending?**

**Jan Hatzius:** No. We are still getting a solid boost from easier financial conditions—about 0.5pp in 2017. And if there is any

remaining labor market slack, it will be gone by the end of the year. We may even overheat a bit. So we certainly don't need a large amount of fiscal stimulus. That said, the types of stimulus expected, high-income personal tax cuts and corporate tax cuts, have relatively low multipliers. So we think the boost to growth will be a few tenths of a percentage point in 2018 and a small amount in 2019, depending on the exact implementation schedule. That is not comparable to, say, 1967, when Vietnam War funding led to massive overheating.

**Allison Nathan: If fiscal stimulus, animal spirits, etc. lead to even more momentum in the economy than what you are expecting, would the Fed just step in to squash it?**

**Jan Hatzius:** I think the Fed would be more aggressive than what the market is pricing, especially for 2018, and potentially more aggressive than its own expectations as reflected in the "dot plot." Post the release of the March FOMC minutes, some investors believe that there will be fewer hikes than the March dot plot suggests given the Fed's apparent intention to bring forward the start of balance-sheet normalization to later this year. But in my view, this was already built into the March dot plot, which helps explain the mild dovish surprise at that meeting. So barring an adverse market reaction to the start of balance-sheet adjustment, even the baseline growth forecast calls for more hikes in 2018 than what is being priced today.

**Charlie Himmelberg:** From a markets perspective, I worry a lot about what happens if the market gets ahead of the Fed on pricing growth and then the Fed has to play catch-up. The result could be painful for risk appetite. Analogous to the "Bernanke put," we've dubbed this risk the "Yellen call."

**Allison Nathan: So, what—if anything—can push risky assets, and especially the S&P 500, higher this year?**

**Charlie Himmelberg:** To me, a lot hangs on whether animal spirits will have any meaningful impact on the economy in the second half of the year, and whether the Fed will be patient while waiting to see how much demand stimulus actually shows up. And even if animal spirits end up translating into real activity, there is still a question of whether those gains go to higher wages rather than earnings. To see the latter, we would likely have to discover some untapped productivity growth along the way. I think it's a tough cyclical story for earnings.

**David Kostin:** The market will move beyond 2400, but only as we look into 2018-19 and see real evidence of better earnings growth. It will be a slow march higher, which is consistent with current exceptionally low volatility. Otherwise, for the market to move higher, you would need multiple expansion or money flow. On the former, the market trades at extremely high valuations on every metric; the median stock's P/E ratio is at the 99th percentile vs. history. That to me is a clear headwind. On the latter, the only true net source of demand is corporate repurchases. But companies need confidence in tax policy changes if they're going to use cash to repurchase shares. Repatriation of overseas earnings would be supportive of major buybacks, but that is a late 2017 or a 2018 story, if it happens.

**Allison Nathan: Valuations are high in absolute terms, but don't you get a different picture looking at the equity risk premium (ERP)? Couldn't the US ERP still come down?**

**David Kostin:** I agree with the idea that the ERP could fall as more regulations are rolled back or if tax reform passes. But it is not clear to me that a declining ERP will have a big impact. If investors believe that the ERP is going to fall, will they be selling bonds and buying equities? The spread between the premium in equities and bonds has been sufficiently wide for some time now, so those trades have already been made. For instance, of the $13tn in pension assets, 60% is already in equities. It just isn't clear where the incremental equity flow would come from. Similarly, from the perspective of a corporate executive, would a decline in the ERP motivate more capital spending? Money has been available at a very low cost for a long time, and there hasn't been a big spending increase.

**Charlie Himmelberg:** I agree with David. The asset that looks most out of whack is bonds, with yields at hundred-year lows. That seems to owe much to slowing population growth, slow productivity growth, and a global preference for principal protection, along with the low level of inflation risk that the market is pricing in, rightly or wrongly. Those fundamentals and preferences would likely have to shift before you would see any further reallocation out of bonds into equities. It's interesting to note that following the US election, we saw a dramatic reallocation of mutual fund flows—out of bonds and into equities—that has since reverted to trend as the market has faded its optimism on prospects for the Trump agenda.

**Allison Nathan: So with downside to our year-end S&P 500 target of 2300, what should investors own?**

**David Kostin:** You have to look for pockets of opportunity. Companies raising dividends are one set to think about. There are also secular growth stocks in industries experiencing tremendous structural changes, like cybersecurity or electronic payments—areas that are not driven so much by economics as by shifts in how business is done. And again, Financials should continue to do better as rates generally move higher.

**Allison Nathan: More broadly, how should investors be thinking about risks and positioning?**

**Charlie Himmelberg:** Tactically it's very difficult to be short here; better growth and a seemingly patient Fed is a favorable mix. But we recommend positioning defensively and maintain an overweight in cash. Fundamentally, the fact that we're contemplating animal spirits and fiscal stimulus at a time of full employment increases the amount of macro risk in the outlook. On a one- or two-year horizon, it's harder to envision a recession now than it was six months ago. But three or four years out, it's easier to envision because you run a higher risk of generating an imbalance that the Fed will have to resolve.

**Jan Hatzius:** I agree. Two key predictors of a recession are current momentum and impulses from financial conditions, which are a lot more positive now than 12 or 18 months ago. We're on a path that eventually requires a growth slowdown, particularly in employment growth. Despite the downside surprise in March payrolls that was partly due to weather, we've been adding roughly 200,000 jobs a month over the last two years when the pace that can be sustained over a longer term is probably below 100,000. That has to converge sooner rather than later, or recession risk will move to the fore.

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