MID-CONTINENT CAPITAL

CONSILIUM*

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*advice; judgment; resolution; wisdom

All Eyes on Washington

The S&P 500 Index generated a 6.1% total return for the first quarter of 2017 – its sixth straight quarterly gain, and its strongest January-March performance in four years. The post-election rally reached a peak on March 1, following the president's State of the Union speech. But in the ensuing weeks, market participants grew increasingly skeptical about President Trump's ability to enact his economic agenda. After the unsuccessful attempt to repeal the Affordable Care Act, a few commentators even suggested that the president was a "lame duck" just six weeks into his term.

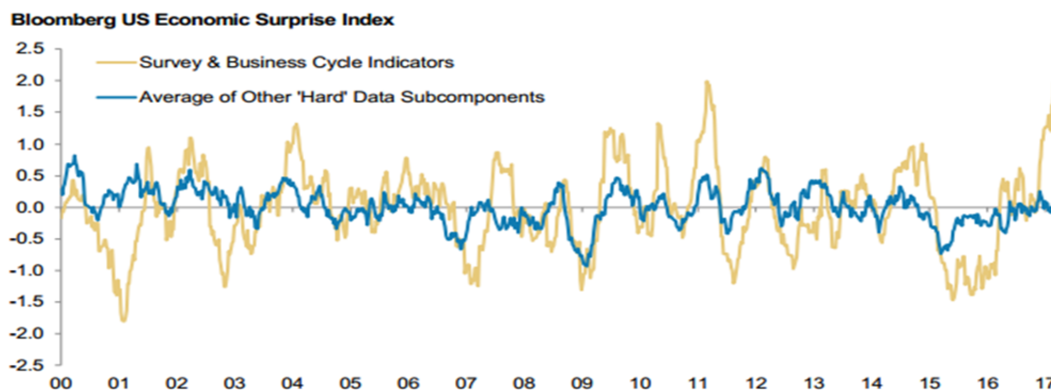
Apparently, consumers didn't get this message. On March 28, the Conference Board reported that its index of consumer confidence had reached a 16-year high. Consumer confidence is thought to be among the most important leading indicators of economic activity, even though its record is statistically uneven. Still — survey respondents indicated surging levels of optimism about future prospects compared to a year ago. Whatever is going on around them at present, consumers are saying they feel the future is bright. This follows an 18-month period of stable views on the economy.

In a similar vein, the Institute for Supply Management survey of purchasing managers continues its recent run into strong expansion territory and is now at its highest level in over two years. Like the consumer confidence index, it is a survey that relies on respondents' qualitative assessments of their situation (are things better, worse, or the same for your business).

A variety of other surveys of consumers and businesses (ranging from chief financial officers to homebuilders to CPAs) tell a similar story.

None of these indicators measure actual economic activity. So – what about the reality of the present? By most measures, the economy is still proceeding forward in fits and starts, at a rate that has been disappointing by all historical standards. Industrial production remains well below its peak two years ago, wage growth is barely higher than the rate of inflation, and growth in real gross domestic product remains stuck at 2% or less. There appears to be little new data that would support the recent surge in optimism. Indeed, Morgan Stanley recently described the apparent divergence between sentiment and hard data as "stunning" (see chart below). Similarly, stock market indices recently reached record highs, even as corporate earnings are at the same level as three years ago.

Exhibit 1: There is a Record Gap Between the Strength of 'Hard' and 'Soft' US Macro Data



Source: Bloomberg, Morgan Stanley Research

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In a sense, consumer sentiment and the stock market might be seen as barometers, reflecting changing levels of optimism about the future for employment, income, corporate earnings and dividends. But they do not just passively reflect expectations – they can become self-fulfilling and actually drive results. High stock prices may encourage businesses to raise capital for new projects. High optimism about future economic conditions may make consumers feel confident enough to spend money on cars, vacations, or home improvement, even before the underlying economy improves.

John Maynard Keynes may or may not have coined the term “animal spirits”, but he is credited with putting the phrase in an economic context. Keynes believed that important decisions about most new economic undertakings – buying a vacation home, or launching a new business – were the result of “a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.” In other words, such decisions came down to “gut feel” rather than hard numbers and analysis, and obviously involved a degree of risk. But when a sufficient number of consumers and businesses feel confident enough to take such risks, the contagious nature of confidence and optimism can create a snowball effect for the economy.

It goes without saying that the election of Donald Trump and his aggressively pro-growth, pro-business agenda has played a major role in igniting these “animal spirits”. Indeed, in the last issue of *Consilium* we discussed several potentially significant benefits from his policies, should they be enacted. If Trump’s plans crash on Congressional rocks, however, confidence could quickly erode. Such is the risk that investors and businesses are taking at the moment, and why developments in Washington bear particularly close scrutiny.

Even if only a portion of Trump’s economic plans come to pass, we believe we may be entering a period of stronger growth propelled by higher business investment (due to potentially lower corporate taxes and reduced regulation) and a pickup in consumer spending (driven by higher wages as we approach full employment). Still, skepticism can be easily found. After doubting the potential for stronger growth (the “new normal” worldview), some economists have already jumped ahead to the notion that the economy will soon overheat and the Federal Reserve will go on an expansion-killing spree of interest rate hikes. Eventually, that may be a concern. For now, investors are very close to a “sweet spot” where increasing interest rates are a sign of health, not reason for panic, and good news for Main Street is once again good news for Wall Street. Here’s hoping for a return to the “old normal”.

Sources: Institute for Supply Management, Conference Board, Business Roundtable, AICPA, Baseline, Factset, Morgan Stanley, J.M. Keynes“General Theory”

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