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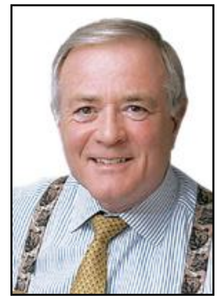

William Rutherford

Mixed messages confound stock market

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President Trump has been in office nearly a year. During that time, he has had scant legislative victories. He has attempted to roll back the signature accomplishments of former President Obama. He has generally only had success where Congress cannot intervene, even though the Republicans control both houses.

After a year of struggle, Republicans are poised to finally produce a win on a tax bill. Called a tax reduction and reform bill, it creates massive new debt for the U.S. Proponents argue that economic growth will make up the needed revenue to overcome the reductions in tax rates. History shows otherwise. Bill Dudley, president of the New York Fed, opines that the result will be even higher interest rates as the government borrows more to fund increasing deficits. Higher rates will dampen economic growth, making it unlikely that the bill will be positive for the economy.

Additionally, it is hard to see how the economy, which is operating at full throttle, can ratchet up the pace. With the unemployment rate at less than 5 percent, achieving improvement is challenging. And so, the tax bill may simply generate more debt for the country. President Trump, with his own multiple bankruptcies, has called himself the “king of debt,” and that may be the role he is playing now. Republicans are typically averse to debt and fond of criticizing Democrats for deficit spending, but not this time.

So, why does the market find good news in what historically has been not so good news? It is in part because of the strong belief that the tax bill will create economic growth and more jobs, even though history has shown otherwise. Businesses are troubled by the short expiration date of some of the provisions. Securing the permits necessary to build the infrastructure that creates new jobs can take years, and by then the tax provision may have expired. Businesses cannot hire more people unless they have confidence that they will not have to lay them off.

Furthermore, what happens when the Democrats return to power? Will the tax provisions be repealed? At a recent meeting of business executives, the chief economic advisor to the president asked for a show of hands by those who would expand their business based on a lower tax rate; only a few raised their hands.

While Congress is struggling with taxes, the North Koreans launched a missile that can hit any target in the United States – yet the market shrugged it off. The North Korean missile is anything but good news. Is the market too optimistic? Well, there are practical reasons why the ability to launch a long-range missile may not equate to delivering a nuclear weapon to the U.S. Putting the darn thing up is not the same as bringing it down intact so that it can deliver its payload; that has not been demonstrated yet.

Nevertheless, the North Koreans have made remarkable progress in a short time with their missiles. It is as though someone gave them a guidebook. And probably someone did. Think Iran and Russia. And now that Russia and Syria are bosom buddies, the Russians should be able to deliver missile technology through the Syrians. And don't forget, our longtime Middle East ally Egypt is now granting landing rights and airspace rights to the Russian military. America for years has been paying the Egyptians billions for those airfields and rights; apparently they are nonexclusive.

While the administration is blowing up NAFTA, Canada and Mexico are finding new trading partners. Our new friends in Eastern Europe are finding the East more congenial than the West. The administration has shattered the Trans-Pacific Partnership, leaving the region to China. We are becoming more and more isolated, and yet the market ignores this information. Why?

Perhaps it is because U.S. economic fundamentals and U.S. multinational corporations remain strong. Total earnings for the concluding quarter are expected to be up 8.6 percent from the same period last year. That is a good result. Earnings revisions have been very favorable. Companies such as Kroger, Tiffany's and Costco, among others, have beaten their earnings estimates – a sign that the consumer is positive on the economy. In the third quarter of 2017, with 495 of the S&P 500 reporting, earnings are up 6.5 percent from last year. And 72 percent of reporting companies have beaten earnings estimates. Increased earnings should support increased stock prices.

To be sure, the yield curve of short-term debt compared to long-term debt is flattening; this is generally thought to be a negative sign for the economy. But while the economy may slow, that doesn't necessarily portend a recession. Also, it appears that foreign buyers are purchasing long-dated U.S. debt because interest rates in their own countries are so low, making a flattening yield curve not seem so ominous.

During the first year of the Trump presidency, headlines have tended to dominate, but fundamentals have proven a far more reliable view of the economy and market action. Stick with the fundamentals.

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