BERKSHIRE MONEY MANAGEMENT

The Knowledge and Experience to Build Your Wealth

2018 Outlook

- Gains for the stock market will be capped next year due EPS growth being, in part, tax cut induced, thus demanding a lower P/E multiple. The market should go up about 4.7% next year (give or take a half dozen months of starting and finishing dates, as the market could experience double digit growth before sharp weakness at the end of the year as it prices in a moderation of earnings growth).
- About half of the Tax Cuts and Jobs Act of 2017 is priced into the stock market.
- Real US GDP will approach 3% in 2018. CPI inflation will creep up to 2.4%. Unemployment will dip below 4%.

Economy

- Unemployment is just over 4% and underemployment (a broader measure of slack in labor market) is less than 8%. The last time the job market was this tight was at the height of the 1990s technology boom.
- Consumer spending has been solid as values of investment portfolios and houses have improved.
- With the Fed winding down QE in favor of a prediction to raise rates three times next year, there are risks that asset prices will come under pressure and that the wealth effect will either fade or, worse, detract from growth.

Unemployment is just over 4% and underemployment (a broader measure of slack in labor market) is less than 8%. The last time the job market was this tight was at the height of the 1990s technology boom. Despite the tight job market, wage pressure has been relatively tame. Wage growth has been moving up to 3%, which is good for workers as that rate is outpacing CPI inflation. It is also good for corporations trying to control labor costs in such a tight market. That has been a fortuitous mix and has allowed stock investors to assign a premium to stock prices. In return, the appreciation of stock prices has allowed for the "wealth effect" to carry the economy even higher.

Consumer spending has been solid as values of investment portfolios and houses have improved. The wealth effect describes a households' propensity to spend more as their net worth increases. The increase in household wealth has been enormous since the Great Recession. Over the last 18-months alone, since the last correction of any real size, stock wealth (as measured by the Wilshire 5000) is up close to 30%, or an increase of $6 trillion of stock wealth. Over that same period, house prices are up almost 10%, or an increase of $2 trillion of wealth.

This was good news for 2017, but the risk is now to the downside. For every dollar increase of net worth, spending increases by about 4.5 cents. More than one-fifth of the consumer spending growth since the Great Recession has been due to the wealth effect, and the wealth effect is responsible for about a half of the consumer spending growth over the last year. More good news is to come, as the wealth effect tends to peak about one year after a change in wealth (so even if the market starts to turn down now, at least some of the wealth effect will remain). However, the wealth effect tends to be more immediate and often larger on the downside.

Over the last nine years the Federal Reserve's quantitative easing program was designed to raise asset prices, resulting in an economic boost due, in part, to the wealth effect. With the Fed winding down QE in favor of a prediction to raise rates three times next year - combined with higher rates from deficit spending from the tax reform - there are risks that asset prices in the stock market will come under pressure and that the wealth effect will either fade or, worse, detract from growth. A significant decline in house prices seems unlikely, but a typical garden-variety stock correction of 10% would reduce GDP by over a half percentage point.

So much of US GDP is comprised of consumption that it is important to maintain asset levels to maintain growth. Fortunately consumers are employed and financing is easy. But the wealth effect can be significant. With any luck, the tax cuts will mitigate any corrections of the 10% magnitude until the second- half of the year. But it will happen. On average a 10% correction occurs once every 14 months. It will happen. To what extent it affects the economy will mostly depend on the duration of the drop, and the market's resiliency as measured by being able to attract buyers relatively quickly.

Threats aside, the economy is humming along. We see no economic speed bumps in 2018 big enough to cause us to take larger-than-normal defensive allocations. However, depending upon the effectiveness of the tax cut in 2018, there is the risk of overheating, higher inflation and interest rates, and then a recession in the few years ahead as that stimulus fades. But, again, the economy is humming along now.

We started this section with a mention of employment because job growth and economic growth are largely synonymous. November's 228,000 gain in jobs marked the 86th consecutive month of net payrolls additions. But we don't take a particular trajectory and just project that the future will be the same – that is just a bad way to forecast. So what has been good news does not mean it will continue to be good news. However, in this instance we believe it will.

The average monthly gains over the last few months has been 170,000, roughly in line with the last year, and about twice the amount required to keep up with population growth. Recent numbers aside, we see continued job growth because of the way we dissected the numbers. First, there is what is called the diffusion index. Without getting into those details, essentially what the number tells us is that gains are not only broad-based (breadth is important because weakness is one industry can bleed to another), but the trend is improving. Also, hourly earnings for all workers has also been trending up, suggesting a need for more work, not less. These numbers are important because the employment rates are so positive that they are approaching what typically would be considered the natural rate of unemployment, a hypothetical, and changing, rate at which there can be no further improvement due to friction within the labor market, thus making job growth very difficult to sustain. (It is entirely likely that we have already breached the non-accelerating inflation rate of unemployment, or NAIRU, which is also a moving target in terms of exactness, whereby any improvement would cause inflation).

The Tax Cut and Jobs Act of 2017

- The tax cut is probably only half way priced into the stock market.
- In terms of massively jump-starting a good economy into something much more stellar, this does the trick – on paper. The problem, in regard to stimulating growth isn't the law itself, it's the timing.
- We see no signs of recession in 2018. But if we had a significant recession in 2023, we could easily sit back and look at the path that got us there – stimulating an already strong economy, causing it to overheat, forcing the Fed to respond by rising interest rates faster than otherwise expected due to rising inflation.

There is debate, mostly among party lines, as to how effective the tax cut will be in creating jobs and stimulating the economy. Given my profession, I do not have the luxury of shaping my narrative of expectation to reflect a political opinion. Actually, given my profession, I am particularly perturbed by people who copy-and-paste partisan comments from their side of the aisle to further their dogma. Economics, not politics, is my religion. But instead of dealing in faith, I deal in probabilities. And the tax cut is probably only half way priced into the stock market (more on that below). The premise of that probability is that the tax cut is good for the economy, in the intermediate-term (at least), ergo good for the stock market. And while we never know for sure why a person is buying stock (because of a tax cut or because of cheap money or bad alternatives or technical analysis), we are pretty certain that the tax cut has and will continue to encourage buyers of corporate stocks. Given the extent to which the tax cut will help corporate profits, clearly that is not a controversial statement.

Two things, quickly. First, we are not going to go into a detailed analysis of the tax cut. This is just not the medium for it. Second, we are going to focus only on the next few years. The further out in time we go, the more debate there is as to the potential efficacy of the tax cut. Besides, the further out we go, the more assumptions we need to make about the other variables that affect the world. So by keeping our outlook a bit briefer in duration, it actually increases the probabilities of our expectations of how the tax plan will affect the economy (which is ironic, given that the predictions of the stock market skew toward the impossible as you shorten the duration of the outlook).

The tax cut dramatically affects the economics and earnings landscape. Businesses are the biggest winners of the tax cuts. Larger C-corporations are going to receive some $650 billion in tax cuts over the next decade as their top marginal rate is permanently reduced from 35% to 21%. (The effective tax rate of these companies is closer to 28%, so while that is good, it's not as good as it looks without considering the details.) Smaller S-corporations and other so-called pass-through-entities will have a lower marginal rate that will give them about $250 billion in tax cuts through 2025, when this cut expires along with the tax cuts for individuals.

In terms of massively jump-starting a good economy into something much more stellar, this does the trick – on paper. The problem, in regard to stimulating growth isn't the law itself, it's the timing.

Fiscal stimulus has been for centuries notoriously ill-timed. It is typically a politically charged response to an economic hardship that has already happened. However, this fiscal policy is uniquely ill-timed.

Admittedly, some – if not much - of the strength in the economy in 2017 can be attributed to the anticipation of tax relief. So, a bit of my concern may not be perfectly fair in citing the timing. Nonetheless, the problem is that the economy is at or near most estimates/definitions of full-employment. Wage-growth is starting to show. While CPI inflation is currently in check, PPI (producer

price index) is starting to leak into and increase inflation. And the Fed is expected to raise short-term interest rates 3 times in 2018. Additional growth, plus more jobs, plus more inflation may cause the Fed to push for 4 rate hikes. And growth plus deficit spending will likely push up longer-term interest rates.

The risk is not necessarily that higher interest rates will wash away the effectiveness of the tax relief, but more so that the economy will overheat over the next couple of years as some of that relief is pulled away, or discounted. We see no signs of recession in 2018. But if we had a significant recession in 2023, we could easily sit back and look at the path that got us there – stimulating an already strong economy, causing it to overheat, forcing the Fed to respond by rising interest rates faster than otherwise expected due to rising inflation.

That is not a forecast of unchecked inflation; it's merely an acknowledgment that the Fed has the mandate to control inflation. So if inflation is above trend, they can comfortably act upon their stated intent to normalize (i.e. raise) interest rates.

But for stock investors, there is no need to be overly cynical at this point. For now, for the intermediate-term, investors can be happy about lower corporate tax rates, which reduce businesses' cost of capital, which encourages them to invest more into to plant, property, equipment, and payrolls, which, in turn, increases productivity and the economic growth.

<u>**2018 S&P 500 Target of…**</u>

- Price-to-earnings multiples are expected to compress next year, even as earnings rise.
- A 19.5 P/E times $145 EPS puts the S&P 500 index at 2,827 points, or about a 4.7% increase in stocks over the next year.

If only it were so easy to figure out earnings to figure out where the stock market will be.There are other variables, fundamental (interest rates, corporate buybacks),), emotional (fear / greed), political (North Korea, Brexit). But over the long -term stock prices are driven by earnings, so we'll start there.

More specifically we'll start with past earnings to get to the future guidance. And not just that S&P 500 operating earnings will be about $125 per share in 2017. That's easy. I like to reflect upon history when considering what will happen with the economy and the stock market. History doesn't typically repeat in these areas, but it does rhyme. The most dangerous phrase uttered in the stock market world is "it's different this time."

Consensus estimates are calling for 15% EPS growth in 2018 for S&P 500 companies. Consensus is usually 9 points too high. Standard & Poor's specifically are calling for a 16% rise to $145 of earnings per share, and they are usually pretty good (at least relative to the consensus).

Me? I think real GDP will be 2.9% and inflation will be 2.4%. Since S&P 500 sales historically have grown about 0.5% of nominal GDP, so that's 5.8% sales growth for S&P 500 companies. The tax cut could boost S&P 500 earnings by 7-14%, let's take the mid-point of that at 10.5%. A separate component of tax reform will incentivize repatriation of overseas cash, which will likely be used for corporate buybacks,

which will reduce outstanding shares by 1.5%. That is growth of 17.8%. Ugh. I'm virtually consensus. We all want to be unique special snowflakes, so let me look at it from a different angle…

Going back in history to a few years, we experienced an earnings recession in the S&P 500 earnings from 3/31/2015 and ended 9/30/2016. An earnings recession is when the year-over-year change in earnings growth falls below 0%. Thirteen of 19 earnings recessions since World War II have been coincident with economic recessions. This one did not. After the previous non-economic (or, mid-cycle) earnings recessions, the earnings rebound has been impressive (though not as strong as those following economic recessions).

As of 12/31/2017 five quarters will have passed from the last earnings recession. In the previous earnings recessions the S&P 500 has gone up 6%in price over the following five quarters while earnings per share (EPS) went up 13.4%, thus making valuations more favorable by pushing down the price-to-earnings ratio (P/E) by a magnitude of 7.4 percentage points. This time the gains of the stock market have practically mirrored the 21.3% rise in earnings. So there has been no compression of multiples, meaning that valuations have not improved. This will be important to remember in a bit. First, that stock market valuation has not improved. And second, that the stock market may not repeat, but it does rhyme.

Past mid-cycle earnings rebounds after mid-cycle earnings recessions have lasted a median of two years, then became flat. Following that historical path, earnings growth could approach zero by late 2018 (9/30/2018 will have been two years). And that argues for a compression of multiples. In 2017, the S&P 500 operating earnings were about $125 per share. At 2,700 that gives the S&P 500 a trailing P/E ratio of 21.6.

I think that price-to-earnings multiples (P/Es) will contract, from 21.6 to 19.5. In 2017, strong earnings growth kept multiples in check even as stock prices rose. In 2018, because a good portion of that earnings growth will be tax cut induced, and not as much sales and profit margin improvements, lower P/Es make sense and will likely cap stock market growth. A 19.5 P/E times $145 EPS puts the S&P 500 index at 2,827 points, or about a 4.7% increase in stocks over the next year.

My usual caveat is that it's stupid to guess the price movement between two precise dates. Just plain stupid. So the measurement could cover the next 6 or 18 months, as the market is known to get ahead of (or behind) itself. The point is, the stock market looks like it might have a regular year (in about a hundred years of history the market goes up about 7% per year, so 4.7% is pretty normal and not that much of a Nostradamus-like expectation). Also pretty normal for every year are three corrections of five percent and one correction of ten percent every fourteen months. I am not supposed to guarantee anything in terms of performance, but I can guarantee that someday we'll go back to more normal volatility.

Predicting the stock market over a very long time is science (or, maybe, science-like). Predicting the stock market's performance is one part art, one part skill, a dozen parts luck, and one part obligation. And maybe just one part fun. I think the stock market corrects 7% in the first quarter of the year (quickly; so quickly that it is soon forgotten), rallies 20% from the bottom of the correction, then alternates corrections and rallies in the last quarter, ending the year up about 4.7%.

But if you believe anyone can consistently and accurately predict the market's antics, I've got a bridge in Brooklyn I think you should take a look at. So why bother? Because we focus on the probabilities of possibilities. In doing so it lets us assess as to whether we should invest cash, raise cash, and/or shift allocations. We will do so according to your goals and our probability in success of achieving your goals.

How much of the tax cut is priced in? (Showing my work)

The number one most relevant question I hear is "how much of the tax cut is priced into the stock market already?" (The most asked question is <groan> "what do you think of Bitcoin?"). I. Love. This. Question.

I love it because while it's impossible to answer with any level of certainty, I can do the math with a high degree of confidence. I only recently tried to do the math at, of all places, a Christmas party. The question came up and I'm pretty sure after dragging the inquiring mind through it, he'll avoid ever approaching me at a party again.

It wasn't even done on the back of a napkin, to give some easy-to-follow graphics. I was verbose and talked fast to keep my mouth up to pace with my thinking. He told me to slow down, and I then remembered I actually had an audience. I came up with the answer and gave the caveat that I'd have to sit down with my calculator and my data and check it. But I just can't find a better calculation than that not-quite-a-back-of-the-envelope calculation.

OK, quickly to add to the caveats. While there is a general consensus that the tax cuts will be good for stock prices, there is no consensus on magnitude. Next, of course, you cannot determine if a buyer of stocks was doing so because of the tax cut. She may have just liked the technical charts, and now tax cuts give her reason to buy more. There is a whole lot more to stock prices than a tax cut.

The answer is simple. About half of the tax cut has been priced into the market.

Remember that earlier conversation about mid-cycle earnings recoveries? Well, if the P/E did contract at the same rate of previous mid-cycle earnings recoveries, the S&P 500 would be trading around 2,550 points, or 5.5% below where the market is now (so the market is about 5.5% higher than it would be expected). The tax cuts should boost S&P 500 EPS by 7% to 14%. Let's split the difference and call it 10.5%. So if the tax cuts will boost earnings (and presumably the market) by 10.5%, but the market is 5.5% higher than it would be expected, then the market has priced in about half of the tax cut.

Here is something I didn't bring up during the holiday party. For the last four months, stocks of the S&P 500 with the highest effective tax rates have been outperforming stocks with the lowest effective tax

rates as investors pick winners and losers of tax reform. Surprisingly, stocks of small cap companies, who have higher effective tax rates than their larger counterparts and thus stand to gain more from the tax reform, have not outperformed large-cap stocks over that period ,or in all of 2017. Yet, given that investors are beginning to distinguish between winners and losers up until the signing of tax reform into law, it makes sense for us to see that broaden out to different stock market capitalizations.

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