MBS Mantra, LLC

<u>Viewpoint: Predictions – 2017</u>

<u>2/3/2017</u>

<u>Samir Shah, CIO, MBS Mantra, LLC</u>

This article was started on 1/3/2017, but due to a heavy travel schedule, was not completed. Much of the data and analysis is as of 1/3/2017, although some of the commentary is more recent.

"The Federal Reserve, consistent with its responsibilities as the nation's central bank, affirmed today its readiness to serve as a source of liquidity to support the economic and financial system"-Federal Reserve Board Chairman Alan Greenspan (Oct. 20, 1987)

"My advice would be, as you consider fiscal policies, to keep in mind and look carefully at the impact those policies are likely to have on the economy's productive capacity, on productivity growth, and to the maximum extent possible choose policies that would improve that long-run growth and productivity outlook." – Janet Yellen, Congressional Testimony, Nov 17, 2016

"Asset price movements as well as changes in the expected path for U.S. monetary policy beyond December appeared to be driven largely by expectations of more expansionary fiscal policy in the aftermath of U.S. elections." – Staff Review of the Financial Situation, Minutes of the F.O.M.C December 13-14, 2016

"The staff's forecast for real GDP growth over the next several years was slightly higher, on balance, largely reflecting the effects of the staff's provisional assumption that fiscal policy would be more expansionary in the coming years." – Staff Economic Outlook, Minutes of the F.O.M.C December 13-14, 2016

"Moreover, uncertainly regarding fiscal and other economic policies had increased. Participants agreed that it was too early to know what changes in these policies would be implemented and how such changes might alter the economic outlook." –Participant's Views on Current Conditions and the Economic Outlook, Minutes of the F.O.M.C December 13-14, 2016

"Since September, almost half the participants revised up their projections for real GDP growth in 2018 or 2019, generally only slightly. Those increasing their projections for output growth in those years cited expected changes in fiscal, regulatory, or other policies as factors contributing to their revisions." – The Outlook for Economic Activity, Minutes of the F.O.M.C December 13-14, 2016

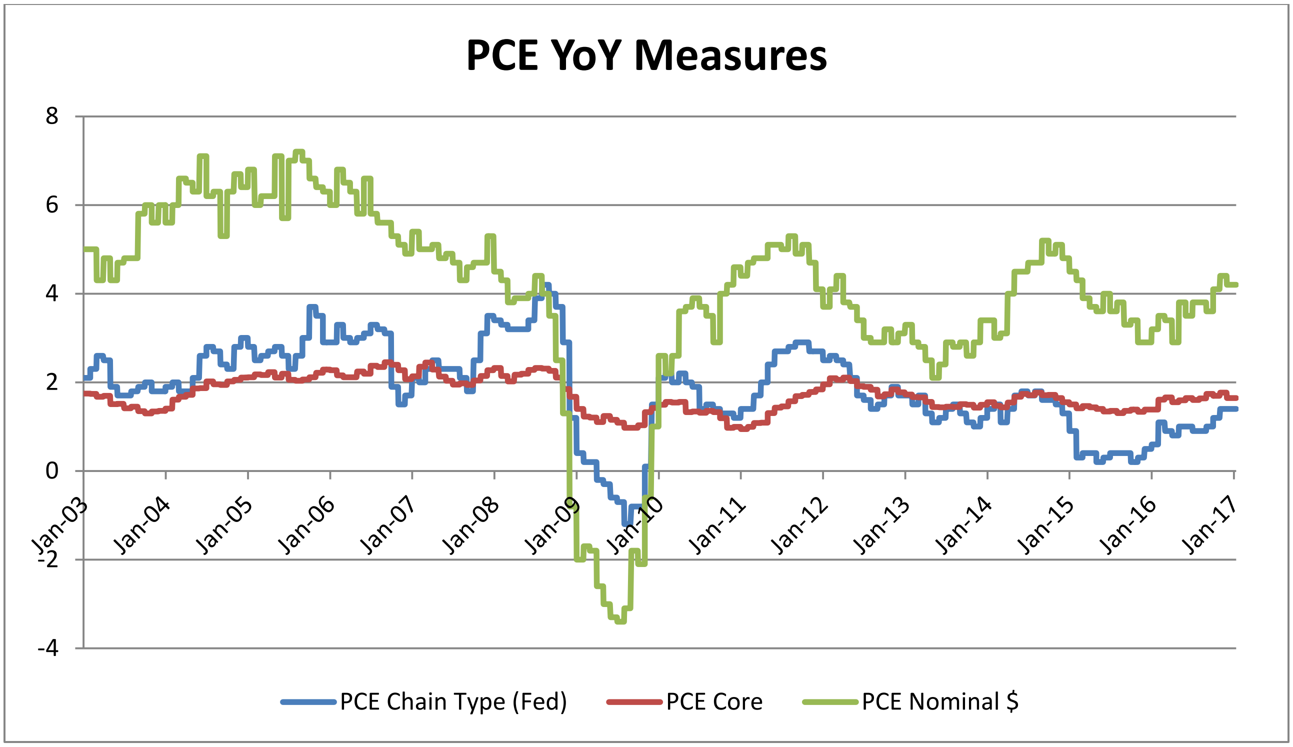
https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20161214.pdf

Fiscal Policy and the Fed

I have read through the minutes of the December 2016 FOMC meeting multiple times, and I am quite amazed. From a Fed that took no prisoners in stating definitively what it stood for (see the "Greenspan put", quoted above, from 1987), the Fed has evolved into an entity that is getting its economic projections from the market, (which in turn is betting on what the Fed will do), and using *market expectations* to justify and rationalize its monetary policy actions.

It is my opinion that the Fed had painted itself into a corner and had to raise rates, as only a year ago it had predicted four rate hikes only to deliver none. Expectations of fiscal policy-driven GDP growth provided a convenient cover in order to save face. Indeed, reading the minutes, there are so many caveats and concerns about lower growth and downside risks, including ***"uncertainty about how federal spending, tax, and regulatory policies might unfold"*** (ie. fiscal policies), that no change in policy would have been wholly justified.

Even the discussions about PCE and energy are easily debunked as rationalizations when one looks at the data themselves – we were at 2.9% PCE ("Chain Type" that the Fed appears to prefer) in 2011, declined to 1% in 2013, and went back up to 1.8% in 2014, only to watch it collapse back to 0.3% in 2015 due to the collapse in energy prices. (I personally prefer the Nominal $ PCE – green line below.)



Bloomberg tickers: PCE DEFY Index, PCE CYOY Index, PCE YOY$ Index

The Fed appears to think that as energy prices recover, PCE, too, will rise, allowing it to reach its 2% inflation target. (If anyone thinks that rising inflation due to energy costs is a good thing, please get a reality fix by talking to your gardener or nanny, and ask them where energy costs rank in their household budgets.) Lower inflation from energy costs should maybe instead be translated into a lower inflation target.

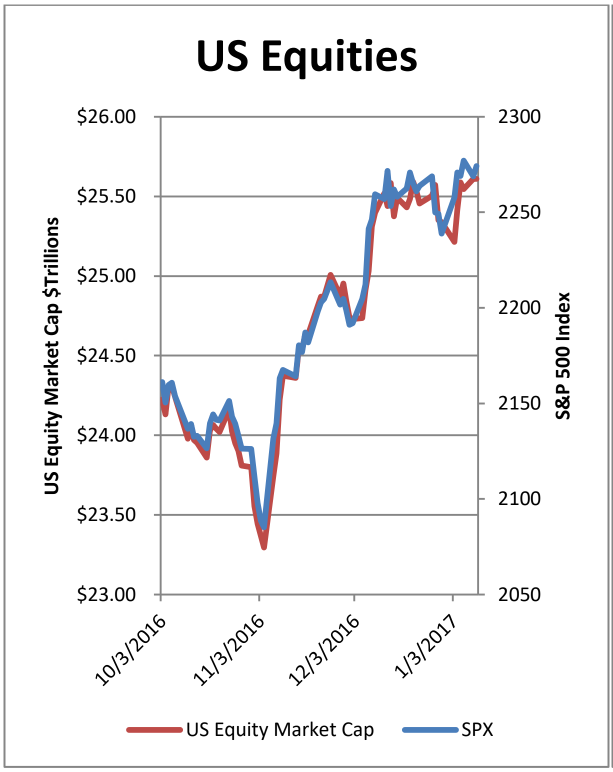
With fiscal policy playing such a large part in the election results as well as in both the Fed's and the market's expectations, we have taken up Ms.Yellen's challenge, and are going "***look carefully at the impact those policies are likely to have on the economy***" – at least some of them.

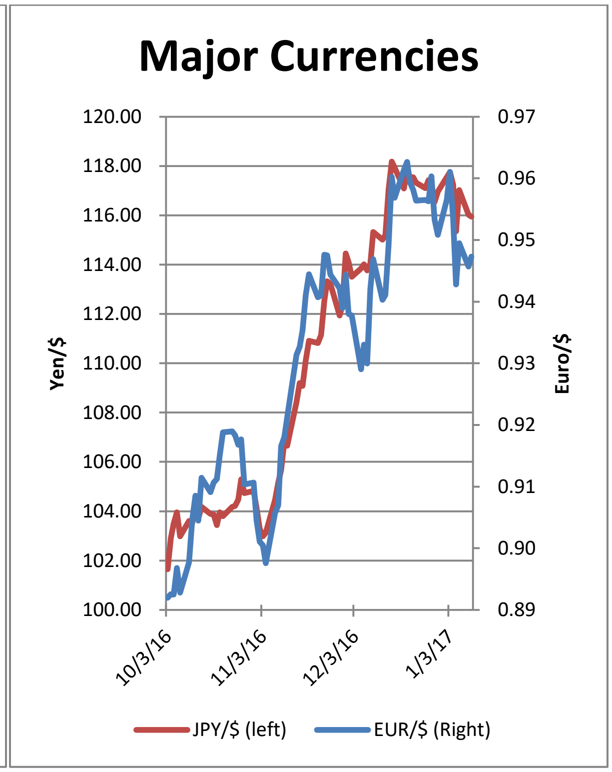
Market Expectations

Since November's Trump election win, the equity markets have had two major rallies, each of which has increased US market capitalization by over $1 Trillion. The first rally was in anticipation of fiscal policies by the Trump administration, while the second rally has been attributed to a huge trade ($1.8B) in S&P E-Minis on December 7th that in turn triggered additional purchasing.

http://www.wsj.com/articles/unraveling-the-mystery-of-last-weeks-massive-e-mini-futures-trade-1481560990

I am a firm believer that capital flows drive currency prices, and from the currency movements shown in the following chart, I suspect that both rallies have strong inflows from foreign investors (or hedge funds funding levered trades overseas). We will know more when flow of funds data becomes available in a few months.





Based on the models I have previously published in '***Determinants of the US Stock Market***', the first rally has no explanation, except for a richening of PE ratios in response to expectations of the effectiveness of Trump's Fiscal policy.

I believe that the second rally was in response to interest rate differentials due to the Fed's rate hike, resulting in additional flows of injected capital, mostly from Europe but also Japan,. (see '***The Failure of Macro Economics***' and '***Determinants of the US Stock Market***', both available in the Analysis section of www.mbsmantrallc.com.) However, the model would have predicted that a 25bps hike in US rates would result in approximately $250B in increased market cap, not four times that amount.

The $1T increase in market cap in December suggests that the equity market has priced in 3 additional hikes for next year as well!

Fiscal Policy – Lowering Corporate Tax Rates

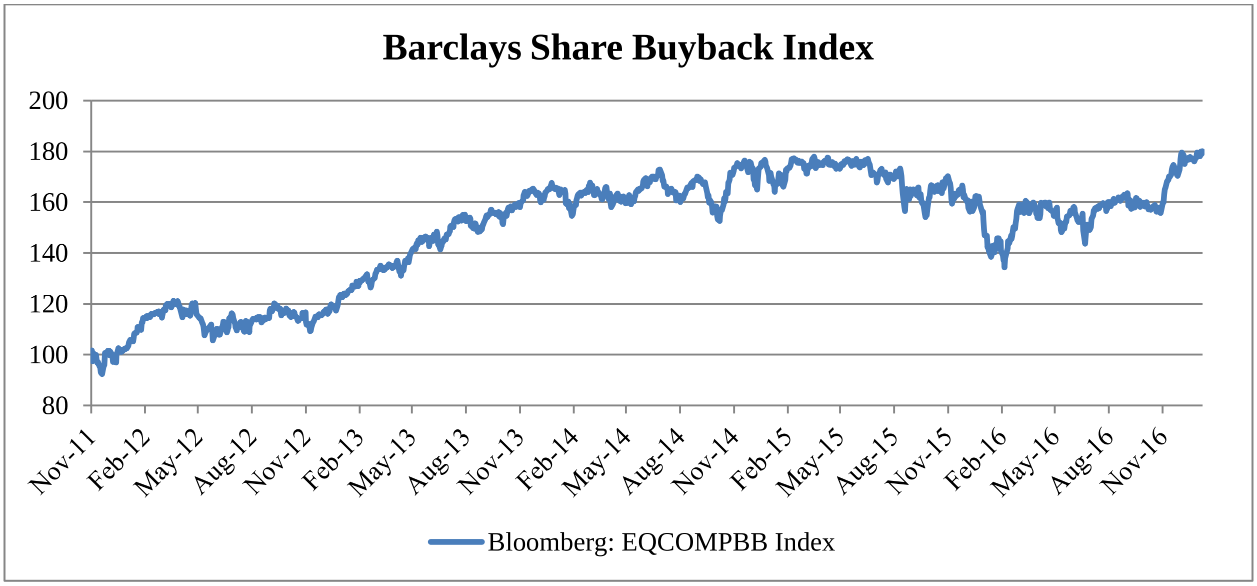
Investopedia defines Fiscal Policy as "*the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy. It is the sister strategy to monetary policy through which a central bank influences a nation's money supply.*"

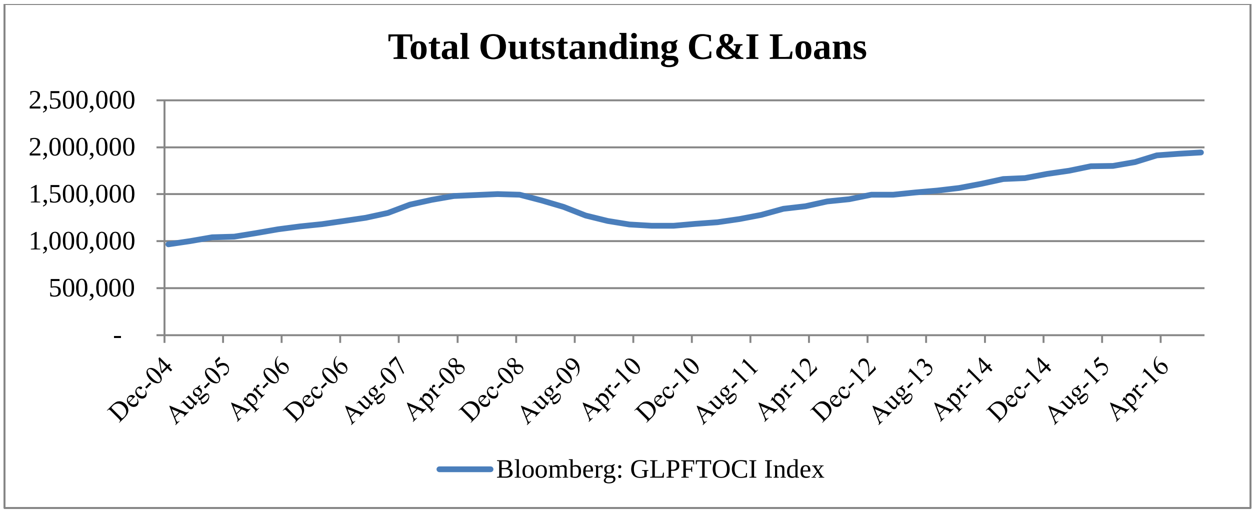
The primary fiscal policy Trump will likely implement is lowering (maybe temporarily) the US corporate tax rate to repatriate retained earnings of US corporations that have been held overseas to avoid paying US taxes. The purpose of lowering tax rates is to incentivize repatriation and leave corporations with greater retained earnings to reinvest into projects, thereby offsetting any limitations in the availability of capital.

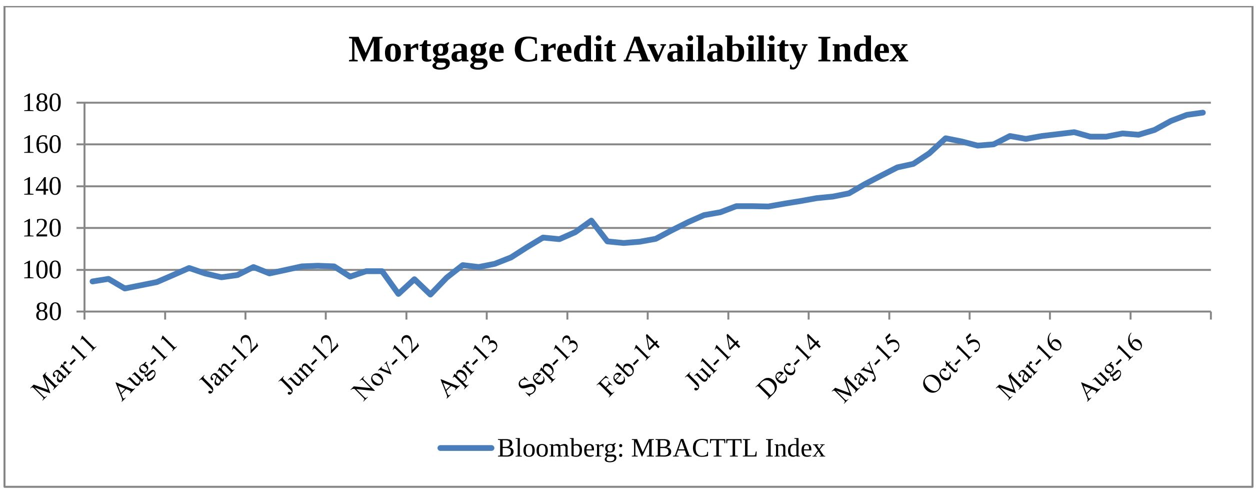
I believe this will have no significant impact. Lowering tax rates might have had an impact in a high interest rate, low money supply environment. In the low interest rate, high money supply environment that we have had for the past 8 years, the marginal benefit and impact on the economy will be negligible.

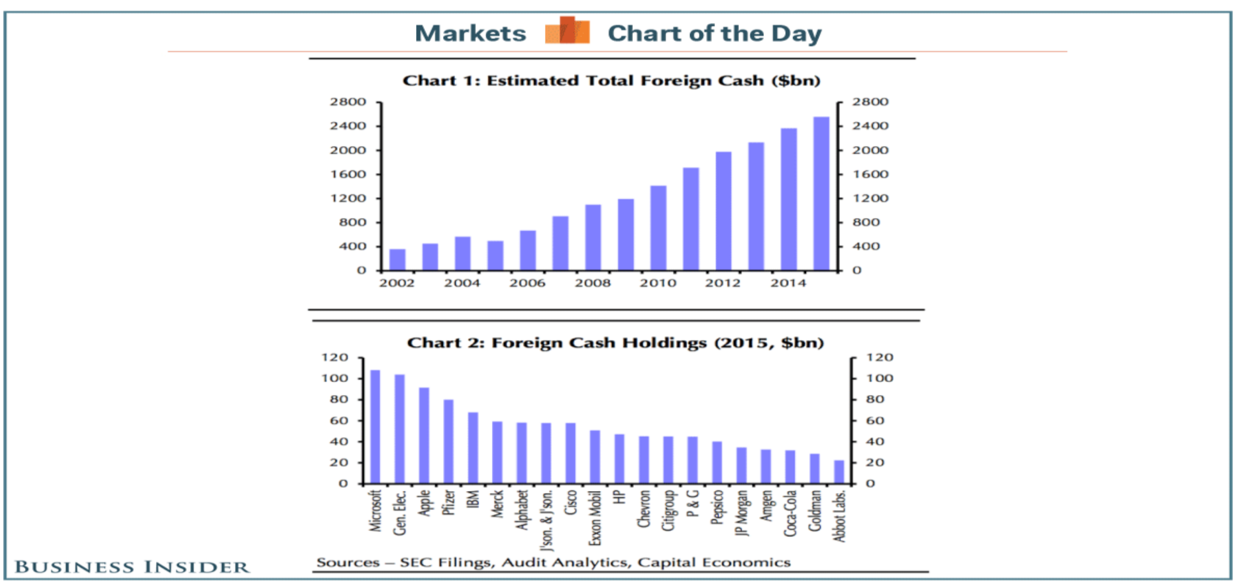
The primary reason that repatriating this capital will have no significant economic benefit is that capital via bond issuance has been freely available for many years now, at very low cost, which is even lower when you factor in the fact that interest is tax deductible, further lowering the after-tax cost of capital. **Yet the primary use debt-issuing corporations have found for this cheap capital is to buy back stock, to artificially increase EPS, and thus boost share price and CEO bonuses.** In fact, many corporations have publically stated that this is why they are issuing debt, and why they continue to do so. ***Even with a 1%-2% after tax cost of debt, corporations have not been able to find profitable investment projects and business plans to meet this low hurdle rate***.

The following graphs show that credit availability has not been an issue – if there were profitable investment projects available, they would have been built. The Barclays Share Buyback Index tells the story.









http://www.businessinsider.com/us-companies-hoarding-25-trillion-of-cash-overseas-2016-9

A case in point is Microsoft. The chart above shows that Microsoft has the largest overseas hoard – over $100B. However, as recently as 2 days ago, the headline in the WSJ was '***Microsoft Sets 2017 High with $17 Billion Bond Sale***'. Quoting from that article:

> *Microsoft Corp.sold $17 billion of bonds, capping a busy month for corporate-debt issuance with the largest deal of the young year…Surprising investors with such a big deal so soon after it sold $19.75 billion of bonds last August, Microsoft nonetheless met with a warm reception Monday from the market, allowing it to increase the size of the offering from an initial estimate of $14 billion…Proceeds from the seven-part deal, which includes a 10-year bond with a 3.3% coupon, are expected to be used for general corporate purposes, including the repayment of short-term debt…Microsoft issued its first bonds in 2009 and has kept issuing bonds even as it pursued an ambitious share-repurchase program. In September, the company announced plans to boost its dividend by 8% and buy back as much as $40 billion in stock as it neared completion of its previous share-repurchase program.*

Allowing or even forcing Microsoft to repatriate capital is unlikely to have any social benefit, or certainly none that impacts the disadvantaged middle class that the Trump administration is trying to appease.

Lowering tax rates also raises the weighted average cost of capital for debt-issuing corporations, thereby raising hurdle rates for their projects (due to the reduced benefit of the interest rate deduction). Most corporations are highly levered already, with a large amount of debt as a percentage of their balance sheets – indeed, corporate and levered loan issuance has been robust over the past many years due to the low rate environment**. Most of this debt has had 2 purposes – M&A activity, and purchasing stock to boost EPS and maximize balance sheet leverage.**

Bottom line: Bringing back capital from overseas will only result in more share buybacks. If this is implemented, my opinion is that this will lead to another huge boost in US stock market capitalization, without any significant benefit to employment, or wages. This will only make asset owners – the wealthy – wealthier. Not quite what the Trump team says they intended.

Fiscal Policy – Infrastructure Spending

Does anyone remember Obama's 'Shovel Ready' projects? The $800B Recovery Act did not have a significant impact for a number of reasons: a) The official reason: it takes time for projects to be prepared and there was a lot of red tape at the regional level; b) the real reason: to generate economic benefit greater than the initial benefit of paying for wages and materials during construction, a project must have a practical economic purpose.

For example building a new bridge to replace an old bridge will not have a lasting economic benefit unless there is an economic reason for more cars or goods to travel over the bridge, increasing commercial activity long term. The US is pretty well connected with roads, bridges and tunnels, and I will argue that we have an excess of commercial capacity in general as we have been constructing things since 2000, along with the required infrastructure. Granted, our airports and ports might be worn out, but for the most part, they do not hinder economic activity. Building more infrastructure will not transform us into a $30 Trillion economy.

The chart of PCE in Nominal $ at the start of this article tells the story: the growth of our commercial activity peaked in 2004, well before the Crisis, and it might not be possible to achieve those levels of growth again.

Japan has also provided many examples of unnecessary infrastructure spending that did not result in economic growth. I have posted the following links numerous times, in my Crisis Notes, and in other publications, but they are worth reading again.

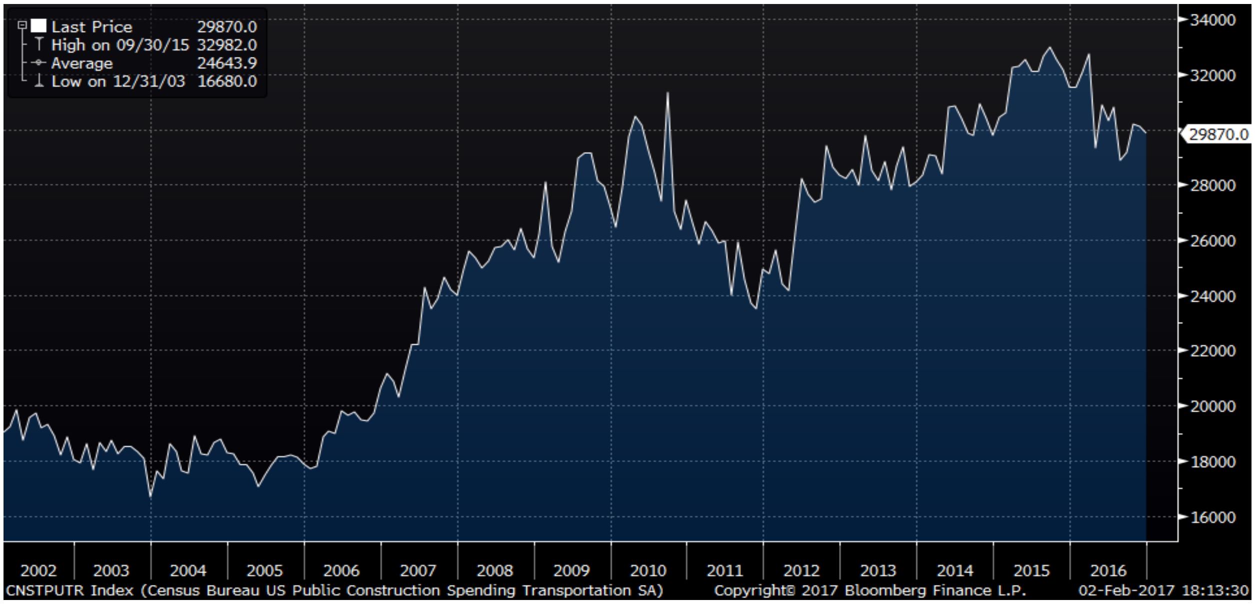
http://www.nytimes.com/2009/02/06/world/asia/06japan.html?pagewanted=1&emc=eta1

http://www.barrons.com/articles/SB122852225697584257

https://www.linkedin.com/pulse/infrastructure-spending-samir-shah?trk=prof-post

The following chart shows that we have not exactly been static with respect with construction spending.

Bloomberg CNSTPUTR Index - US Public Construction Spending Transportation (SA)



Bottom line: I do not think that fiscal infrastructure spending will give the US economy the boost that the stock market has priced in.

Manufacturing Jobs

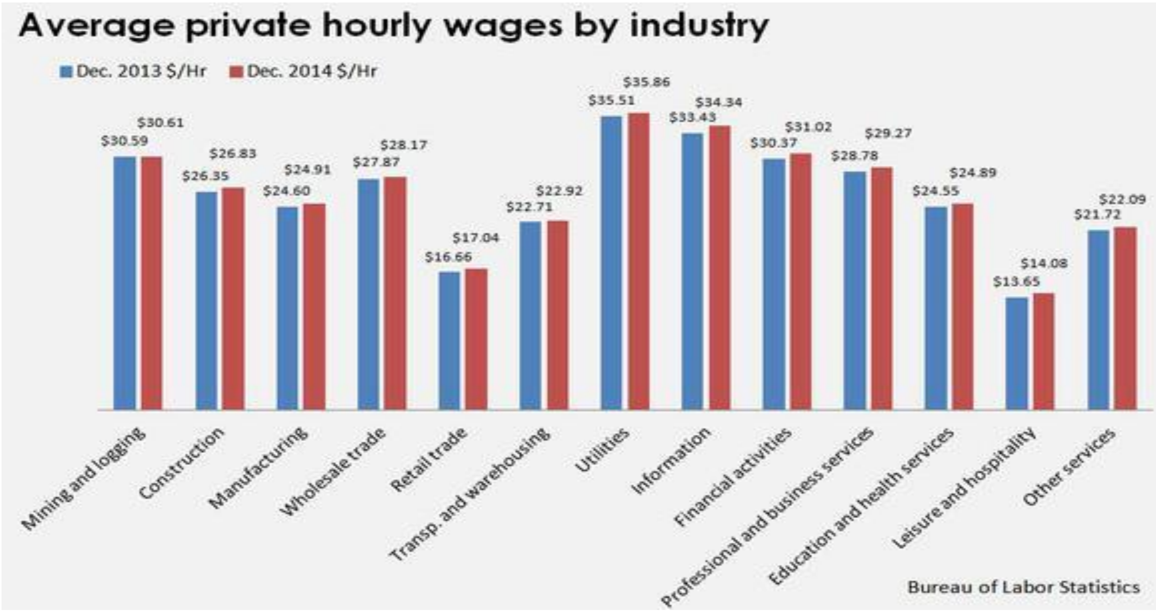
Trump's promises to the rust belt are likely going to be unfulfilled – I think it is impossible to bring back employment in manufacturing to the levels when 'America was great'.

There are multiple reasons:

1) **Automation**
2) **Wage levels**
3) **Shipping Costs**

Automation is the easiest to comprehend – most factories globally are going dark, including in China, due to increased use of robots. Humans are mostly needed for maintenance. As a result, not only are employee levels dropping to 10% of pre-robot levels in those factories, but quality control is also improving exponentially. This is a trend that is not going away, unless robots become 'self-aware', and their use gets outlawed. Maybe Trump should be imposing taxes on the robot-made component of goods?

The graph below shows US wage levels – (the graph is from the Motley Fool website).



The link below shows wage data for Germany, as well as other countries.

http://www.tradingeconomics.com/germany/wages

Mexican wages are 318.65 MXN/Day. US wages are $21.84/hour. At an exchange rate of approx. 20 MXN/$, a Mexican worker earns about as much per day that a US worker earns per hour!

As I have mentioned before in my Crisis Notes, foreign wages will need to rise up to US levels (or US wages to drop to foreign levels) before US workers and manufacturing can be substituted for overseas manufacturing.

Given the large differentials in wages, shipping costs will determine if there is an advantage to manufacturing close to the demand in the US. With a global glut of shipping capacity, and low energy costs, it is unlikely that the arbitrage of manufacturing overseas will go away anytime.

I believe that Trump knows this, thus his insistence on raising import taxes to equalize the cost of imports with that of domestic production. This will lead to higher prices. Micro Economics anyone? Raising prices leads to reduced demand! No wonder Wharton and UPenn are having an existentialist crisis!

http://www.politico.com/magazine/story/2016/11/donald-trump-2016-wharton-pennsylvania-214425

If we stop buying goods from overseas and instead manufacture locally with our high wage structure (assuming robots do not get the jobs), demand will undoubtedly drop due to the higher cost of goods, unless we get wage inflation to offset the reduced real purchasing power of our population.

US GDP could drop as a result. In addition, without the US, the world's largest consumer, purchasing good from overseas, GDP in the rest of the world will decline. Thus, imposing tariffs on imports could lead to a global recession!

Predictions

My predictions for 2017, based mostly on the analysis above:

1) **The rally in equities from November is highly optimistic**, and appears to be have lost some velocity, but is still ongoing. While some US investors might take gains, leading to a slowdown in appreciation, **I believe the both the European and Japanese Central Banking policies will continue to drive their citizen's capital to the US.** This will accelerate if the Fed raises rates, in which case the foreign capital will forget that that they already priced this in, and will drive up US stocks even more, along with the US Dollar. **I would not be surprised by $1T to $2T more US market cap before year end even without any more Fed rate hikes**.
2) **A reduction in corporate tax rates for the purpose of repatriating capital will result in further stock market appreciation**, as buybacks and M&A activity will resume.
3) **Bond market inflation expectations will rise in the near term**. However, in about a year, the market will realize that there is no economic stimulus from fiscal actions, and that the only rising inflation realized is asset inflation. Bond yields will thus rise some more in the near term and **then decline later in 2017, resulting in a flattening of the curve**.
4) Hints of trade wars, or tariffs imposed, will also lead to flights to quality in USTs and also lead to curve flattening. **EOY to mid 2018 UST 10yr – I'll call 1.5%.**
5) **Don't forget that US Treasuries are high yielding compared to other Sovereigns**: Looking at 10yrs - US at 2.47% vs Canada at 1.76%, Italy at 2.25%, Germany at 0.4%, UK at 1.35%, and Japan at 0.09%. It might take less than a year to get longer US yields to reverse course as central bank repression continues to impact foreign savings. Even if China dumps its USTs, Europe and Japan will buy them.
6) **I suspect investment consultants will rotate their clients out of fixed income,** resulting in increased supply of secondary market bonds in the near term. If Dodd Frank is repealed or weakened by the Trump administration, and dealer balance sheets are allowed to expand, the dealers will have a field day prop trading in the bond markets. **This will result in a transfer of wealth from the pension system** whose fixed income managers will sell bonds at weakening yields to large dealers that have enough capital to do proprietary trading.
7) **The dollar will continue to strengthen,** primarily due to expectations of Fed Fund hikes. This of course would result in limiting the US ability to export and thus manufacture.

I would love to hear your comments.

Samir Shah, CIO, MBS Mantra, LLC

sshah@mbsmantrallc.com

203-388-8356

Important Notice - Disclaimer

This overview is being provided to you by MBS Mantra, LLC ("MBS Mantra" or the "Firm" or the "Adviser"), for informational purposes only, on a confidential basis and is intended solely for use by the company or individual to whom it is being delivered. Potential investors are advised to request and carefully read and review MBS Mantra's Firm Brochure (Form ADV Part 2), and other documents, if any, provided by MBS Mantra (the "Documents").

Under no circumstances should this overview be used or considered as an offer to sell, or a solicitation of any offer to buy, interests in any securities, funds, other financial products or investment strategies managed by MBS Mantra, nor shall it or its distribution form the basis of, or be relied upon in connection with, any contract for advisory services or otherwise.

The information contained with this brochure has not been audited and is based upon estimates and assumptions. No reliance should be placed, for any purpose, on the information or opinions contained in this overview. The information contained in this brochure is based upon proprietary information of MBS Mantra and public information, but it may not be comprehensive, and it should not be interpreted as investment advice. No representation, warranty or undertaking, express or implied, is given as to the accuracy or completeness of the information or opinions contained in this overview by MBS Mantra or by its affiliates and any of their principals, members, managers, directors, officers, employees, contractors or representatives.

Investors must make their own investment decisions based on their specific investment objectives and financial position. Charts, tables and graphs contained in this overview or in the Documents are not intended to be used to assist an investor in determining which securities to buy or sell or when to buy or sell securities. While this overview may contain past performance data, PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS, WHICH MAY VARY. There can be no assurance that any investment strategy will achieve its investment objective or avoid substantial or total losses. Except as required by law, MBS Mantra assumes no responsibility for the accuracy and completeness of any forward-looking statements. Further, MBS Mantra does not provide legal and tax advice; MBS Mantra recommends that investors consult with their own independent tax and legal advisers.

Any example represents an actual trade made by Samir Shah, MBS Mantra's principal, and/or MBS Mantra; any hypothetical represents a possible trade. None of the examples, whether actual or hypothetical, contained in this overview and the Documents should be viewed as representative of all trades made by MBS Mantra, but only as examples of the types of trades MBS Mantra expects to complete for its customers. None of the examples provided can in and of themselves be used to determine which securities to buy or sell, or when to buy or sell them. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities used as examples in these Documents. To the extent that this document contains statements about the future, such statements are forward looking and subject to a number of risks and uncertainties, including, but not limited to, the impact of competitive products, product demand and market risks, fluctuations in operating results and other risks. (A complete list of trades made by Samir Shah and/or MBS Mantra is available upon request.)

This overview and all Documents provided by MBS Mantra should only be considered current as of the date of publication without regard to the date on which you may receive or access the information. MBS Mantra maintains the right to delete or modify the information without prior notice; MBS Mantra undertakes no obligation to update such information, including, but not limited to, any forward-looking statements, as of a more recent date, except as otherwise required by law.