GOOD DATA & A BIT ABOUT DISASTER ECONOMICS

In my previous note, I floated the notion that the U.S. economy was progressing quite independently of the international tensions and political discord that had been dominating the headlines. Three months hence, I'm inclined to argue similarly. Despite continued political contentiousness, despite North Korea's continued quest to rattle the U.S. and its Asian allies with thermonuclear threats, and despite a slew of destructive storms, the U.S. and other important economies seem to have rolled along pretty well during the most recent quarter. Further progress looks like a reasonable bet.

2ND QUARTER GDP RESULTS PRETTIER THAN EVER

After growing at an annualized rate of only 1.2% during the first quarter of the year, the initial tally for annualized economic growth within the U.S. jumped to 3% during the second quarter. Not only is that a solid growth figure for such a large economy, the official scorekeeper recently nudged that figure up to 3.1%. Investors love upward growth revisions the same way spouses like to hear they're now more attractive than ever. Whereas spousal praise might be occasionally augmented by a bit of obligatory homage, that upward growth revision is apt to be accurate. That 3.1% figure also happens to be the highest rate of annualized GDP growth posted by the U.S. in over two years. Although a solidly expanding economy does not necessarily result in happy investors, history suggests it improves the odds.

DISASTERS: EASILY-SPOTTED WINNERS & HARD-TO-NOTICE LOSERS

Although hurricanes and other disasters are obviously destructive, post-disaster reflection sometimes causes people near microphones to falsely surmise that the resulting destruction could be an economic catalyst. Disasters do tend to trigger obvious increases in demand for restorative products and services, but the gains experienced by that sliver of an economy tend to be more or less offset by decreases in demand experienced by the rest of that economy. Whereas the gains in disaster-related demand that inure to that relatively small segment of an affected economy are easily noticed by even the undiscerning, the offsetting decreases in demand that tend to be spread across the rest of that economy are easily overlooked, so they often are. If gamblers accounted for winnings and losses that same way, Las Vegas would be known as an *investors'* paradise.

DISASTERS: GDP GROWTH AT THE EXPENSE OF DESTROYED CAPITAL

To the extent economic growth is gauged *only* by changes in GDP, natural and man-made disasters can boost economic growth. While GDP measures changes in economic output, GDP is an incomplete measure of the financial well-being of an economy and society the same way income is an incomplete measure of the financial well-being of a person or business. More specifically, both measures fail to account for accumulated wealth (assets).

Moody's Analytics estimates that hurricanes Harvey and Irma caused at least $134 billion worth of combined damage. Whereas some economists expect those storms to trim around .6% from near-term GDP estimates before boosting it in subsequent quarters, those GDP estimates do not capture the reduction in well-being caused by the destruction of $134 billion of accumulated wealth. As the U.S endeavors to replace that lost store of wealth, economic output may temporarily surge and people near microphones may continue to report that the economy has improved, but if disasters really were a path to improved economic well-being, society would already have resolved to periodically destroy its infrastructure to ensure everyone stays economically busy. Sergeant Carter used to delight in having Gomer Pyle move the same heap of dirt back and forth, but busy work offers no net benefit in the real world.

DISASTERS: DESTROYED CAPITAL FUNDED BY INSURERS' RESERVES

Once a disaster occurs, insurers begin absorbing their portion of the tab. As they pay their claims, they burn through their own capital. To operate soundly, insurers must maintain minimum levels of capital, in reserve. Since a major disaster can consume large chunks of reserves, insurers must necessarily replenish those reserves to remain operationally solvent.

DISASTERS: INSURERS' LOSSES TRANSFERRED BACK TO SOCIETY

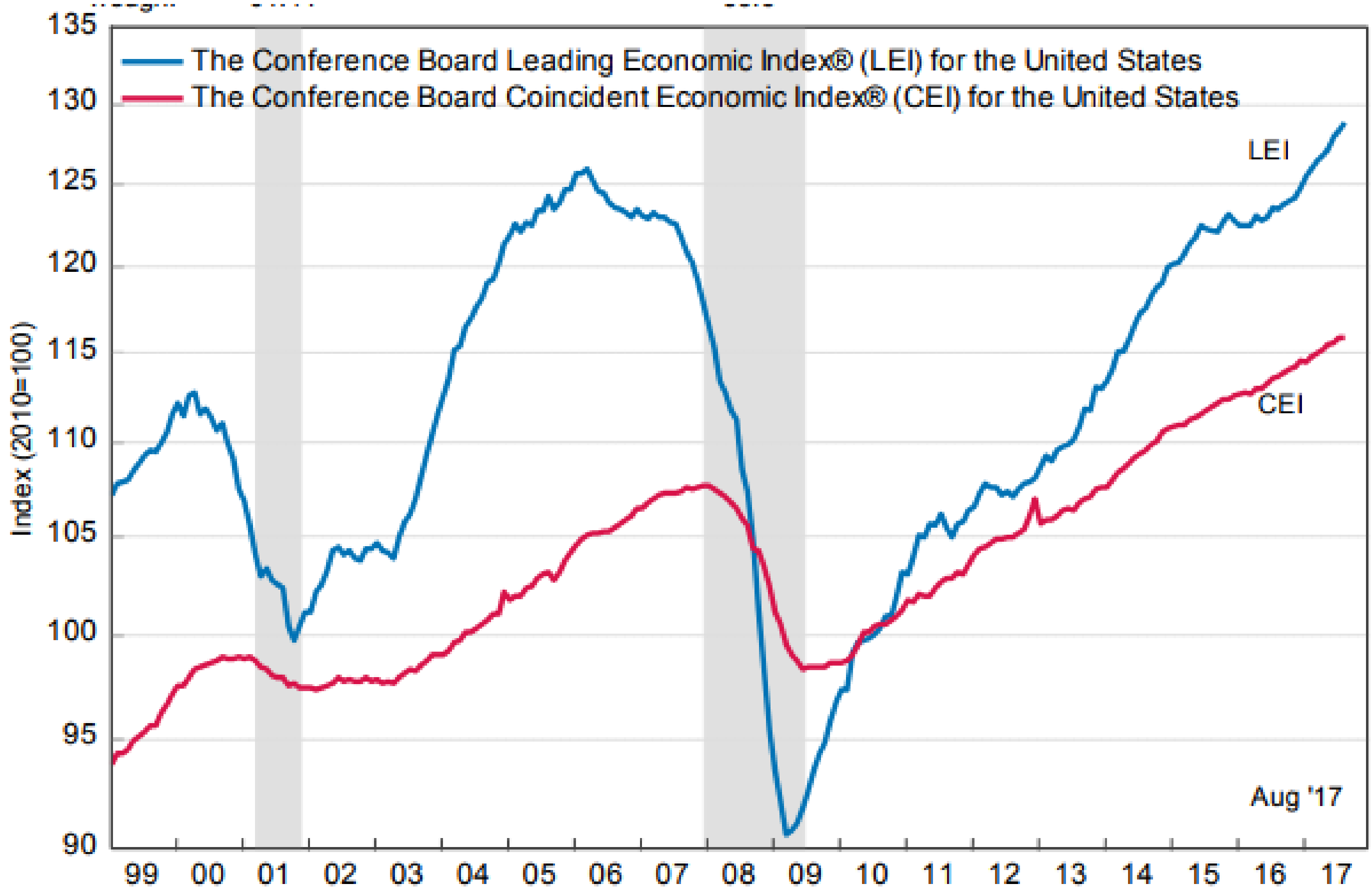
Ultimately, the replenishment of those depleted reserves is accomplished through premium increases. For every extra dollar society pays to an insurer to replace something it already had, society has one less dollar to spend on some incremental product or service. Ultimately, the losses borne by the insurance industry are transferred back to the whole of society through premium increases and reduced coverage. Regardless of any inflated GDP figures the press may eventually report, disasters are not only unambiguously negative in human terms, they're unambiguously negative in economic terms, too.

CEO ECONOMIC OUTLOOK INDEX DRIFTS HIGHER

As I mentioned last quarter, the CEO Economic Outlook Index is based on the views of 141 prominent CEOs regarding their expectations of sales, capital spending and hiring plans within their respective companies over the ensuing 6 months. After sharply rising to 93.9 in the second quarter of 2017, this indicator has further improved to 94.5 as of the end of September and continues to sit well above its long-term average of 80. As with GDP data, CEO optimism does not necessarily result in happy investors, but all else being equal, CEOs are probably more apt to help the economy along when they're feeling optimistic than when they're not.

LEADING ECONOMIC INDEX® HIGHER, TOO

In May, the Conference Board's Leading Economic Index (LEI) surged to a reading of 127. As of August, this index has drifted still higher to 128.8, as shown on the following page. While stocks do not necessarily decline during recessions, they often have and they certainly have tended to become more volatile during such periods. As an investor, your rooting interest is to wish against them. As you can see from the following chart, the LEI has inflected downward well before the onset of our previous two recessions. As of August, however, the index is resting at a fairly high level, so far, I see no hint of any downward inflection.



OTHER ECONOMIC TIDBITS

The labor market also appears healthy. Seasonally adjusted initial unemployment claims fell from 272,000 to 260,000 during the final week of September. Of note is that when initial unemployment claims fall below 300,000, the labor market is considered to be robust. Not only are claims well below that threshold, the associated robustness has now endured for 134 straight weeks. This is the longest such stretch since 1970, when the labor market was much smaller.

The unemployment rate of 4.2% is now as low as it has been since 2001, the Institute of Supply Management's Non-Manufacturing Index is now as high as it's been in 13 years, and the International Monetary Fund seems set to increase its growth forecast for the global economy. Although the Philadelphia Fed Business Outlook Survey addresses only that region of the U.S., index jumped from 18.9 to 23.8 new orders were not only noted to be "pouring in," the term "frenzy" also appeared in the report so manufacturing is certainly hopping in at least that corner of the U.S.

ZACKS INVESTMENT THINKS THE S&P 500 COULD DOUBLE IN 5 YEARS

To be more precise, it thinks the S&P 500 *will* double in value within the next five years. The annual, 14.9% returns implied by that statement are far higher than any market-related guess I've ever offered to anyone who's ever requested one from me. I've never been inclined to make bold predictions and I'm not inclined to start now, but after reading through the premises that support such a scenario, they resonated with me at least enough for me to decide to paraphrase them for you. In its August 26th commentary, Zacks suggested the following (indented and italicized):

AVERAGE EQUITY RETURNS TO REMAIN HIGH

Acknowledging 14.9% represents a pretty generous level of returns over an extended period of time, Zacks notes that equity returns have, in fact, generated that approximate level of average total return since equity values began rebounding in March of 2009. Zacks further notes that those returns have materialized while U.S. GDP has advanced by only 1.48% per year over that same span of time. In this respect, that 14.9% figure is at least plausible.

CONTINUED SLOW GROWTH MAY RESULT IN LESS ECONOMIC CYCLICALITY

Following a recession, U.S. GDP would historically advance by 3+% per year and a new bull market would begin. As the recovery would take hold, excesses would eventually begin to accumulate within the economy. The Fed would respond by hiking interest rates to eliminate those excesses which might then trigger a recession. After the financial crises of 2008/9, however, growth has been much slower, as already mentioned. Zacks argues that this lower rate of growth has reduced the Fed's need to intervene which, in turn, has reduced the risk of recession within the U.S.

LESS ECONOMIC CYCLICALITY WOULD REQUIRE LESS FED INTERVENTION

Although GDP has recently surged and labor is certainly in demand, inflation is muted. To the extent inflation remains muted (and a case can be made that it could), Zacks argues that there may not be much in the way of economic excesses for the Fed to address. Zacks envisions the U.S. economy continuing to grow modestly in the context of reduced cyclicality. Zacks didn't draw this conclusion, so I'll note that a reduced level of cyclicality would likely decrease the risk premium investors are willing to pay to own stocks, thereby pushing their values higher.

MARKET ADVANCES DON'T DIE OF OLD AGE

The current bull market has been intact since March of 2009 (over 8 ½ years) and equity values have risen over 265% over that span of time. However, the current market advance represents only the second longest market advance in modern history. The longest advance spanned December of 1987 through March of 2000, a run that resulted in stocks advancing by 582%.

Zacks has long reminded subscribers that the demise of a given bull market requires an actual cause. Zacks' didn't mention it in this piece, but Zacks' long-standing position is that bull markets do not die of old age. As of now, Zacks does not yet speak of any malignancies that might trigger a recession.

TRUMP TAX-CUTS BUILT INTO THE STEW

Zacks' ruminations include the impact of reducing the corporate tax rate from 35% to 20%, a tax-cut that would reduce corporate taxes to their lowest level since 1936. They also include the impact of reducing the tax on repatriated profits to an even lower 10% tax rate.

HISTORICAL NOTE REGARDING TAX RELIEF ON REPATRIATED EARNINGS

Income earned overseas is not taxed by the U.S. until the associated funds are "repatriated" back to the U.S. This creates an incentive for multinational companies to accumulate profits overseas. President Trump has argued that bringing those dollars (he estimates $5 trillion; other estimate less) back into the U.S. economy could result in billions of dollars of new investment within the U.S.

When Congress sanctioned a similar effort in 2004, some 9,700 corporations were eligible to repatriate foreign-sourced earnings during a period of time where the tax on those repatriated earnings was reduced to only 5.25%. With respect to whether that previous tax break did, in fact, stimulate domestic investment and employment, the nonpartisan Congressional Research Service (CRS) concluded, "While empirical evidence is clear that this provision resulted in a significant increase in repatriated earnings (843 companies brought $312 billion back to the U.S.), empirical evidence is unable to show a corresponding increase in domestic investment or employment." According to the CRS, as much as 91% of the repatriated funds dolled up corporate balance sheets rather than flowing into new investment.

EITHER WAY, TAX BREAK ON REPATRIATED EARNINGS GOOD FOR INVESTORS

If a reduced tax rate on repatriated earnings were to come into fruition and corporations were to apply the funds to domestic investment projects, the economy would benefit and investors would indirectly benefit as they normally do from economic activity.

However, if corporations were to once again use the repatriated funds to remove shares of their own stock from the public markets as they largely did when Congress enacted similar legislation in 2004, the incremental benefit to investors would be more direct.

Regardless of how much money a company earns, to the extent the resulting profits are distributed across fewer shares of stock, the earnings attributable to each share of remaining stock must necessarily rise. When that happens, history strongly suggests that stock valuations would also rise.

Of course, there's no assurance the current administration and Congress will pass any meaningful tax legislation, especially since the proposed tax cuts would increase the national deficit without any offset from the healthcare reform that is now dead. However, corporate earnings are already good. Since they drive stock prices, let's peek at them.

CORPORATE EARNINGS EXPECTED TO ADVANCE NICELY

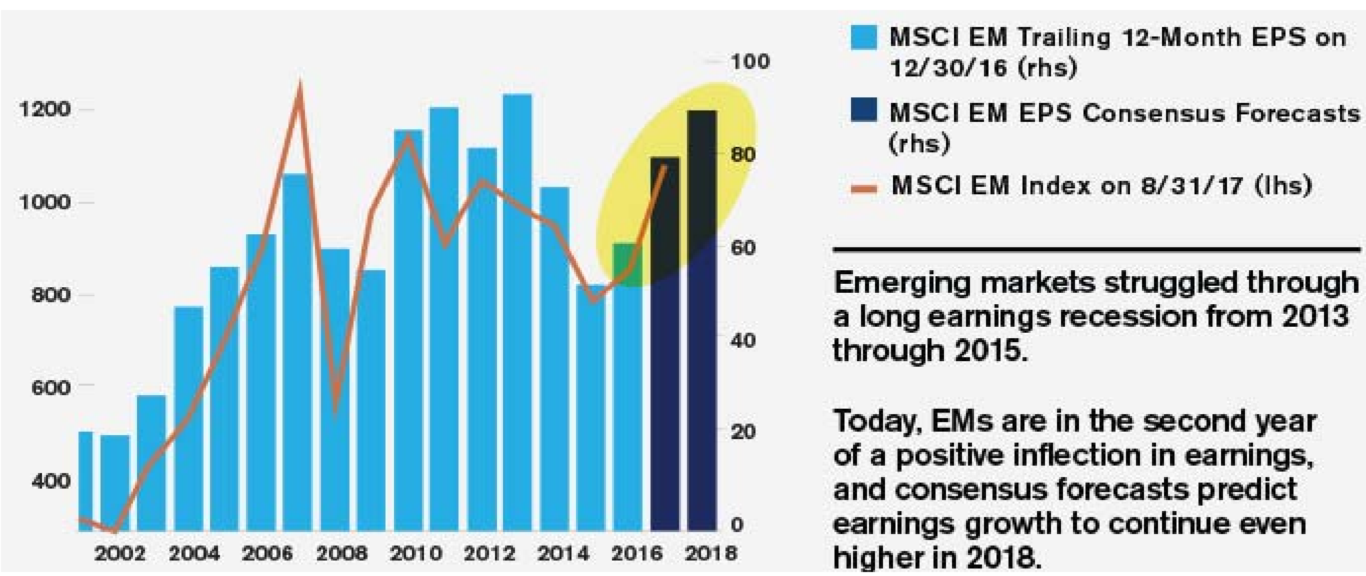
Earnings results for the third quarter won't really begin in earnest until after this note is printed, but the earnings outlook through at least the middle of 2018 still looks pretty good.

EMERGING MARKETS' EARNINGS: GOOD AND IMPROVING

In previous notes I've mentioned that embryonic things tend be less stable than more developed ones, but that they generally have an ability to grow faster. In 1988, Morgan Stanley Capital International launched the MSCI Emerging Markets Index. At that time, this index tracked the performance of equities of 10 countries that represented less than 1% of the world's public-market capital. Today, that index covers 24 countries representing 10% of that capital.

Since most of our clients are retired, my appetite to play with emerging markets fire is limited. However, we maintain at least some exposure to the equities of companies domiciled in various emerging market economies for the overwhelming majority of our clients. To be sure, I could show you some scary emerging markets' charts, but I thought I'd let you know that emerging markets equities have advanced some 31% through mid-September, versus a still not-too-shabby 16% for the equities of companies in the U.S. and 22 other developed countries.

I can't definitively say why emerging markets' equities have recently performed as well as they have, but I would wager that corporate earnings results factor into those results. Through the end of September, emerging markets' earnings have reversed their decline from the previous year and estimates for 2017 and 2018 are quite encouraging.



If equity valuations were to suffer an unexpected downdraft, almost every portfolio we oversee has substantial exposure to fixed income securities that could provide some dry powder we could use to take advantage of equities at more attractive prices that could set the stage for later gains. Except for North Korea, things could be a lot worse. — Glenn Wessel