The Outlook: Dec. 12, 2017

The Big Picture.

We're pretty sure to feel, as we absorb the loudest daily noises from the media, that the biggest things going on today are, first, political scandals; and second, Bitcoin. They are not. They're both just variations on the media's golden Rule of Survival: if it bleeds, it leads, sometimes known as "Spectacles Sell!" As he often does, economist Scott Grannis (at www.calafiabeachpundit.com) has put his finger on the genuinely "big things" going on today, at least in the economic, financial and investment worlds. Here they are:

That is a very powerful long-term chart, which captures something historically remarkable and exceedingly important for us investors, as we naturally wonder whether the seemingly long Bull Market since 2009 is about to die of old age, taking our sacred fortunes to the grave as well. As a share of national income, corporate profits have risen emphatically beyond their long-term average, and stayed there since 2009. They did so because the Calamity badly scared business leaders (rightly) and almost all of them reacted with terrible speed, and great effectiveness. They slashed costs, built liquidity, and stayed extremely careful about adding those costs back, or reducing that hard-won liquidity, as the economy grew over these 9 years. Outlook has often commented on the way our core companies (Caterpillar, Cummins, and all the rest) are generating higher earnings from lower sales than ever in their histories—and the chart above shows that very many other companies have been achieving the same thing.

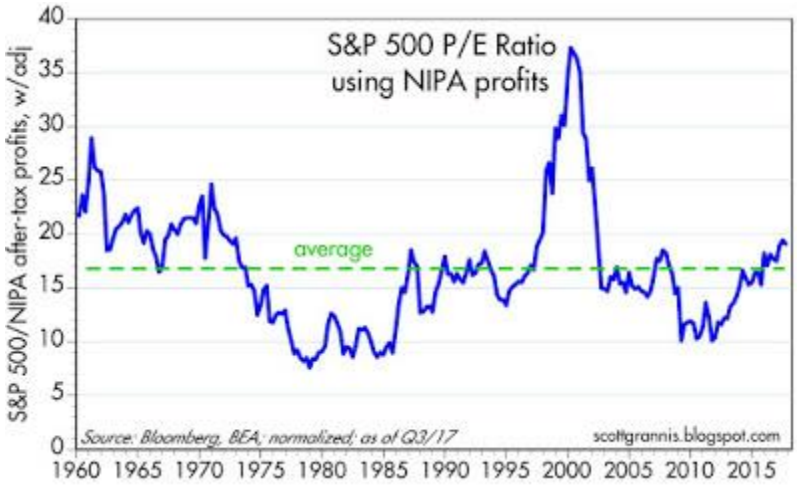
It's hard to imagine anything more real and more powerful than what this chart and its background tell us about how carefully and productively U.S. companies have been handling our invested capital.

Alongside Bitcoin and scandals, the imminent tax law changes have earned fairly minor volumes of media noise. They deserve something more deafening. Mr. Grannis summed it up very well:

The principle virtue of the Tax Cuts and Jobs Act about to be passed by Congress is that it significantly increases the after-tax rewards to business investment by slashing corporate income tax rates and by allowing immediate expensing of capital investments. This automatically lowers the hurdle rate for all investment projects, and thus it should lead to a significant increase in investment, jobs, and incomes over time.

As Mr. Grannis also observed, despite the usual flaws this tax bill is historically unique in its aim to emphatically boost the growth and productivity which America's business sector can deliver to the U.S. economy as a whole. The Reagan tax changes, which were dramatic, aimed mostly at individuals. The most powerful of this Administration's tax changes aim directly at energizing the business sector. Significantly lower corporate tax rates mean immediately higher profits—they don't imply or suggest higher profits, they mean higher profits. Lower tax rates and faster deductions of business capital spending do not imply or suggest more such spending, they mean *there will be* more such investment—because the simple arithmetic of "break-even return-on-investment rates" (Mr. Grannis' "hurdle rate") is what business people do all day, every day. The day after the tax law change, a great many capital spending projects will be a lot more compelling than the day before—not because of political opinions, but because of arithmetic.

Mr. Grannis has many more charts, each aimed at different sectors and viewpoints toward the U.S. economy, which together paint an overwhelming picture of combined "strength and caution" throughout the economy. From household financial strength to small-business optimism surveys, and very many things in between, we can see levels of strength and potential growth which are much higher than anything seen in the past 10 to 40 years (depending on the particular item scrutinized.) But for us investors, there is one factor which always deserves to cancel out all that good, if it is in its historical danger zone: stock market valuation. In the years 1999 and 2000, the economy had plenty of all-round strength: but the market's valuation of that strength was too silly for words—hence deadly. Here's Mr. Grannis' take on valuation, today:



NIPA profits are the business earnings counted in the national income and product accounts: GDP, essentially. The many sharply differing ways to measure profits each have their pros and cons; but NIPA profits are particularly good for historical comparisons because they mostly get rid of the distortions from changes in taxes and accounting principles, which happen fairly often. As Mr. Grannis' chart reflects, the "big market's" valuation of corporate earnings is not appreciably above its 67-year average . . . and it's not in the same ballpark as the extreme danger-zone valuations of the Dotcom era . . . or of Bitcoin, of course.

One of the most fun and most nerve-wracking features of the investment business is that while history "rhymes" quite a bit, it never exactly repeats itself. Each market cycle is its own unique thing, and really needs to be understood for that uniqueness, as well as for the parts which may rhyme

with the past. In Outlook's opinion, in this very long cycle we are still benefiting from the tremendous energy and determination brought to strengthening the business world after the Calamity of 2008 – 2009; from the market's long-lasting state of anxiety and caution about most stocks' valuations, also resulting from the Calamity; and of course from the technological wonders which have never stopped flowing from the engineers who build the growth engines behind most U.S. businesses. This market did not need the upcoming tax law changes to keep marching forward; but there is a fair likelihood that those changes will trigger something more like a jog or even a run toward the future, as we look at the next few years.

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