Thoughts from the FRONTLINE
John Mauldin's free weekly investment and economic newsletter

Year of the Octopus, Part 1

JOHN MAULDIN | January 6, 2018

Greetings from Hong Kong, where the locals are preparing to welcome the new year on February 16. While 2018 is the Year of the Dog on the traditional Chinese calendar, on the nontraditional Mauldin calendar we call it the Year of the Octopus. I don't know exactly what's coming, but I'm pretty sure it has more than four limbs.


Photo: Getty Images

IN THIS ISSUE

In last week's letter, "Economy on a Roll," I gave you my own fairly upbeat 2018 forecast. I think the US economy and markets will probably hold up well, thanks to tax cuts and deregulation – assuming the Federal Reserve gets no more hawkish than it already has. That assumption may be a stretch, given the Fed's changing composition, but I'm feeling optimistic anyway.

The one real potential wrench in the works that I did not mention last week was Trump's actually enacting significant tariffs or tearing up NAFTA, which would cost millions of jobs and cause significant backlash. I am hopeful that mistake won't be made.

This week and next we'll look at forecasts from some of my most trusted friends and colleagues. I have so many that our project may even stretch into a third week. Some disagree with my own views – and that's perfectly fine. I want you to see all sides so you can make good decisions for your own family and portfolio. I'll let these forecasters speak for themselves in longer quotes than I usually allow, then add my own comments.

Before we start the trek, I want to mention that we're closing the doors to the Alpha Society soon – on January 15, to be exact. While my instinct is to always keep doors open, the Alpha Society needs to stay exclusive in order to thrive. I talked about it in a two-minute video we recorded over the holidays. Please do me a favor and watch here.

I am looking forward to meeting many of my Alpha Society and VIP members in Hong Kong this Sunday late afternoon/evening. I always find such times to be great learning experiences.

Hunt: Chaotic System

Let's start not with a forecast but with an important story about forecasts. It appeared on Ben Hunt's always-excellent Epsilon Theory site last month, in a piece he titled "The Three-Body Problem." Keeping it in mind as I read the various annual reports and year-ahead forecasts has proved quite helpful.

Ben's wide-ranging essays are hard to summarize or excerpt in a way that captures their breadth and depth. I'll give you a tiny snippet; but please, set aside some time this month to read the entire article. It is long but worth your while.

> The Three-Body Problem is a famous example of a system which has no derivative pattern with any predictive power, no applicable algorithm that a human could discover to adapt successfully and turn basis uncertainty into basis risk. In the lingo, there is no "general closed-form solution" to the Three-Body Problem. (It's also the title of the best science fiction book I've read in the past 20 years, by Cixin Liu. Truly a masterpiece. Life and perspective-changing, in fact, both in its depiction of China and its depiction of the game theory of civilization.)
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> What is the "problem"? Imagine three massive objects in space … stars, planets, something like that. They're in the same system, meaning that they can't entirely escape each other's gravitational pull. You know the position, mass, speed, and direction of travel for each of the objects. You know how gravity works, so you know precisely how each object is acting on the other two objects. Now predict for me, using a formula, where the objects will be at some point in the future.
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> Answer: You can't. In 1887, Henri Poincaré proved that the motion of the three objects, with the exception of a few special starting cases, is non-repeating. This is a chaotic system, meaning that the historical pattern of object positions has ZERO predictive power in figuring out where these objects will be in the future. There is no algorithm that a human can possibly discover to solve this problem. It does not exist.

And that of course is the basic problem we have in economics and investing. When we say that past performance is not indicative of future results, that aphorism is more than just legalese.

I've written before about chaos theory and complexity economics. Such ideas can easily discourage us from even thinking about the future. Ben Hunt explains why that's not the right response. The real answer is to think about the future *differently.*

With that prelude, let's move on.

Gavekal Trifecta

If I had to rank economic forecasting groups (as opposed to individuals) for consistent quality, Gavekal would be high on the list. They publish a staggering amount of good research on wide-ranging topics. I especially like that they don't have a "company line": The Gavekal partners and analysts frequently disagree with each other, often with considerable vigor. Watching their arguments from the outside is a bit voyeuristic but enjoyable.

Here are just a few Gavekal snippets from the opening week of 2018. We'll start with Anatole Kaletsky, who zooms in on inflation as this year's key unknown factor.

> Will inflation accelerate in the US, but not in other major economies? I think the answer is "Yes", for the same reasons as above. However, I also expected inflation to accelerate and bond yields to increase last year. Instead, both inflation and growth ended the year exactly where they were.
>
> The simple answer is that US unemployment is now 4.1% instead of 4.8%. I was wrong about 5% unemployment being a non-inflationary growth limit, and maybe 4% isn't either. But whatever the exact number may be, the US is certainly closer to its non-inflationary growth limit now than it was a year ago. In addition, the Trump tax cuts, if they actually stimulate higher US consumption and/or investment (which they may not do by any meaningful amount) will add to US inflationary pressures, since new production capacity will take several years to boost non-inflationary trend growth.

My prediction of higher US inflation and bond yields last year was partly motivated by the expectation of Trump tax cuts. Since these tax cuts passed only two weeks ago, the risk of economic overheating also subsided. But 2018 could well be the year when Trumpflation actually happens, especially if Trump is emboldened by the tax cuts to follow through on his protectionist promises too. If the prediction of higher US inflation turns out to be right, it will be a game-changer, producing much more volatile market conditions and even greater under-performance by US equities and bonds relative to assets in Europe and Japan, where inflation is not a risk.The follow-on question, if Anatole is right about inflation, is how the Fed will respond to it. The ideal response would have been to start tightening about three years ago. That opportunity having past, the remaining choices are all varying degrees of bad.

Now let's move on to Louis Gave, who gives us some stock market ideas at the end of a long, thoughtful essay on liquidity.

> Putting it all together, 2018 does seem to be starting on a different note than 2017. While the bull market may not be in peril, it is a tough environment for a price/earnings ratio expansion to occur. Such an outcome usually relies on excess liquidity moving into equities. Yet in 2018, equity markets are more likely to be a source of liquid funds than a destination for them. It follows that if a multiple-expansion is off the table then equity gains will rely on earnings rising. The area where such an improved profit picture is likely is financials (higher rates and velocity) and energy (higher prices). The fact that both of these sectors presently trade on low multiples also helps.

If you want specific sector ideas, there are two good ones.

Personal aside: the corporate tax cut is estimated to add as much as $10 per S&P share to overall earnings, which should in fact contribute to an upward bias for stocks, at least by the end of the year.

Lastly, here is a note from Chen Long, who covers China for the Gavekal Dragonomics service.

> From a financial market perspective, the biggest question is what the "key battle" against financial risk means in 2018 after a year of regulatory tightening throughout 2017. Some press reports of the CEWC [Central Economic Work Conference] claimed that the government is already soft-pedaling efforts to control debt, on the grounds that the communiqué made no specific mention of "de-leveraging" and that the early December Politburo meeting talked about "keeping macro leverage under control" rather than "de-leveraging".
>
> I disagree: the policy stance on leverage remains pretty much the same as it has for the past year or more. As I have repeatedly stressed, the "de-leveraging" goal pursued by Chinese policymakers is not a reduction in the gross debt-to-GDP ratio that many analysts focus on. Instead, Beijing wants to de-leverage the corporate sector (by cutting debt-to-equity ratios) and the financial sector (by cutting the claims that banks have on each other and on non-bank financial firms). The overall aim is not to bring down total nationwide leverage, but to reduce financial risk while maintaining credit support for the real economy (see The View Into 2018).
>
> Seen in this light, the language from the latest meetings might represent a slight softening in tone, but certainly signals no policy reversal. The communiqué of the 2016 CEWC talked about making "corporate de-leveraging as a priority under the precondition of keeping total leverage ratio under control" – essentially the same as the statement from the December 2017 Politburo meeting.

Kotok: A Permanent Shift Upward

Swinging back to US markets, my friend David Kotok of Cumberland Advisors had some New Year's Day thoughts on the Republican tax bill's impact.

> Once the transitional shock of yearend is absorbed, we think the tax bill will raise the valuation of US stocks. Simply put, the tax bill will generate a permanent shift upward of somewhere between $10 and $14 in the threshold of S&P 500 earnings. Once you adjust for that permanent shift, you may continue to factor in the earnings growth rate that you expect from a US economy that is going to grow at 3% instead of 2%. We believe that growth rate is likely for a couple of years.
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> So, S&P 500 earnings should range up to and then above $150 by the decade's end. They will do so while the Fed is still engaged in a gradualist restoration of interest rates to something more "normal," whatever that word means. And those earnings will occur while a repatriation effect is unleashing $1 trillion of stagnant cash in some form of robust redistribution (dividends or stock buybacks) or as productivity-enhancing capex spending. Bottom line is no recession in sight for at least a few years; and low inflation remains, so interest-rate rises will not derail the economic recovery, nor will they alter rising stock market valuations.
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> Years ago we projected a 3000 level on the S&P 500 Index by 2020. Those writings are archived at www.cumber.com. We stick to that forecast.
>
> (http://www.cumber.com/welcome-to-2018/)

That is considerably more bullish than most 2018 forecasts I've seen. Rather than argue with David, I'll say this: Be ready for anything this year. The future is no more uncertain than it always is, but the consequences of a mistake are growing as the bull market and economic expansion grow long in the tooth. They will end at some point. That means you need a strategy that will let you both participate on the upside and defend yourself when the bear appears. I reiterate that you should be diversifying trading strategies, not just asset classes.

Krugman: Return to Normalcy

Next we turn to Paul Krugman, who is not generally one of my favorite economists. I quote him this time because he sounds a lot like, well, me.

> So we're living in an era of political turmoil and economic calm. Can it last?
>
> My answer is that it probably can't, because the return to normalcy is fragile. Sooner or later, something will go wrong, and we're very poorly placed to respond when it does. But I can't tell you what that something will be, or when it will happen.
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> The key point is that while the major advanced economies are currently doing more or less OK, they're doing so thanks to very low interest rates by historical standards. That's not a critique of central bankers. All indications are that for whatever reason — probably low population growth and weak productivity performance — our economies need those low, low rates to achieve anything like full employment. And this in turn means that it would be a terrible, recession-creating mistake to "normalize" rates by raising them to historical levels.
>
> But given that rates are already so low when things are pretty good, it will be hard for central bankers to mount an effective response if and when something not so good happens. What if something goes wrong in China, or a second Iranian revolution disrupts oil supplies, or it turns out that tech stocks really are in a 1999ish bubble? Or what if Bitcoin actually starts to have some systemic importance before everyone realizes it's nonsense?
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> (https://www.nytimes.com/2018/01/01/opinion/can-the-economy-keep-calm-and-carry-on.html)

That was from Krugman's January 1 *New York Times* column, and his assessment is not far from my own view. I wrote the previous day that the economy is pretty good and will likely remain so until something makes it change course. Like Krugman, I don't know when that will happen, or exactly how, but I'm sure it will.

The difference between us is that Krugman has made a remarkable turnaround since the imminent doom he predicted right after the election. In fairness, he utters a little mea culpa in this column, admitting that he let his political feelings distort his economic judgment. So I'm glad to welcome his Damascene conversion. I hope it sticks this time.

Rosenberg: "Pretty Late in the Game"

I don't know any economic forecaster more prolific than David Rosenberg is. I don't know how he even finds time to sleep, frankly. His *Breakfast with Dave* is often the same length as my weekly letters, and he writes it every working day.

Dave's December 29 letter was a tour de force on world markets, which I can't possibly summarize and do any justice to the original, so I'll cut straight to his conclusion.

> In other words, expect a year where volatility re-emerges as an investable theme, after spending much of 2017 so dormant that you have to go back to the mid-1960s to find the last annual period of such an eerie calm – look for some mean reversion on this file in the coming year. This actually would be a good thing in terms of opening up some buying opportunities, but taking advantage of these opportunities will require having some dry powder on hand.
>
> In terms of our highest conviction calls, given that we are coming off the 101 month anniversary of this economic cycle, the third longest ever and almost double what is normal, it is safe to say that we are pretty late in the game. The question is just how late. We did some research looking at an array of market and macro variables and concluded that we are about 90% through, which means we are somewhere past the 7th inning stretch in baseball parlance but not yet at the bottom of the 9th. The high-conviction message here is that we have entered a phase of the cycle in which one should be very mindful of risk, bolstering the quality of the portfolio, and focusing on strong balance sheets, minimal refinancing risk and companies with high earnings visibility and predictability, and low correlations to U.S. GDP. In other words, the exact opposite of how to be positioned in the early innings of the cycle where it is perfectly appropriate to be extremely pro-cyclical.
>
> So it's either about investing around late-cycle thematics in North America or it is about heading to other geographies that are closer to mid-cycle — and that would include Europe, segments of the Emerging Market space where the fundamentals have really improved, and also Japan. These markets are not only mid-cycle, and as such have a longer runway for growth, but also trade relatively inexpensively in a world where value is scarce.

Dave gives us some geographic focus, and it's mostly outside the US and Canada. He likes Europe, Japan, and some emerging market countries because they are earlier in the cycle. He's certainly right on that point, though I think we may differ on how long the cycle can persist. The past doesn't predict the future.

For the record, in my own portfolio design, we are about 50% non-US equities. My managers are finding lots of opportunities outside of the US.

Wien: "Speculation Reaches an Extreme"

We'll wrap up today with an annual tradition: Byron Wien's annual "Ten Surprises" list. It always causes me a little cognitive dissonance because by definition you can't "expect" a surprise. That aside, Byron's list is always a useful thought exercise. Here it is.

> 1. China finally decides that a nuclear capability in the hands of an unpredictable leader on its border is not tolerable even though North Korea is a communist buffer between itself and democratic South Korea. China cuts off all fuel and food shipments to North Korea, which agrees to suspend its nuclear development program but not give up its current weapons arsenal.

2. Populism, tribalism and anarchy spread around the world. In the United Kingdom Jeremy Corbyn becomes the next Prime Minister. In spite of repressive action by the Spanish government, Catalonia remains turbulent. Despite the adverse economic consequences of the Brexit vote, the unintended positive consequence is that it brings continental Europe closer together with more economic cooperation and faster growth.

3. The dollar finally comes to life. Real growth exceeds 3% in the United States, which, coupled with the implementation of some components of the Trump pro-business agenda, renews investor interest in owning dollar-denominated assets, and the euro drops to 1.10 and the yen to 120 against the dollar. Repatriation of foreign profits held abroad by U.S. companies helps.

4. The U.S. economy has a better year than 2017, but speculation reaches an extreme and ultimately the S&P 500 has a 10% correction. The index drops toward 2300, partly because of higher interest rates, but ends the year above 3000 since earnings continue to expand and economic growth heads toward 4%.

5. The price of West Texas Intermediate Crude moves above $80. The price rises because of continued world growth and unexpected demand from developing markets, together with disappointing hydraulic fracking production, diminished inventories, OPEC discipline and only modest production increases from Russia, Nigeria, Venezuela, Iraq and Iran.

6. Inflation becomes an issue of concern. Continued world GDP growth puts pressure on commodity prices. Tight labor markets in the industrialized countries create wage increases. In the United States, average hourly earnings gains approach 4% and the Consumer Price Index pushes above 3%.

7. With higher inflation, interest rates begin to rise. The Federal Reserve increases short-term rates four times in 2018 and the 10-year U.S. Treasury yield moves toward 4%, but the Fed shrinks its balance sheet only modestly because of the potential impact on the financial markets. High yield spreads widen, causing concern in the equity market.

8. Both NAFTA and the Iran agreement endure in spite of Trump railing against them. Too many American jobs would be lost if NAFTA ended, and our allies universally support continuing the Iran agreement. Trump begins to think that not signing on to the Trans-Pacific Partnership was a mistake as he sees the rise of China's influence around the world. He presses for more bilateral trade deals in Asia.

9. The Republicans lose control of both the Senate and the House of Representatives in the November election. Voters feel disappointed that many promises made during Trump's presidential campaign were not implemented in legislation and there is a growing negative reaction to his endless Tweets. The mid-term election turns out to be a referendum on the Trump Presidency.

10. Xi Jinping, having broadened his authority at the 19th Party Congress in October, focuses on China's credit problems and decides to limit business borrowing even if it means slowing the economy down and creating fewer jobs. Real GDP growth drops to 5.5%, with only minor implications for world growth. Xi proclaims this move will ensure the sustainability of China's growth over the long term.

(https://www.blackstone.com/media/press-releases/byron-wien-announces-ten-surprises-for-2018)

Whatever your predisposition, there's plenty to both like and dislike in there. On #7, I think 10-year Treasury bonds at 4% or more will look like the end of the world to younger folks. It's been more than a decade since we saw any such thing, and at that point they were falling, not rising. But if he's correct that CPI pushes over 3%, then bond yields have to rise.

Personally, I think I would take the other side of that bet. I think the yield on the 10-year actually has a chance to fall.

On another note: If Byron is right that "speculation reaches an extreme," the resulting correction will be a lot deeper than 10%. I don't think we are there yet and probably won't reach that point in 2018. But we will get there eventually.

All right, my stack of New Year's predictions is barely any smaller, but we'll stop here and pick up again next week.

Jet-Lagged in Hong Kong, Sarasota, and Boston

Shane and I are in Hong Kong, and the first 24 jet-lagged hours have been difficult, to put it mildly. But one soldiers on, and I did get my new shirts. This is the third time in six years I have visited the same tailor, and he was really surprised about the change in my neck size. It's a full inch larger than it was two years ago. Now I again have shirts that I can button and wear a tie with.

When I get back I will spend one day in Sarasota (in and out) and then a few days in Boston.

I think I will forego making any personal remarks so I can relax a little before the evening's activities begin. You have a great week.

Your hoping I can sleep tonight analyst,

John Mauldin

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