AQUILA FLASH

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US deregulates, cuts taxes and raises the competitive pressure on the EU

US tax cuts will put the EU and other countries under increased competitive pressure. We think 2018 will be the year of maximum monetary policy stimulus so far as the world economy is concerned. The present upswing is now the third longest in US history. A rise in volatility is coming and, in view of this, we stick with a neutral weighting in equities and prefer European and Japanese stocks over the very expensive US stock market.

Tax reform and deregulation in the US

Investors should not underestimate the combined effect of US tax reform and deregulation. Following reregulation in the wake of the financial crash and following decades of increasing regulation and the creation of a massive regulation industry, the US is now moving in the opposite direction albeit at a slow pace.

What might happen were the US to turn itself, if only for a short time, into a lightly-taxed, deregulated capitalist paradise? Such a development could breathe new life into an already ageing business cycle. It would also boost profits and might even raise the chronically weak growth in labor productivity. With the current upswing then extended into 2020, a second Presidential term for a Republican candidate might start to seem probable. In an optimistic phase markets would likely ignore, at least for a while, the burgeoning US fiscal deficit and focus rather more on the positive trends for the economy and corporate earnings.

Mike Pence, President in 2020? or even before?

Investors should take care not to be over-influenced by the strong dislike of Mr. Trump felt by many Europeans. Those who allow themselves to be so influenced risk underestimating the outlook for Republicans, especially if they overestimate the slim chance of Mr. Trump's impeachment.

In the event that Congress voted for Mr. Trump's impeachment, Vice-President Mike Pence would automatically become President. A Pence presidency would likely be much, much less scandal-prone and therefore probably more effective. The White House under Pence would be more modest and probably more conservative. The Congressional pressure to block the Administration's policy initiatives, especially on the Republican side, would probably diminish.

The impeachment risk notwithstanding, the Trump Administration has arguably a good record – at least relative to normal political standards – in one important area, namely on doing what it said it would do. Several promises have been redeemed, while others have been aggressively pursued. A good example of the Administration's consistency is the decision, deplored by many, to recognize Jerusalem as the capital of Israel.

US deregulation increases the competitive pressure on more highly regulated Europe

While Mr. Trump looks a bit more firmly established than a while back, the opposite is true for Mrs. Merkel. Bundespresident Steinmeier, whom one could describe as a "moderate socialist", probably welcomes the difficulties of Mrs. Merkel and her CDU/CSU coalition as these difficulties mean a moderate socialist agenda is more likely to be implemented.

Germany and the EU look set to move towards the left. The EU is developing into an overreaching, centralizing body bent on extending its powers of regulation and restricting the scope of market mechanisms to function. So far as the EU is concerned there are now only a few oases where markets are left free to operate. Elsewhere the agenda is driven by an Administration determined to regulate and to redistribute.

With the US now moving in the opposite direction – becoming almost a deregulating tax paradise – an EU which is moving to the left will find itself increasingly pressured by international competition.

The "Trumpian" push for deregulation is also important for the outlook for oil prices as President Trump wants to maximize the energy production potential of the US. He is pushing for oil production in environmentally sensitive areas such as within the Arctic Circle, in nature protection zones and along America's coastline. This is the ugly side of deregulation which the US political process has to balance against the enormous productivity and cost gains that doing away with such restraints on economic activity can bring.

Peak stimulus

All in all, 2018 looks like being the year of maximum monetary policy stimulus for the global economy. Although the Fed raised interest rates last year and made a start on reducing its balance sheet, the aggregate balance sheet of the 5 most important central banks still expanded strongly in 2017. As from this January the ECB will halve its bond purchase program, implying continued but slower balance sheet expansion. Meanwhile, the BoJ continues its policy of strong stimulus. The picture may well change somewhat towards end-year, when we forecast the ECB will suspend its bond purchase program altogether.

Volatility is set to rise

As central banks move in aggregate towards less expansion, we expect equity volatility to rise, causing corrections in at least some equity markets. Stock market risk will be greater to the extent that the pace of economic expansion slows.

Aged now 103 months, the current upswing is a Methusela among economic expansions

Now 103 months old, the current US upswing is the third longest in history. The all-time record is 10 years, implying just another 17 months to go before a new record is set. And, given the trend to deregulation, the tax cuts and the likelihood that monetary policy will remain expansionary until at least the year-end, we expect that the current expansion will end up becoming the longest in history. That said, we are definitely in its later stages and can expect the favorable trends to last for only another one to three years.

For the markets, 2017 was an exceptionally "correction-free" year

2017 was an exceptionally strong year for US stocks. The S&P 500 index rose every month of last year, with no correction larger than 2%. Thus there is the risk that, after the longest stock market rally of all time, investors have become blind to risk, excessively motivated by the fear of "missing out".
Hefty valuations, a very aged economic upswing and the likely reining back of monetary stimulus are all themes that the financial markets will have to assess in 2018. But, so far as the economic backdrop is concerned, we are relatively optimistic and forecast a 2018 growth rate for the global economy of 3.5%.

On the basis of relative valuation we continue to prefer European stocks to the generally very expensive US stocks. But we keep our overall equity weighting at neutral.

Given the unfavorable risk/reward balance on offer, we now avoid the high yield bond market.

Last, but not least: we consider the government shutdown in the US as a no-event. It should only be a matter of days, until a solution is found.

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