

A bull market top under Donald Trump?

"We elected The Apprentice, not David Copperfield."

By Brian Shapiro (11 Jan 2017)

While the world's equity markets are enjoying the euphoria of the Donald Trump victory, the move higher could be a mirage blinded by the reality of the upcoming economic and political landscape in 2017. As this stock market rally percolates, the corrosive divide that overtook the political landscape in 2016 seems to be simmering. The protests and minor riots we saw in the streets following the Trump win have now been replaced with a managed political landscape that has produced mostly qualified if unorthodox cabinet picks in the White House. However, this moment of stock market steadiness may just be the calm before the storm as the post-election upward period could be a cyclical top.

As many now speak about a great new Reagan-like bull market, it may be that we are actually in the last leg of a higher valuation cycle whereby stock prices have already been driven to their heights. Immense corporate financial engineering buoyed by low interest rates manufactured by the world's central banks have allowed corporations to make record repurchases of their own equity which have served to depress share counts while increasing share values.



Traditionally there have been three ways in which bull markets find their demise. Two of these three elements may now be at play. The first of these headwinds is higher interest rates. Higher interest rates are an inherent deterrent to borrowing which initially affects two of the most important sectors of the economy: auto sales and housing. These two sectors traditionally bear the brunt of steep rate changes immediately. Certainly, in comparison with historic norms, interest rates are still low. However, the rate of change in the recent rate move higher in such a short time period creates an abrupt and undeniable headwind which could show up in housing and auto sales slowing as soon as the first quarter of 2017.

The second of the three factors known to potentially derail bull markets is fallout from unknown geopolitical risk. Although President-elect Trump's tweet storms against China, Mexico and anything else that comes to his focus have not caused market consternation at this point, the chance that a nerve is hit by a tweet or policy would appear to be very high. As there is minimal political risk priced into valuations at a 21x trailing price to earnings ratio for the S&P 500, steep valuations adjustments may now occur if any problems surface.

The final of the trio of dangers to bull markets can be classified as access to credit. Credit tightness can be a result of the two factors above coming into play in short order. Currently we are experiencing property functioning and open capital markets giving broad access to available credit in a number of ways. However, credit spreads as measured by the Traxx Investment Grade bond index are now tighter than they have been since 2007, leaving little further room for further tightening.

So we enter 2017 with two of three potential factors in place necessary to derail this bull market, and the third factor, credit availability, is unlikely to improve. The above factors coincide with full stock market valuations, whether measured by the P/E of the S&P 500 or other indicators, such as the highest [Tobin's q ratio](#) (the ratio of stock prices to book value) since before the global financial crisis.

We are standing at the corner of potentially massive social, political and economic change. It would be magical for this to be the start of a new bull market. Bloomberg quotes a 2016 EPS of 106.80 and an estimated 2017 EPS of 129.97. How can U.S. earnings grow 20% this year while GDP grows 3%? We elected The Apprentice, not David Copperfield.

The question with the economy in the new year is not how much money consumers will be left with to spend after higher oil prices combined with higher interest rates servicing consumer debt eat into earnings. The question is where will our current politics and potential for geopolitical upheaval leave us? We are now in a world where government involvement is such that Bernie Sanders and his socialist liberal left base and Donald Trump's conservative right agree that the government should intervene in business as we have recently seen with tax incentives given to the United Technologies division of Carrier to keep jobs in the U.S.

Will this left-meets-right moment when diverging policies came full circle to meet be a precursor to cooperation or disaster? Amid this interventionist policy, how long will the historic base of the Republican constituency — which supports free trade — continue to look the other way? Also, will this paradox challenge single party unity as the conservative base assesses a President-elect who has already created a brand new government agency, the National Trade Council, before even taking office? Will the mockery associated with appointing conservative Rick Perry to head a government agency he was on the verge of closing (in an unforgettable — forgettable for him — moment) produce a reality wake up call regarding this political maelstrom?

When going down the road of free trade and the polar protectionist methods being employed to achieve it, how does a Trump America implement a plan that works both ways? For example, with Mexico being the largest buyer of natural gas from America, does Mexico retaliate and stop buying natural gas from the U.S. if there is unilateral change to NAFTA? If so, what just

happened to the free market? NAFTA traditionally has worked both ways, as it allowed Mexico to import and buy from America, too.

The problem in any sort of protectionist adjustment is that the Latin (and Asian) world are on the rise and not because they're claiming America's stake in the world but because they have billions of people who have to eat and work, too. The way developing economies work is that these economies will become more oriented toward domestic consumption and the U.S. should be adjusting the wheels of commerce to export to, and not alienate, these potential buyers.

The real risk for America now is that U.S. politics divides the nation internally, in turn strengthening America's enemies. While many view dollar strength as a negative, any hiccup to that dollar strength can actually be a more substantial negative, as the U.S. remains an international repository of wealth. Any break with what the world has come to expect from the American financial and regulatory system, such as a default on government debt (threatened or real), could lead to a loss of confidence and a lower dollar.

One proven American advantage has been increasing efficiencies and lower costs realized through technological gains. As we have seen, \$15 per hour McDonald's employees can be replaced with machines to take orders as customers pay by mobile phone. The rust belt may face as grave a threat from robotic warehouses in Seattle as from foreign labor. As we enter 2017, Amazon is even threatening to do away with one million supermarket checkout jobs with one stroke of a phone app. So the real issue may not be Russia, China or Mexico. The real outlier may now be within domestic America once the current Presidential honeymoon period is over.

The past leader of global stability now has a chance to become a disjointed union. A U.S. at war with itself socially and economically, in dispute over the basic tenets of free trade, at odds with its trading partners, and in jeopardy of losing its benighted status as a safe haven and trusted global reserve currency can hardly be expected to trade at a high multiple. Tax breaks and lighter regulations might help, but at these multiples for the market to embark on another bull run, Donald Trump would have to be a magician.

Brian Shapiro is chief executive officer of Specialized Performance Advisory Group, a New York hedge fund firm.

Previous columns by Brian Shapiro: [It's Time](#), [Five absolutely incorrect consensus views](#), [Lower oil prices will be a net drag on the economy](#), [Draghi's negative rates will send equities soaring](#), [Don't be surprised when helicopter Ben flies away](#), [Money printing won't lead to inflation](#)