Another Good Year Ahead
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Many investors think that this bull market and economic expansion have gone on long enough and a bear market and a recession will take place soon. In my view, we have at least a year or two before the next major downturn in either the market or the economy, barring a major geopolitical conflict such as a shooting war with North Korea, Russia or Iran. A 10%+ correction could occur at any time because sentiment is so optimistic, but the signals that usually warn of a recession, like a loss of economic momentum or an inverted yield curve, are not in place.

Every year for the past 33 years I have prepared a list of Ten Surprises. These are events that could impact financial markets and that I believe have a better than 50% chance of taking place. Most investors, as I assess it, would give each of the Surprises only a one-in-three probability. The Surprises of 2017 turned out pretty well, with about six of the ten close to the mark. My objective in creating The Ten Surprises is to stretch my thinking, and hopefully yours; not to get a high score. This essay will discuss the 2018 Surprises in greater detail than I did last month, when I merely listed them.

My first Surprise is that China will decide to cease shipments of food and fuel to North Korea unless Kim Jong Un stops the development of nuclear weapons. China accounts for a very large part of North Korea’s food and fuel imports, and if the flow of these essential resources were to stop, the North Korean economy and its people would be severely hurt. Up until now the Chinese have resisted taking this action because they like having a communist buffer between themselves and South Korea. At some point China will decide that tolerating a nuclear-armed neighbor led by an unpredictable person is unacceptable and they are willing to take action. There is, however, something else that China would achieve. The whole world would like to prevent North Korea from having a nuclear weapon. The Chinese, by taking steps to prevent this development, would catapult themselves to a prominent position as a leader in global affairs. That is a position they aspire to, and this ambition may be part of their motivation to act. Time is a factor here. The longer we go without a military confrontation with North Korea, the less likely it is we will have one. The opening of talks between North and South Korea is a constructive sign. So far, I have gotten more pushback on this Surprise than any other.

For the second Surprise, I said that populism, tribalism and anarchy would continue to be political forces around the world. The Brexit vote on June 23, 2016 was probably the first hard example of populism, and it has had a major impact on the British economy. Real growth there was 2% in the fourth quarter of 2016 and it is 1% now. Even though the next election in the U.K. is not scheduled until 2022, a special election could be called if there were two closely consecutive votes of no
confidence or a supermajority of Members of Parliament supported the action. (The latter would require some Tory votes.) Should the weak economy force such a move, I believe the Labor Party candidate Jeremy Corbyn would become Prime Minister on the promise that he could get the economy growing at a more satisfactory rate. While populism continues to be a divisive movement, most notably in Spanish Catalonia, the unexpected positive consequence of the Brexit vote has been to bring the countries of continental Europe closer together. The European Union is stronger than ever before and the economic outlook for that region continues to be favorable. The initial reaction to the Brexit vote was that European unity would be weakened.

In the third Surprise I thought the dollar would finally come to life. This is similar to one of the Surprises I got wrong last year, and I rarely carry a surprise over from one year to the next. Nonetheless, with the new tax law, the repatriation of the foreign profits of U.S. companies that have been held abroad and the continued strength of the American economy, I think the dollar can pull out of its decline and appreciate to 1.10 against the euro and 120 against the yen. Higher interest rates in the U.S. will help. If the U.S. can maintain a 3% growth rate while Europe and Japan stay at 2%, U.S. assets should look relatively appealing.

The world equity markets have been favorable to investors in 2017 and I think 2018 could be another good year. We have waited all year for the 10% correction that has never come, but with sentiment showing enthusiasm near all-time highs, a correction is not only possible but likely. I would encourage investors to endure the correction and not interpret any decline as the beginning of a bear period. Further, I expect that the Standard & Poor’s 500 will end the year at 3000 on the index or above. My dividend discount model, a table that shows the various points at which bonds and stocks are equally attractive based on a formula relating earnings and interest rates, shows that at current 10-year bond yields (2.5%) and with S&P 500 earnings projections at $150, the equilibrium point is 3200.

Oil is the subject of my fifth Surprise. While I was bearish on oil last year, saying that a barrel of West Texas Intermediate crude would stay below $60, I now believe the price could exceed $80 in 2018. The reason is that world-wide demand continues while production from hydraulic fracking in the U.S. is disappointing, heavy inventories are depleted, OPEC remains disciplined in keeping production levels low and only limited oil shipment increases occur in Russia, Venezuela, Iran, Iraq and Nigeria.

Inflation is the subject of the sixth Surprise. I have the Consumer Price Index rising above 3%. Wages might be the best warning signal. They are increasing at a 2.5% annual rate now. When average hourly earnings approach 4% increases on a year-over-year basis, you should begin to worry. World growth has created a tight labor market and commodity prices are rising as well. The other important historical contributor to inflation is real estate prices, and although they have moved substantially higher over the past decade, they are reasonably stable now.

If inflation were rising, you have to expect interest rates to be affected negatively. One of the favorable aspects of 2017 was that the 10-year U.S. Treasury yield stayed below 2.5%, keeping price-earnings ratios from deteriorating, so stock indexes rose with better than expected earnings. In order to control inflation, the Federal Reserve is likely to be more restrictive, believing that an economy growing at better than 3% can endure higher short-term interest rates. The seventh Surprise is that the Fed raises short-term interest rates four times during 2018, bringing the Federal Funds rate to 2.5%, still low by
historical standards. Many observers think the Fed will raise rates two or three times, but four is an outlier. The Fed’s plan to shrink the balance sheet from $4.45 trillion to $2.5 trillion has, however, been implemented very slowly (the amount was only $1 trillion in 2008 and it took 95 years to reach that level). Similarly, a number of fixed income investors expect the 10-year Treasury to reach a 3% yield, but my experience has taught me that trends, once established, often extend much further than one’s initial inclination. I believe the yield on the 10-year could go well above 3% this year.

Before actually taking office, Trump said he was going to tear up most of the international agreements (and some domestic ones) that had been negotiated by his predecessors. Once on the job, he learned how difficult that objective is to accomplish. I have him modifying, but not trashing, both NAFTA and the Iran agreements. In the case of NAFTA, too many jobs would be lost if the rules for this trade document were not in place. As for Iran, they may be continuing to do research on nuclear development, but, as far as we know, they are not making weapons. Moreover, our allies support the agreement even though it only defers Iran’s weapons program for a decade. The current unrest in Iran provoked by a lack of jobs and economic malaise may cause its leaders to be less defiant and more likely to adhere to the nuclear agreement. My sense is that Donald Trump may be beginning to understand that multinational trade deals are not necessarily bad, and he could be thinking that not participating in the Trans Pacific Partnership was an unwise decision, particularly as China expands its influence throughout the region. The result may be that we will negotiate more bilateral deals in Asia.

Many believe the Democrats have an opportunity to take control of the House of Representatives in the coming November election, but I believe they can take the Senate as well. They only need to gain two Senate seats, but there are more than 20 Democratic Senate seats at play and only eight Republicans up for re-election. For the Democrats to get control of the Senate, the electorate has to believe that the Trump administration has failed to deliver on its promised agenda. Right now, the Republicans have a lot to brag about. Taxes have been reduced for corporations and many individuals, regulations have been dismantled, the economy is growing at 3%, unemployment is at 4% and looks like it is going to decline further, inflation and interest rates are low, and the stock market is at an all-time high. Something very important would have to go wrong in Washington for this Surprise to work out. Perhaps the Mueller investigation could be the catalyst.

In the tenth Surprise I return to China, the world’s second largest economy. Their most serious problem is the accumulation of non-performing loans on the books of their banks, built up during the steep growth period when manufacturers and infrastructure construction companies were borrowing heavily. If Xi Jinping were to slow the economy down from 6.5%–7.0% to 5.5%, he would have some slack to reduce the debt problem and perhaps, over time, correct it. His incentive for taking this action is that it would ensure the sustainability of the country’s growth rate and, as we know, China takes a long-term perspective on policy issues.

Every year I always have a few Surprises that I have developed during the three months I work on the project but which do not make the list of Ten. The two major reasons they don’t survive the cut are that they are not as relevant as the ten I picked or I cannot bring myself to think they are “probable,” having a better than 50% chance of happening. Nonetheless, some of them are worth thinking seriously about and here are six “also rans” for your consideration.

For a good part of the last year, I have been traveling around the world and encouraging individual and
institutional investors to diversify their portfolios into more international securities. Although earnings of the S&P 500 are growing at 10% a year or more, many quality European and Asian companies are growing at twice that rate and some emerging market companies are growing even faster. The Surprise (Number 11) would be if this expanded global diversification actually takes place.

In the twelfth Surprise, I speculate that the Mueller investigation results in some further indictments or plea bargains but members of the Trump family are not implicated in the Russian attempt to influence the outcome of the 2016 election. I do believe that Mueller’s team will come up with some embarrassing findings that will be damaging but not criminal. Whether this will have an influence on the 2018 election is hard to determine until we know the findings.

We are all aware that artificial intelligence is having an impact on our life. The Internet and the Smartphone have changed the way we function as private citizens and employees. In my January webinar, I pointed out how hundreds of thousands of retail workers and bookkeepers had been replaced by technology but somehow had found other jobs in e-commerce or as auditors or financial analysts. As a result of the strong economy, the unemployment rate has declined to 4.1%, but this figure does not seem to reflect the many people still out of work and seeking government assistance. The Surprise would be that during the year the Department of Labor determines that the method of calculating unemployment, developed during a period when manufacturing was more important, is flawed because now we are more of a service economy. The result is that the figures are less accurate and the level of unemployment is currently understated.

Cyberattacks don’t appear in the newspapers every day but they are a real and present danger. Thousands of hackers are working to invade the computer systems of our corporations and financial institutions. In the fourteenth Surprise, I suggest that a major money-center bank is forced to suspend withdrawals or deposits for several days because its systems have been compromised, impacting consumer confidence. In my view, the hackers are smarter and more innovative than the personnel protecting our data systems. More corporate attention and resources need to be focused on this problem.

In Surprise fifteen I say that government authorities in both Europe and the United States become concerned that Internet-related companies are playing too important a role in people’s lives and the creative disruption of their innovations is causing deterioration in the quality of life around the world. People are losing jobs and children are spending too much time online and texting with their friends. In that connection, an investigation by authorities in both Europe and the U.S. is initiated to determine whether Amazon, Facebook and Google have too much power, making them anti-competitive, and should be regulated in some way. A probe into the market power of both IBM and Microsoft occurred in the past, without much being changed in the way those companies operate.

Finally in Surprise sixteen I weigh in on Bitcoin, which I see as a speculative instrument rather than a medium for transactions. I suggest that the U.S. government steps in to regulate cryptocurrency transactions. The blockchain concept can be replicated many times. There could be a thousand or more cryptocurrencies with no sovereign backing and each could be trying to capture investor attention, entailing the possible loss of billions by naïve investors. The blockchain technology is sound, however, but only if cryptocurrencies have transaction utility will they be accepted as a substitute for the dollar, the euro and the yen.
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