

At the beginning of the year it was consensus outlook that the 2017 ‘goldilocks’ scenario¹ would continue and the ‘fear of missing out’ (FOMO) was rampant. In our [2018 Outlook](#) from mid-December, we argued against this narrative and said that most 2017 dynamics would change, leading to a wake-up call in asset prices. With the first quarter in the books and the wake-up call well under way, it seemed appropriate to revisit our 2018 themes and outline what has taken place plus what we are looking for next.

We took the executive summary from our outlook and created a ‘2018 checklist’², seen below.

2018 Checklist

- ✓ *We expect higher volatility and flat to low single digit returns in 2018. Market positioning is very one-sided with risk premia at record lows.*
 - It only took four weeks for this to play out. The risk parity unwind and the collapse of several ‘short vol’ products underlined the one-sided positioning. Going forward, volatility is here to stay and it wouldn’t surprise us if volatility doesn’t get back to the 2017 lows for many years.
 - Flat to low returns in 2018 still seem like the ‘safe bet’ (-3%ish YTD), but the variables to create a negative return this year are gaining.
- ✓ *China & a weaker US dollar boosted global industrial production in 2017.*
 - Admittedly this one should get a half-check, as 2/3 months of data isn’t sufficient to confirm. Nonetheless, PMI data from the Eurozone, Japan, and China all show slowing. Base metal markets are cooling down and business confidence is reverting back to the mean. GDP estimates are also being revised lower. US data remains noisy from the recent tax changes, markedly the accelerated depreciation rule.
 - Going forward, we expect data to plateau as labor capacity constrains volume and price becomes front and center, i.e. input inflation. We expect GDP to be very ‘middle of the road’ in most regions.
- *Wage inflation seems primed to impact corporate margins.*
 - This call can’t get a check since we haven’t seen any 2018 earnings yet, but remains the most important block to our 2018 thesis and targets. *See page 2 for more.*
- *Global central banks are beginning to retract the liquidity underpinning markets.*
 - 2018 will mark a year of tightening across all the major central banks. It has mildly started in the US & Japan and the EU will begin this summer. This call will earn its check this summer when the ramifications are more widespread.

¹ Referring to low volatility, low unemployment, high margins, elevated global growth.

² See ‘endnotes’ for references contained in the box.

The Labor Market

A lot of detail was outlined in our '[2018 Outlook](#)' and '[\\$10tr Question](#)' about market fundamentals and its liquidity environment created by the central banks, so we are going to keep this note short and to the point. The main market drivers we are watching going forward are labor, wage inflation, and input and/or price inflation.

At the core, what ends this business cycle? We (OECD³) simply run out of workers. The underpinning to all western economies since the great recession has been an abundance of workers, i.e. cheap labor or 'the sharing economy'. Cheap labor means low price inflation and high profit margins. This era is ending and financial capital has to adjust.

Western economies are driven by services (versus manufacturing goods)⁴, and services require people. Think child/medical care, travel/leisure, dry cleaners, food & beverage, finance & accounting, etc. Generally, when labor is abundant (cheap) these businesses do well. Entire business models (e.g. ride-sharing) have been created on the back of abundant labor since this dynamic has persisted for so long. But now the regime is shifting as we are starting to see tangible evidence of a labor shortage. Transportation companies can't find drivers. Restaurants can't find workers. Construction companies can't find builders.

The number of jobs needing to be filled is at a multi-decade high. The last time US unemployment was this low was in April of 2000. The time before that was 1969. The aggregate OECD unemployment rate is lowest since the 1970's (near 5%). When something is in shortage, the price goes up. We have no reason to believe this time is different. Additionally, labor shortages



³ The Organisation of Economic Co-operation and Development contains 34 member countries and can be thought of as North America and Europe.

⁴ Roughly 65% of consumer spending is on services v. goods according to PCE data.

always begin with the lowest marginal producers – which means construction, transportation, agriculture, etc. feel the pinch first. They have to pay more to fill positions which directs them to charge more for their product or service. This creates input inflation (e.g. increased prices on shipping, foods, plumbing, electric, etc.) that will flow through to the high margin businesses. As the labor market gets tighter, profit margin compression keeps moving up the curve.⁵ These relationships can be confusing and very noisy – so in summary:

The labor market is now tight enough where few business will be left unaffected as wages move markedly higher.ⁱⁱ The tax cuts and subsequent ‘one-time’ bonuses were a last resort effort for employee retention before companies start taking a hit to their operating margins.

Go-forward Playbook

Late last year we outlined numerous factors we believed the market wasn’t properly discounting. Our attempt to simplify that:

Investors need to rethink the market’s earnings potential and need to re-evaluate the discount rate by which they price an asset.



1. **Consensus earnings estimates are too optimistic.** The heart of equity prices is their earnings – this drives price more than all other variables.⁶ We believe the consensus numbers are much too high for 2019 (markets trade on future potential) and will be revised lower. This process will take time and be elongated between now and the end of the year.
 - a. **Why?** Consensus numbers still assume ‘peak’ operating margins which we believe will come under pressure from input prices and wages as the year goes on. As operating margins contract faster than sales expand, profits fall. We also believe 1) more of the tax benefit will be competed away and 2) the global growth story is weaker than consensus assumes.⁷

Scenario	Probability	2017 EPS	2018e EPS	2019e EPS	Fwd. P/E	Y.E. 2018 Target
Bull	10%	\$132	\$156	\$168	17.5x	3,000
Growth			18.2%	7.5%		
Base	60%	\$132	\$151	\$156	16.5x	2,500
Growth			14.4%	3.0%		
Bear	30%	\$132	\$145	\$135	14.5x	1,900
Growth			9.8%	-7.0%		
Consensus		\$132	\$156	\$173	17.5x	3,000
Growth			18.2%	11.0%		

All numbers adjusted for comparison to consensus

Source: Doxa Research, S&P Capital IQ

⁵ High margin business usually require less workers at a higher price. As workers get more expensive, they can easily take workers away from lower margin business (down the curve). This leaves the bottom of the curve with no workers to take from someone lower – and results in capacity constraints and/or price increases.

⁶ Over the long term, underlying operating earnings has the highest correlation to stock prices.

⁷ For 2018, we assume a 7% net tax benefit & 6% sales growth with a 10.25% profit margin.

2. **A re-rating of multiples is messy.** The level of confidence investors have in an economy or a market is shown through interest rates and multiples (the amount someone is willing to pay over current cash flow). As the macro environment changes around us (e.g. central bank actions, short term rate hikes, currencies, etc.), the amount investors are willing to pay changes with it. This process is not exact; therefore, is volatile. We believe that this began late January and will continue through the end of the year as investors debate how variables influence each other going forward.
- a. Ultimately, we believe investors will not be willing to pay a 2017 (high) multiple for lower operating margins and lower taxes. Although taxes 'boost' the bottom line, the underlying business performance will become focus.

We see these two factors keeping pressure and volatility high on equity prices throughout the year. Additionally, we again point to our [fall note](#) on central bank stimulus and the removal of liquidity as a major current underneath the market. This is oft forgotten but should not be overlooked as market liquidity issues can create massive opportunities in business that are able to ride through these dynamics.

Data to watch:

PCE Inflation, wage growth, BLS jobs data, operating margins, commodities.

Chase Lee

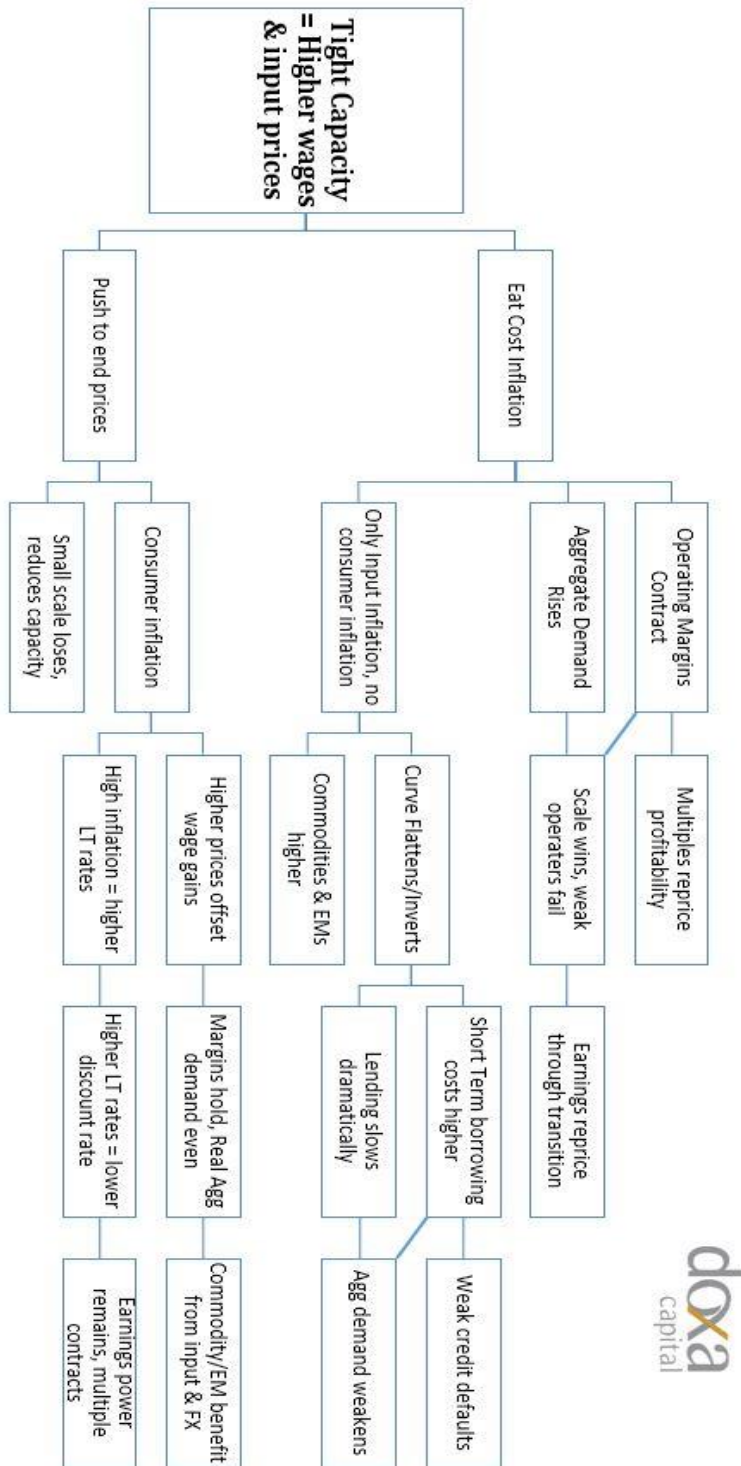
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Additional Info: We try to make our spring note brief - but if you find yourself wondering how the scenario above 1) impacts inflation, 2) influences aggregate demand (higher wages = higher spending), or 3) sets up for 2019 – see the flow chart on the following page. It, too, is slimmed down but paints a decent picture of some scenarios we see playing out. To chat about this or any other market commentary, please feel free to reach out. We would love to hear from you!

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ⁱ “Short Vol” products is referencing the collapse and unwind of the XIV etn. Economic data cited here:
<https://www.bloomberg.com/news/articles/2018-03-22/global-momentum-shows-cracks-as-trade-tensions-loom-over-economy>

ⁱⁱ http://www.economicsonline.co.uk/Global_economics/Phillips_curve.html

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