ARGUS®

WEEKLY ECONOMIC COMMENTARY

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## First Quarter Ending with a Fizzle, but Economic Conditions Still Solid

After booking a 5.6% gain through the end of February, the S&P 500 is somewhat dinged heading into quarter-end. The blue chip index has surrendered over one percentage point of gains in March. Should the index finish with its current appreciation in the 4.5% range, that would still be better than the 2.7% average gain for all first quarters between 1980 and 2015. But March itself will be below average. Since 1980, March has averaged a 1.6% gain on the S&P 500, and now finds itself over 250 basis points behind its bogey.

The president's decision to pull the Ryan healthcare bill happened late in the month, on 3/24/17. However, the stock market was wobbling well before that vote. Broadly, there has been a dawning recognition that even under optimal circumstances, the fiscally stimulative portion of the Trump agenda – tax cuts and infrastructure investment – will require a slog through Congress that will be wending, difficult and time-consuming. For both policy wonks and investors, the failure of repeal-and-replace may have crystalized a loose set of misgivings into a clear concern about the president's ability to deliver.

Once it became evident that the American Health Care Act could not pass the GOP-controlled House of Representatives, President Trump quickly moved on to his next agenda item, and his party quietly concurred. By contrast, President Obama was set for a long fight in his efforts to implement a nationwide healthcare insurance system. Universal healthcare has long been a Democratic party objective, preceding the Clinton plan in the 1990s and even Senator Ted Kennedy's efforts in the 1970s and 1980s, which seemed Quixotic at the time. While universal healthcare has never been a GOP priority, the GOP has fought for tax cuts at least as long as Democrats have fought for universal healthcare.

The failure to repeal and replace ACA, however, sets up both psychological and practical impediments to the president's next major agenda item, which is reforming the tax code. On the psychological front, the president's "brand" as a deal-maker may have been damaged by the repeal-and-replace failure. Dissidents within GOP's House caucus may have been emboldened, including Freedom Caucus on the right and the Tuesday group of moderates that, while not on the left, are left of the current GOP center.

Practical challenges may be more daunting. Replacing ACA with the American Health Care Act would have reduced federal deficits by $337 billion over 10 years, according to the Congressional Budget Office. That would have allowed a more revenue-neutral approach to tax cutting. In turn, that would have allowed the GOP to enact more substantive tax cuts under the Reconciliation legislative process, which is both filibuster-proof and requires just 52 votes (the current GOP Senate count) to pass. Any tax reform attempted outside of Reconciliation would require 60 votes, which may be very hard to attain in the current highly bipartisan environment, and could face a filibuster.

The S&P 500 ran from 2,085 early in November 2016 to 2,395 at the end of February 2017, gaining 15% in the process. Investors are concerned that much of this trough-to-peak run was predicated on successful implementation of the president's agenda.

Argus Chief Investment Strategist Peter Canelo believes that investors were not hanging their hats on healthcare reform; and infrastructure investment has always been seen as a gradual and multi-year process. But Peter believes investors would respond negatively to failure to enact tax reform or even to a watered-down tax-cutting plan. Unlike programs

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that take years to implement, tax cuts can become immediately stimulative with a stroke of the president's pen. If tax reform goes the way of repeal-and-replace, we expect an immediate angry market reaction.

**ECONOMY STILL SOLID**

Given the mounting challenges for quick and comprehensive tax reform, Argus sees a reasonable likelihood for a 5%-8% stock market correction. We would see any such selloff as a buying opportunity, given the still-strong fundamentals in the economy.

Just a few days after the GOP failure on repeal-and-replace, U.S. consumer confidence surged to a 16-year high. While the policy events of 3/24/17 likely happened after most of the data in this sentiment index was compiled, it is not certain that the GOP's failure would have hurt sentiment. Indeed, Obamacare had never been so popular as it was in the weeks before its planned demise; its survival might have actually improved sentiment.

Consumer confidence rose to 125.6 in March, its highest level since December 2000. The index not only rose sharply from 116.1 in February, it far exceeded consensus expectations in the 114 range. Improving consumer optimism is important in that it would set the stage for additional economic activity and growth in coming months.

On the details, consumers report increasing plans to buy new vehicles and appliances, although home-buying intentions moderated somewhat. The percentage of households who expect their incomes to rise in the next six months increased from 19.6% in February to 21.5% in March, the highest percentage since 2006. The labor differential, which measures the gap between those perceiving jobs as plentiful minus those who see jobs as hard to get, spiked from 7.0 points in February to 12.2 points in March, the widest gap since 2001. And more than 27% of consumers expect better business conditions in the next six months, the highest percentage since 2003.

One reason for rising consumer confidence maybe higher home values. U.S. home prices rose 5.9% year-over-year in January, according to the Case/Schiller U.S. National Home Price index. This series, which measures all nine U.S. census divisions, reached a 31-month high. Of the nation's 20 largest cities, three (Seattle, Portland, and Denver) recorded all-time highs in home prices. Twelve of 20 cities reported growing price momentum, meaning prices for the year ended January 2017 rose faster than prices for the year ended January 2016.

While the consumer is undoubtedly feeling good, the industrial economy also continues to flash positive signs. U.S. durable goods orders rose 1.7% in February, led by greater demand for commercial aircraft. January's annual gain in orders was revised upward to 2.3% from a previously reported 2.0%. When the volatile transportation equipment component is stripped out, orders still rose a healthy 0.4%.

Smoothing out monthly trends that can be lumpy along with the volatile aviation component, non-defense durable goods orders ex aircraft rose 6.5% for the three-month rolling period ended January 2017. That followed similarly adjusted order growth of 4.9% for the quarter ended October 2016.

**CONCLUSION**

Much as investors try to tear their eyes away from Washington to focus on solid fundamentals, we are drawn continuously back, partly by the spectacle but also by necessity. Even as the GOP prepares to confront tax reform, Congress must pass a spending measure to keep the government operating after April 28, when the current funding provision runs out. The House Freedom Caucus is reportedly considering making its support for any spending bill conditional on the defunding of Planned Parenthood.

This organization provides abortions but also provides health services for women, making it popular among Democrats and some Republicans. Neither the Freedom Caucus nor the moderates budged on repealing and replacing ACA, casting doubt on their willingness to do so on such fraught issues. A government shutdown, however brief, would further erode confidence in the president's ability to leverage his core popularity and enact his agenda.

We once again find ourselves in the uncomfortable position of writing about Washington when we would prefer to focus on the stock market. As the consumer confidence, housing and durable goods data cited above indicates, the economy is showing signs of broad strength. We will continue to take out cues from the economy while keeping a necessary eye on Washington. And we would be prepared to respond to any sell-off by deploying sideline cash, given that fundamentals should continue to trump politics in the months and quarters ahead.

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