Memo to: Oaktree Clients

From: Howard Marks

Re: Latest Thinking

Travel to clients abroad and preoccupation with my coming book on cycles (final draft submitted just the other day) have combined to keep me from writing a memo since September, but fortunately not from thinking. Thus I have ideas to set down on two significant subjects: the market environment and the new tax law. Further, I'm highly motivated to do so, since if I skip a few months, people start writing in, "Are you sick?"

More on the Markets

As I wrote in September ("Yet Again?"), some readers of my July memo, "There They Go Again . . . Again," perceived my stance as ultra-bearish. This was epitomized by the TV commentator who reported, "Howard Marks says it's time to get out." As I said in September, there are two things I would never say (since they require far more certainty than I consider attainable): "get out" and "it's time." It's rare for the market pendulum to reach such an extreme that views can properly be black-or-white. Most markets are far too uncertain and nuanced to permit such unequivocal, sweeping statements.

In September I observed that the cautionary July memo hadn't said much with respect to what people actually should do about the markets, and I tried to remedy that. Now I want to provide a more complete discussion regarding today's markets, covering the pros as well as the cons.

Positives – Whereas in my last two memos I talked primarily about reasons to be cautious, I want to make it clear here that I do recognize the positives in the current situation. Most of them have to do with fundamentals – primarily the healthy macro-economic outlook and thus the potential for increasing EPS.

- **The U.S. economy is chugging along, and the recovery that started in 2009 has become one of the longest in history (103 months old at this point). The rest of the world's economies are joining in for that rare thing, worldwide growth. Most economies seem to be gaining rather than losing steam, and they don't appear likely to run out of it anytime soon.**
- Since the economic recovery hasn't been marked by excesses to the upside, when a recession eventually does occur, it doesn't have to be extreme. In short, no boom, no bust.
- One of the reasons for the sluggish recovery during the Obama administration was the low level of capital investment (a frequent site of excesses during recoveries). I think that was due to corporate concern over the president's seeming indifference to business and his tendency to regulate. No one wants to make long-term investments in an inhospitable environment for business. **In contrast, it's very clear that President Trump is committed to being a pro-business president and a deregulator.** This change has led to a rise in optimism, confidence and "animal spirits" among corporate executives, things that have great potential to be self-reinforcing. Thus, for example, in the first three quarters of 2017, capital spending rose at an annualized rate of 6.2%.
- The recent tax law will put money into the pockets of corporations that pay U.S. taxes by reducing their tax rate, and it will result in the repatriation of large amounts of foreign profits that

U.S. companies have been holding abroad. The results will generally be very positive for corporate profits, cash flows and perhaps capital investment (see below).

- The unemployment rate is down to 4.1%, nearly the lowest level in 60 years, meaning we're nearing "full employment" (albeit with an unusually low percentage of adults participating in the workforce). With so little employment slack remaining, it seems reasonable to think near-term GDP growth will translate into wage gains, and thus back into further increases in demand.
- Although low, today's prospective returns are described as being reasonable in the context of low interest rates.
- The low levels of inflation worldwide mean central bankers needn't rush to raise interest rates to restrain it. There's no obvious reason to predict hyperinflation.
- **Thus the near-term rise in interest rates – while probable – can be expected to be gradual and limited in scope.**
- Except in pockets, investor psychology can't be described as euphoric and imprudent (although it has been strengthening of late). **For years the markets have been "climbing a wall of worry," an old-fashioned phrase used to describe a healthy ascent that's occurring not because of euphoria and risk-obliviousness, but rather despite a catalog of perceived ills.**
- The known catalysts for a market downturn – recession, ballooning inflation, much-higher interest rates, major central bank missteps, a governmental breakdown in Washington, and war – can't be assigned probabilities that are more than modest.

Negatives – As opposed to the positives listed above, most of the negatives surround either (a) positive fundamental factors that have the potential to deteriorate or (b) the high prices being paid for those macro-positives, and the investor behavior creating those prices.

- While the outlook isn't dire, a number of subjects do represent genuine uncertainties and provide basis for concern: the possibility of slow long-term economic growth, the potential for rising interest rates and inflation, the impact of reversing stimulative monetary policy and the Fed switching to being a net seller of securities, the implications for employment as automation increases, the world's dependence on China's growth, and political and geopolitical tail risks. **As the markets have risen, talk of all these things seems to have gone quiet.**
- We know interest rates are likely to rise (creating competition for most asset classes and arguing for lower asset prices). We just don't know by how much.
- Some of the elements characterizing the macro-economic environment can be described as "long in the tooth" or "unusually elevated." For example, the current recovery is one of the longest ever; the GDP growth rate is at the top of the range for the last decade; and profit margins are well above average. Things like these can continue or even get better, but the odds are against it. It feels as if we may get through the next 18 months without a recession, but if we do, that'll make this the longest recovery since the 1850s. Certainly not impossible, but against the odds.
- **Most valuation parameters are either the richest ever** (Buffett ratio of stock market capitalization to GDP, price-to-sales ratio, the VIX, bond yields, private equity transaction multiples, real estate capitalization ratios) **or among the highest in history** (p/e ratios, Shiller cycle-adjusted p/e ratio). **In the past, levels like these were followed by downturns. Thus a decision to invest today has to rely on the belief that "it's different this time."**
- Prospective returns in the vast majority of asset classes are some of the lowest in history.
- **The need of investors to wring out good returns in this "low-return world" is causing them to engage in what I call pro-risk behavior.** They're paying high prices for assets and accepting risky and poorly structured propositions. In such a climate, it's hard for "prudent" investors to insist on traditional levels of safety. Investors who don't want to sign on for risk (that is, who "refuse to dance") can be constrained to the sidelines.

- As a result, we see a lot of the reaction that greeted my July memo: "the market's expensive, but I think it has further to go." How healthy can it be when investors think an asset or market is rich but they're holding anyway because they think it might go up some more? Fear of missing out (or "FOMO") is one of the more powerful reasons for investor aggressiveness, and also one of the most dangerous.
- Market behavior implies a level of equanimity on investors' part that could prove unrealistic (and thus subject to reversal). For example, 2017 was the first year in history in which the S&P 500 didn't decline from high to low by more than 3% at least once. Likewise, in a six-month period late in the year, the VIX (an indicator of the level of volatility implied by investors' pricing of S&P 500 options) closed below a reading of ten more than 40 days; never before had it done so more than six times in a six-month period (*The New York Times*, January 14).
- **It appears many investment decisions are being made today on the basis of relative return, the unacceptability of the returns on cash and Treasurys, the belief that the overpriced market may have further to go, and FOMO. That is, they're not being based on absolute returns or the fairness of price relative to intrinsic value.** Thus, as my colleague Julio Herrera said the other day, "valuation is a lost art; today it's all about momentum."
- The potential catalysts for decline that we have to worry about most may be the unknown ones. And although I read recently that bull markets don't die of old age or collapse of their own weight, I think sometimes they do (a dollar for anyone who can identify the catalyst for the collapse of the bull market and tech bubble in 2000 – it's not easy).

The bottom line of the above is that some people are excited about the fundamentals, and others are wary of asset prices. Both positions have merit, but as is often the case, the hard part is figuring out which one to weight more heavily.

As I wrote in September, most people (and certainly the media) want definite answers: in or out? buy or sell? risk-on or risk-off? But it's rare for answers that simple to be correct. There's a wide range of possible stances that investors might adopt. At one end of the spectrum there's maximum aggressiveness (100% invested in high-beta, high-risk assets, or maybe more than 100% through the use of leverage), and at the other there's maximum defensiveness (100% cash, or perhaps being net short). Most investors are never either of those.

And I certainly wouldn't be either of them today; I'd be someplace in between. That's easy to say. But where? Closer to the bullish end of the spectrum or the bearish end? Or balancing the two equally? **My answer today, as readers know, is that I would favor the defensive or cautious part of the spectrum.** In my view, the macro uncertainties, high valuations and risky investor behavior rule out aggressiveness and render defensiveness more sensible.

For one thing, I'm convinced the easy money has been made. For example, the S&P 500 has roughly quadrupled, including income, from its low in 2009. It was certainly easier for the p/e ratio to go from the low teens in 2011-12 to 25 today than it would be for it to double again from here. Thus the one thing we can say for sure is that the current prospects for making money in U.S. equities aren't what they were half a dozen years ago. And if that's the case, isn't it appropriate to take less risk in equities than one took six years ago?

Prospective returns are well below normal for virtually every asset class. Thus I don't see a reason to be aggressive. Some investors may adopt an aggressive stance to be in the riskiest (and thus hopefully the highest-returning) assets; to squeeze out the last drop of return as the markets continue to rise (under the assumption they'll be able to get out at the top, something that's present in every strongly rising market); or to achieve a high return in this low-return world. I don't view any of those as good ideas.

For years my description of the factors characterizing the markets has been essentially unchanged:

- a large number of big-picture uncertainties,
- sub-par prospective returns,
- above average valuations, and
- pro-risk investor behavior.

For as long as I have been discussing this view, no one has ever taken issue with any of these observations. Do you? That's the key question. And if not, what will you do about it?

You could have made the above four points a year ago, and two years ago, and three years ago, etc. And in general I did. Thus it was possible to argue for raising some cash at a variety of times over the last few years. However, going meaningfully to cash would have been a big mistake – certainly based on how markets performed, but also on the merits – and I think it still would be wrong today.

When I came up with the mantra that has governed at Oaktree over the last several years – "move forward, but with caution" – I described my position as follows:

- the outlook is not so bad, and prices are not so high, that it's time for maximum defensiveness (and if you turn to maximum defense today, your return will be near zero, something most people can't stomach), but
- the outlook is not so good, and prices are not so low, that it's right to be aggressive. In fact, the only thing I was sure of was that there was no place for aggressiveness.

So I didn't say, "Get out now," and I still wouldn't. But I think this continues to be a time to incorporate a good helping of defensiveness in portfolio management. Being fully invested in a cautious portfolio has been an appropriate stance over the last few years. It gave Oaktree performance that in general was respectable or better. **Aggressiveness would have produced higher returns, of course, but I don't think it could have been justified a priori.** (Is an incorrect decision one that didn't work out well, or one that was wrong at the time it was made? I insist it's the latter, as you know.)

And today? What has changed? To the four descriptors of the investment environment listed above, I would add three more:

- the economy is strengthening, not slowing, and Washington is supporting its progress,
- prices are even higher and valuation metrics have moved up,
- and, as I said, the easy money has been made.

Thus the current environment is still mixed – better fundamentally and worse price-wise. The positive near-term economic outlook, lowness of interest rates, need of most investors for return and moderate psychology all seem to suggest it would be a mistake to get out. On the other hand, the extremely high asset prices, macro-fragility and risky behavior going on all around us argue for considerable caution.

At times when the economy does well, risk doesn't rear its head, risk-takers prosper and the returns on low-risk alternatives are unattractive, investors tend to drop their prudence and conclude that high prices aren't a problem in and of themselves. This usually turns out to be a mistake, but it can take years.

For authority, I'll cite a passage that seconds that view:

> The market seems extremely comfortable with the proposition that as long as the macro-environment remains benign, stocks prices can continue to appreciate at rates that far outstrip the growth of their issuers' profits, and thus the growth of their intrinsic value. Few market participants seem concerned about appropriate valuation levels – the relationship between assets and their prices – and this is a condition that we think must eventually have negative consequences. . . .
>
> Today's combination of a stable economy, low interest rates, enormous cash flows and strong investor optimism has created a climate in which capital is available for both good investments and bad, and in which risk is rarely seen as something to be shunned.

I wrote that in 1997, in a clients-only memo entitled "Are You an Investor or a Speculator?" I was cautionary then, like I am now. And it took almost three years for that to turn out to be correct. That doesn't mean it wasn't correct when it was written . . . just early.

Today there's beginning to be talk of a possible late-bull-market melt-up, making investors more money but perhaps fulfilling the requirements for a full-fledged bubble. (This may be part of the usual pattern of capitulation that occurs when those who haven't fully participated lose the will to keep abstaining after years of market gains.) The basic themes supporting the "melt-up" theory include (a) the existence of the fundamental positives listed above and (b) the arrival of euphoric psychology, which has been absent to date.

For me the key points regarding the general market outlook are as follows:

- The absence of widespread euphoria certainly is an important flaw in any near-term bearish view.
- Thus there's no reason for confidence in the existence of a soon-to-burst bubble.
- Investor psychology continues to grow more confident, however.
- Asset prices are already unusually high.
- Future events remain unpredictable, but today's high prices mean the odds are against a significant long-term upward move from here.
- No one can say what's going to happen in the short term.

Asset prices and valuation metrics are certainly worrisome, but psychology and its implications – as well as timing – are unpredictable. I think that's about all we can know.

Thus Oaktree will continue to invest on the basis of value and its relationship to price, and to refrain from trying to time markets based on predictions regarding economies, markets or psychology. The "melt-up" school says securities that already are highly priced may become more so. We'd never bet on whether they will or won't.

Our post-2011 mantra remains in force: we're investing when we find reasonable propositions, albeit with caution. We're investing, and with the exception of the distressed debt fund specifically raised to await an upsurge in opportunities, we aren't intentionally uninvested. If we find things with decent return prospects, structure and risk, we don't pass them by because we think they'll be cheaper a year from now. And we're making our views clear to clients so that, especially in our open-end strategies, they can make their own choice between aggressiveness and defensiveness. We would be happy to continue this discussion with clients off-line.

Reactions to the New Tax Law

The Republicans in Congress have passed and the president has signed a bill they hailed as "sweeping tax reform." It's worthy of comment. Everything going on in Washington is more politicized and less bipartisan than ever, but I'll attempt here to remain objective and not partisan while making what I think are the important observations.

First, with respect to the taxation of individuals, it's not much of a reform. It doesn't fundamentally change what income is taxed, how it is taxed, or the structure of the tax process. It reduces or eliminates some write-offs or loopholes, but not a great many. And I doubt it shortens the tax code.

I think what matters most is that it's primarily a tax cut for the majority of Americans, and tax cuts are stimulative. As I said before, the current U.S. economic recovery is one of the longest in history. The economy is doing well; it seems to be gaining strength; and it feels like the recovery can go on longer. With the unemployment rate nearing full employment, GDP growth may well go into a more dynamic period. So why stimulate?

- **It doesn't make sense to try to artificially prolong an already-long recovery.** Economies go up and down, and growth rates rise and fall. Governments (and central banks) should accept this rather than attempt to bring about rapid growth forever, which increases the risk of overheating. In the last twenty years we've had painful first-hand experience with the results of efforts to prevent the economy from slowing. GDP growth can be enhanced temporarily through a shot of fiscal adrenaline (like a tax cut), but that can't raise it permanently.
- **And doesn't it seem odd that the government is implementing a stimulative tax cut just as the Fed is raising interest rates and reversing its purchases of securities?** The Fed is concerned that a continuation and possible strengthening of the recovery will cause inflation to accelerate; thus it's acting to "remove the punchbowl." That makes sense. Why is the government taking fiscal actions in the opposite direction?
- The unanimous willingness of former "deficit hawks" to pass a bill that adds more than $1 trillion to deficits and debt is indicative of what I've seen described as "ideological pliability." Those who voted for it must have concluded that giving out goodies garners the most votes. **That bodes ill for fiscal discipline in the future.**

The centerpiece of the tax law is the reduction of the stated tax rate on corporate profits from 35% to 21%. What are its merits?

- Our corporate tax rate shouldn't be higher than the rates in other countries, as it has been to date. A higher rate gives companies an incentive to increase capacity abroad rather than in the U.S.; encourages U.S. companies to merge into foreign companies or relocate overseas; and gives foreign companies superior profitability.
- Lower rates will be good for our companies, and now our tax rate on corporate profits is one of the lowest in the developed world. Those of us who attribute much of the U.S.'s leading position in the world to capitalism think that's a good idea. I'm a strong believer that, within limits, "What's good for General Motors is good for America."
- Because of our previous corporate tax system, U.S. companies have $2.8 trillion of cash from foreign profits stranded overseas. Now that will be brought back at tax rates as low as 8%.
- **There's every reason to believe the rate cut and repatriation will put money in corporate coffers, enhance credit ratings, fatten dividend payments and finance stock buybacks.**
- But none of the above was the basis on which the corporate tax cut was sold to the public. Instead, it was billed as a job-creator. With unemployment already below average, many CEOs

tell me they're hamstrung by a scarcity of qualified workers. So who will fill the new jobs if corporations expand in the U.S.? And if workers aren't available, will new plants (and jobs) really be created?

- In the last days of the effort to pass the tax bill, I heard a talk-show guest say corporations and their owners would share its benefits with employees and consumers. We've seen a number of companies give raises or bonuses following the enactment of the tax law, but I doubt it was done out of generosity. Corporations may increase compensation if needed to attract, retain and motivate workers, and they may cut prices for competitive reasons, but the motivation will be to maximize profits – as always. I doubt the tax law will fundamentally alter their behavior.

So call it a gift to the corporate sector if you want, but I think it's unlikely to be much of a job-creator or long-term boon for the American middle class.

There will be pluses from the law, and there will be minuses. For me, the bottom line was captured best in a January 11 speech by William Dudley, the long-term and highly respected president of the New York Fed:

> While the recently passed Tax Cuts and Jobs Act of 2017 likely will provide additional support to growth over the near term, it will come at a cost. After all, there is no such thing as a free lunch. The legislation will increase the nation's longer-term fiscal burden, which is already facing other pressures, such as higher debt service costs and entitlement spending as the baby-boom generation retires. While this does not seem to be a great concern to market participants today, the current fiscal path is unsustainable. In the long run, ignoring the budget math risks driving up longer-term interest rates, crowding out private sector investment and diminishing the country's creditworthiness. These dynamics could counteract any favorable direct effects the tax package might have on capital spending and potential output.

Of all the possibilities, I find myself agreeing with Dudley's take on the likely consequences. **All else equal, the tax law is likely to result over time in higher deficits, higher national debt, higher economic growth, higher inflation, higher interest rates, higher federal debt service requirements, and thus still-higher deficits and debt. These things tend to go together, and together they constitute the fiscal path Dudley describes as unsustainable. The outlook was troubling before; the tax cuts will make it worse.**

The reward from the tax law is pretty clear: it's likely that in the short run the economy will strengthen, corporate profits will increase and take-home pay will rise for most Americans. But the long-term benefits are less certain, and meaningful hidden risks exist.

*   *   *

Next I want to spend some time on SALT. It wasn't long ago that most of us thought of this as the acronym for "strategic arms-limitation talks," but all of a sudden (in just the last few months, as far as I know), it has come to stand instead for "state and local taxes."

People who live in states with low or no income taxes may not have paid particular attention to the aspects of the new law relating to SALT, but it's a big topic in New York, where I live, and very much worth discussing. Up until now, to limit the impact of double taxation, itemizers have been able to deduct all state and local taxes paid from the income that was taxed at the federal level, the principle being that one should pay federal income tax only on what's left after state and local taxes have taken their cut (including income, property and sales taxes).

The proposed House bill eliminated this deduction completely, but the final law permitted deductibility up to $10,000. This avoided harming people with incomes below $100,000 or so, but those who earn more will feel it directly.

To simplify my calculations, I'm going to ignore tax rates on lower-bracket income, as well as the effect of exclusions and credits, and talk about the impact of this change on the higher earner's marginal dollar of income. I'm also going to round the figures and ignore Social Security and Medicare taxes.

- Before the new tax law, a top-bracket earner in New York City, for example, took home about $53 from $100 of marginal earnings (after federal income tax at 40% and state/city income taxes at 12%, less the benefit from recouping 40% of that 12% on the federal return because of its deductibility).
- Under the new law, take-home pay from $100 of incremental earnings will be about $51 (after federal tax at 37% and state/city tax at 12%).

Thus take-home pay per incremental dollar of earnings will decline by about 4%. The impact under the House bill would have been worse, but it was eased by a reduction from 39.3% to 37.0% of the tax rate applied to top earners. Still, 4% of take-home pay is a painful loss for most people.

Is the elimination of SALT deductibility unfair? The debate is complex, and like many things it depends on your point of view.

- On one hand, some states choose to give their citizens a lot of services (or have populations that require a lot of services, which has the same effect), and to pay for those services, they impose high income taxes. **Why, some say, should the federal government (and through it, residents of the low-tax and no-tax states) subsidize the high-tax states by absorbing some of their residents' tax burden?**
- On the other hand, according to estimates from *WalletHub*, the residents in fourteen "donor states" pay more to the federal government than they get back. They generally include states with high per capita incomes, such as New York, California, New Jersey and Illinois, and exclude states with the most people depending on federal largesse for their incomes. **Thus high-tax, high-business states subsidize the rest.**

One thing is not debatable: high-tax states are hurt in the absolute by this tax law, and hurt very much relative to low- and no-tax states. Because the deductibility of state and local income taxes is limited to $10,000, the impact will fall primarily on people in states with higher per capita incomes. There's a parallel treatment of property taxes, with deductibility also capped at $10,000. (The $10,000 is an aggregate limit for any combination of income, property and sales taxes.) And, relatedly, the law lowers the limit on the size of the mortgage on which interest is deductible. Not surprisingly, high incomes are correlated with high property values (and large mortgages), so people in some states are likely to be hit by all these limitations, and people in other states by none of them.

Is it a coincidence that most of the negative effect falls on states that are primarily Democratic or "blue"? Did President Trump mind reducing upper-bracket take-home pay in states that gave Hillary Clinton overwhelming pluralities a year ago? No one can say for sure, but there's no doubt about where the impact falls. As conservative economist and CNBC commentator Larry Kudlow put it, "It's a blue-state tax."

What are the important conclusions?

- **The reduction in take-home pay increases the penalty for living in high-tax states**. (For example, in 2015, 34% of California taxpayers itemized deductions, and on average they deducted $18,500 of state income tax. On average those taxpayers will lose an $8,500 deduction and thus pay roughly $3,000 more in federal income tax.)
- **Especially when added to high property taxes, this can give top-bracket earners a significant incentive to move to no-tax states such as Florida, Texas, Nevada and Washington.** As I wrote in "Economic Reality" in May 2016, states can raise their income tax rates (and the loss of federal deductibility is the equivalent of an increase in tax rates), but they can't prevent taxpayers from moving away.
- It's true the top federal income tax rate was reduced in the final law, perhaps halving the pain on taxpayers in high-tax states. But residents of no-tax states also get the tax rate reduction without having lost any deductions. I estimate for someone with a given large income, marginal take-home pay will be about 20% higher in a no-tax state than it is in New York, and that's a lot.
- **The bottom line is that the incentives for high earners to move in order to avoid SALT, always substantial, have increased.** I expect this to have a strong impact on the economies of the high-tax states. What CEO will move his company to New York or California in the future? Won't future company relocations and formations tend to favor the low-tax and no-tax states?
- I know a Republican congressman from New York who voted in favor of the tax bill. How could he? Won't his constituents turn against him and vote him out? He may figure that since he represents a low-income district, his voters won't be hurt by the loss of SALT deductibility. And that may be true as far as direct effects go. But the second-order consequences could easily see employers move away, taking their companies and the jobs of the congressman's constituents with them. **High-income people may move to chase lower state income tax rates, but folks with low incomes generally are much less able to do so.**
- The other day a friend told me the top 1% of New York taxpayers pay 50% of the state income taxes. **If and when their emigration accelerates, states like New York may get into a negative spiral**: a few big earners leave; the state has to raise tax rates to make up for the lost revenues; that increases the differential and causes more big earners to leave; which requires further tax-rate hikes, and so forth. High-tax cities and states may be greatly affected. New York City residents may feel there are attractions that justify the high rates, but neighboring "bedroom communities" lacking those attractions may be affected even more.

For me the bottom line on the new tax law is as follows:

- Our tax system is not fundamentally reformed. Such changes will be feasible only in the unlikely event that bipartisan cooperation returns to Washington.
- The net income of corporations that pay U.S. taxes will be enhanced, but the impact of the corporate tax reduction on other segments of the economy will be limited.
- The outlook is enhanced for no-tax and low-tax states and impaired for high-tax states.
- Overall, the tax law is likely a short-term positive and a long-term negative in a variety of ways.

* * *

The forthcoming book I mentioned earlier, due out in October, is about cycles. Why do cycles occur? Why doesn't the U.S. economy just grow at the average rate of 2-3% every year? And since the average return on the S&P 500 is in the range of 9-11%, why isn't the return between 9% and 11% every year (and, in fact, why does the yearly return fall between 9% and 11% so infrequently)?

The simple explanation is that because of the involvement of people, economies and markets – as well as other cyclical phenomena – tend first to overshoot in one direction (and given how people are wired, usually to the upside) and then they are bound to correct in the opposite direction.

I think that description is highly relevant to the two topics discussed above.

- When markets do too well for a while – that is, when equity returns far exceed the growth rate of companies' profits, and when bonds return more than their promised yield to maturity – it usually means they've become overpriced and will correct sooner or later.
- And when an economy expands faster than the potential growth rate determined by its population growth and increases in productivity – usually because companies or consumers borrow, invest or spend to excess – it's likely to contract eventually. This happens either because the excesses are unsustainable in and of themselves or because central bankers take steps to cool things off in order to avert hyperinflation.

That's the common thread here: markets that may have been doing too well, and an economy that may be in the process of being overstimulated. Both feel good right now, but each has potential negative consequences.

* * *

I've been able to devote four pages to the new tax law primarily because so little has changed in the markets. Investors are still pursuing high returns in a low-return world. This entails a decline in risk aversion and produces risky behavior, rising asset prices, diminished prospective returns and increased risk. **It's impossible to say the negatives will win the tug-of-war anytime soon, but that doesn't mean caution should be discarded . . . especially now.**

January 23, 2018