The transition from summer to winter is marked for me by a beautiful maple that sits in our front yard. This magnificent tree puts on an incredible show each fall, turning shades of red, yellow and green that are beyond compare. I take photos every year to ensure the memory sticks. While this tree gives a timely and outward sign of the change of seasons, other transitions can be more subtle, especially when they relate to the economy.

After years of extremely accommodative monetary policy that has supported a nine-year economic recovery, we are beginning to see a transition to fiscal stimulus as central banks reduce their monetary stimulus. The Federal Reserve is leading this transition, stepping away from its accommodative stance by raising short-term interest rates four times (and we expect another rate hike in December) and finally starting plans to shrink its balance sheet (otherwise known as “quantitative tightening”).

This phenomenon is not just occurring in the U.S. Other central banks, including the Bank of England and Bank of Canada, have also raised short-term interest rates. However, it might take other central banks a little longer. The European Central Bank recently announced it will reduce its bond-buying program from €60 billion per month to €30 billion per month in January 2018, and keep it at that level until at least September 2018. They also reiterated that interest rates would remain at current levels well past the end of the asset-purchase program. Meanwhile, the Bank of Japan has stopped accelerating purchases.

As the Fed begins to unwind its balance sheet, the question becomes whether the transition to fiscal stimulus will provide the right policy mix to support economic growth moving forward. After all, global accommodative monetary policy has not only supported growth, it has also helped drive up valuations across many asset classes, including stocks and bonds. As central banks take steps to withdraw stimulus, fiscal policy, in the form of tax cuts, tax repatriation and infrastructure spending, can help support corporate earnings, business and consumer spending, and economic growth. But will the passing of the baton from monetary to fiscal policy meet investors' expectations? Or will it fall short, leaving us with a subpar trend growth and the potential for a recession?

**Fiscal Stimulus: U.S. Tax Cuts**

Following President Trump’s election last November, markets rallied in unison as his pro-growth regulatory, tax, health care and infrastructure policies pointed to stronger economic growth ahead. Beneath the surface, the rally revealed several traits, such as small cap stocks outperforming large cap, and value stocks outperforming growth (with a strong contribution from financials).

Although Trump’s attempts at repealing the Affordable Care Act failed over the summer, the other three large agenda items, especially taxes, are now coming to the fore. After the release of the GOP’s framework for overhauling the tax code, markets are once again anticipating the benefits of tax cuts. Just look at the performance of the market in September and October: It mirrored post-election markets, with interest rates and the stock market both moving higher.

As a strategist, I always focus on history as a guide for how markets may react to different types of events or developments. The last time the U.S. cut taxes was in 2003, when President Bush passed the Jobs and Growth Tax Relief Reconciliation Act of 2003, which cut marginal rates, lowered the capital gains rates and introduced lower rates on “qualified” dividends. As you can see in Exhibit 1, the market not only advanced before the tax cut was announced, but also rallied significantly afterwards. So while markets anticipate the pro-growth benefits ahead of tax cuts, they also seem to leave room to advance further as the tax cuts become reality. While this is just one example, it does seem to show that equity markets don’t overly discount the benefits of tax cuts before they take effect.
Timing and Potency Matter

In recent presentations I’ve given around the country, I’ve shared that I believe we are in the “wall of worry,” mid-cycle phase of this bull market. However, we are at a fork in the road, one that will determine the future direction and magnitude of the market moving forward. At this point in the cycle, history seems to dictate that we need stronger organic economic activity in order to keep the economy growing and the stock market moving higher. We believe that the U.S. economy will require another source of growth as the Fed normalizes interest rates and shrinks its balance sheet. In fact, a shift from monetary to fiscal stimulus was one of our themes as we entered 2017.

It now seems that tax cuts, more than any other fiscal stimulus, will be the impetus the U.S. economy needs to grow at a faster pace. However, the timing and potency of the tax legislation will influence the potential benefits to corporate profits, the economy and the markets. The recent passage of a budget resolution was a key step in moving tax reform forward as it unlocks a procedure called “reconciliation” that will prevent Democrats from filibustering the final bill. Details of the recently released Republican tax plan appear to consist mostly of tax cuts rather than a full overhaul. While policymakers suggest that tax legislation can be completed before year end, we believe negotiations will involve some dealmaking and expect a timeline closer to next spring, with the final bill potentially more modest than originally intended.

Now don’t get me wrong, the world economy is doing its best to grow without fiscal help. I’ve talked about global synchronized growth, as measured by Purchasing Managers indexes that are above 50 worldwide, which shows a consistent marker for an expanding economy. In fact, our forecast for domestic and global growth this year is 2.2% and 3.6%, respectively. We are only anticipating a modest pickup in U.S. growth to 2.5% in 2018, but this does not include a boost from tax cuts. But as long-term interest rates begin to rise, the need for fiscal reform to take the baton from monetary stimulus might become more necessary. Undoubtedly, more expansive cuts should help to spur growth at a faster rate than the U.S. and world economy are currently growing. But if markets are disappointed with the scope of the tax legislation, we could see a pickup in market volatility and a slowdown in growth.

A Critical Juncture

The fork in the road is often a critical juncture: Will the global economy and the markets muddle through without assistance from fiscal stimulus or will the transition actually propel a new level of growth? The path of least resistance is "more of the same," where we’d expect modest equity returns and decent corporate earnings growth, but perhaps with higher volatility. For stronger economic growth, the transition to fiscal policy needs to deliver better earnings growth and increased spending among businesses and consumers, without sparking significantly higher levels of inflation. If that transpires, we can expect the equity-friendly backdrop to continue for the foreseeable future. Just as I watch my maple tree for a signal that the seasons have changed, I’ll be watching Washington to see if it takes its cue from the Fed and central banks around the world and works toward stimulating global growth.

Jeff Mortimer