

Monday, December 19, 2016

2017 OUTLOOK

- Using a P/E multiple of 20, our S&P 500 target for 2017 is 2,400 (only 5.0% higher than current levels). That target has a margin of error of (at least) one P/E point, bringing the S&P 500 to a range of about 2,280 to 2,520. The S&P 500 has a tough time pushing P/E's past 22, but if it did reach that level it would put the S&P 500's highest upside at 2,640 points (roughly a 17% gain).
- The valuation of the S&P 500 is stretched while optimism is very high (a contrarian factor). The start of 2017 is vulnerable to a start that is painfully similar to 2016. This is a contrarian view as well; the consensus is for continued equity strength with headwinds being more seasonal (Sell In May; October crashes).
- Higher interest rates are going to be a major detriment to growth relative to 2016. Interest rates rising faster than we expect is a greater risk to the price of equities than overvaluation or excessive optimism.
- We expect higher oil prices and higher capital expenditures in 2017.
- There is virtually no chance of a recession in 2017, making high yield bonds more attractive than Treasuries.

After President Elect Trump's poll-defying victory, I wrote the piece called "A Trump Presidency". At the time I wrote it, I felt that would serve as our annual "year ahead" piece. And it mostly will. But an update and expansion couldn't hurt, as it is clear that stated policies are changing. When it comes to Trump's influence on the economy and the stock market, the changing dialogues show there are just as many questions as answers. Virtually no details about policies as well as uncertainty with respect to the timing of their implementation contribute to a wide range of estimated economic boosts (and where said boosts will come from).

This article isn't meant to be a rehashing of what was written a month ago, though there will be some redundancies if only to launch said updates and expansions. But this piece is written as if you have read "A Trump Presidency".

Although we made modifications through last year regarding the 2016 Outlook, it might be fun to look at what we got right and what we got wrong. So we'll throw some of that into this report, too. The mention of the existence of those intra-year modifications is important. It is not so much that we are trying to show how wrong or right we were. ***It is important to note that you never really know what's going to happen a year out, which is why portfolios require constant monitoring.*** So while we perform an almost obligatory-year-ahead look, we do so knowing full well there will be a need for constant updates.



On December 31, 2015 we said:

“Next year the stock market will go up about seven percent, even though there will be three five percent corrections and one larger correction of ten percent.”

As we write this, there was one larger correction of about ten percent (closer to 12%) that ended in February, and three five percent-ish corrections in May, June, and November. Right now the market is up closer to nine percent than seven percent; but it’s the direction we were interested in more than the magnitude.

We wrote in 2016’s Outlook:

“Anticipating a return based on a calendar year feels obligatory and insanely arbitrary. So high-single digit returns are more like a prediction of 2016-ish, give or take half a dozen weeks on either end of the year for measuring purposes.”

The same can be said for 2017.

Those predictions were good, but where we got it wrong was that we expected that ten percent correction to start closer to the middle of the year, not the beginning. But no big deal – as we have often said, that volatility is the price of being invested in equities. We are going to sit through ten percent drops when there is a high probability of it being short-lived and that the rebound is likely to be generous.

Financial Companies

As President-Elect Trump’s cabinet fills up, it appears that financial companies will enjoy favorable policy that allows them greater profits. We, of course, cited that likelihood in the missive “A Trump Presidency” and argued that this would be a major catalyst for the markets to rally. That certainly has been the case, and we will continue to monitor the financial companies to determine if we should further allocate toward that sector. (15% of the S&P 500 is already invested in financial companies; the S&P 600 Small Cap Index is closer to 18%.)

As to adding to direct sector exposure to the area, that’s a possibility. Many investors recently have been attracted to higher prices without actually understanding the reasons behind the higher prices (welcome to the stock market!). We will look for better reasons than just inflated prices (a correction would be nice). With Steve Mnuchin as the Treasury Secretary and Gary Cohn as director White House National Economic Council (both of Goldman Sachs), there is more than just hope for improved profits in financial companies. But for me, the big hope for a boost in profits is a repeal of the Dodd-Frank legislation.

I refuse to get into the nitty gritty of this (really just because the boredom of it might cause you irreparable damage). But the gist of it is that while Trump has been inconsistent on Dodd-Frank, Mnuchin has been a rather outspoken critic of it. Repealing Dodd-Frank would not be easy, based on bureaucratic red tape alone.



But let's not get lost on the idea of sector allocation. This is not necessarily an endorsement of sector allocation so much as it is acknowledgement that policy is likely to make it easier for banks to extend credit, the lifeblood of entrepreneurship, capital expenditures, equipment purchases and all other business decisions that lead to job formation and economic growth.

Oil

The dollar is inversely correlated to oil prices. So while policy may be good for the energy sector overall, **oil prices may be held in check by a rising dollar**. That doesn't mean oil prices can't go much higher from here as the price reverts to the mean after its 2016 crash, it just means that if they do go higher they will go less high than they otherwise might have.

The Federal Reserve and Interest Rates

In our 2016 Outlook we wrote,

"The US economy is expected to avoid recession ...The path of rising interest rates will be gradual, allowing BMM to feel comfortable going into 2016 being more constructive on the US stock market..."

That call worked out well through the year.

One of the most important questions for 2017 is how many times will the Fed hike interest rates? By now, Fed Chairwoman Janet Yellen must know that President-elect Trump doesn't want her around after her term expires on January 31, 2018. Her goal will be to deliver full employment with a Fed-targeted 2% inflation rate. As a result, she'll be patient next year, only hiking when the economic data clearly calls for action. **We don't think that will happen more than twice in 2017. The consensus calls for three additional hikes in 2017**, per the Fed's "dot plot" released after they raised the federal funds interest rate by one-quarter of one percent on December 14 to a range of 0.50 – 0.75%.

Perhaps the most unexpected market reaction to the election of Donald Trump was that the yield of Ten-year Treasuries rose over a full percentage point from their July 6th low, approaching 2.5%. Fair value of the Ten-Year note is around 2.20% (like stock prices, this calculation is more of an art than a science. Fair value for yields, like stocks, move depending upon a bevy of variables.). Since the financial crisis of 2008, ten-year yields have not been more than 40 basis points (0.4 percentage points) above fair value. That means, **in the very short-term, ten-year yields probably won't break 2.60%, but likely will be approaching 3.0% by year-end 2017**. In the intermediate term, over the next couple years, it is entirely likely that these yields move past the 3% level, which was last seen back in 2013 during the "Taper Tantrum" (when the Fed reduced its bond buying program).

Over the long term, ten-year yields track nominal growth, so, in a sense, let's hope that yields do go higher. But let's hope that interest rates don't get ahead of themselves – for now, **this jump in rates is going to be a drag on economic growth. It is going to put a hurting on Q1 2017 GDP unless animal spirits and optimism somehow overwhelm the negative effects of the rate hike**. For now, it looks as if animal spirits are stronger than the interest rate bite.



U.S. Economic Outlook

For 2017, there is a very low risk of a recession.

In our 2016 Outlook we noted that,

- the US labor market will reach full employment,
- wage growth will continue to accelerate,
- the path of higher interest rates will be slow and rates will remain low, and,
- US GDP will advance over 2%.

There is always some argument as to how to define “full employment”, but the US unemployment rate did drop from 5.0% to 4.6%, so we’ll call that a win. GDP averaged 1.81% for the first three quarters and Atlanta Fed GDP Now tracks Q4 at 2.4%, which would put GDP for the year at 1.96% (we’ll call that a win, too). Wage growth was solid and interest rates remained low. **Assessing all this data at the beginning of the year is important because pretty much every calendar year the market is going to go down ten percent, and we need to figure out if it’s just an ordinary drop, or the start of a serious price restructuring associated with a recession.**

If some of the several broad policy proposals from President-elect Trump, such as infrastructure investment, tax cuts, increased defense spending, and deregulation could boost GDP growth in 2017 and 2018 by a wide range of 0.5% to over 3%. That’s a huge spread because we don’t know what policies will be put into action and at what level, and when. Also, we can’t add up the numbers in a vacuum. With the labor market close to full employment, growth-intended policies would likely fuel higher inflation, prompting the Fed to accelerate its tightening path. A sharp dollar appreciation, protectionist policies, higher interest rates, and inflation will have a drag on growth. There are just too many variables to feel comfortable in predicting the stimulus effect of new policies.

The range of numbers, while, wide, are reliable; we used the multiplier levels that the Congressional Budget Office applied to the 2009 American Reinvestment and Recovery Act. We see a near-zero risk of recession in the near-to-intermediate term. ***With the current recovery now in its eighth year and growth close to potential, actual multipliers are likely to be toward the bottom of the CBO’s ranges.***

Nevertheless, all indicators at this time are for at least a moderate boost to GDP growth in the second half of 2017 and into the first half of 2018 (leading up to recession in late 2018 or early 2019?).

We expect 2017 to see growth in capital expenditures due to rising oil prices driving rig creation, continued improvement in the global economy, a Trump-led fiscal stimulus bill which includes infrastructure spending, and higher wages spurring investment in automation technology. We’ve oft mentioned the dangers in excessive optimism for the stock market. That is because higher stock prices draw in money from the sidelines by investors who only use higher prices as a gauge as to when to buy more stocks. But when CEO optimism rises, that’s a positive. When it comes to assessing their businesses, they tend to be more rational, which makes CEO optimism surveys less fickle. And as CEO optimism has risen, so too has CEO-expected capital expenditures. It will likely be some time before that action is built into GDP and profits as corporations wait for word on various tax treatments under a Trump presidency, but it’s coming.



U.S. Stocks

Heading into 2017, our biggest concerns are stretched valuations and excessive optimism. Stretched valuations make it harder for stocks to go higher without a jump in sales (which have been sluggish) or rise in profit margins (which are already at near-record levels). And excessive levels of optimism leave stocks vulnerable to selling. When everyone is optimistic, that usually means everyone who wants to buy has bought, leaving little room for demand and more exposure to supply (i.e. selling).

Trump's victory has opened the door to the possibility of growth oriented policies, perhaps alleviating some of our concerns about market fundamentals. But make no mistake –we are concerned. The combination of high valuations and excessive optimism screams for a start of 2017 that isn't too dissimilar to that of 2016, with a drop in the stock market (ultimately to be completely forgotten, but boy is it painful as we go through it!).

Consensus estimates for S&P 500 company operating earnings per share is a growth rate of 22.4%. Even if all of Trump's growth policies are instituted, I just find it difficult to picture an economic growth scenario that would move earnings more than twenty percent. (I told you optimism is high!). **In a typical year, consensus estimates start the year at about 8.6 percentage points too high. With a consensus of \$131 of S&P 500 earnings for calendar year 2017, an 8.6% miss would translate to \$119.73** of earnings. As I write this, the S&P 500 is approaching 2,300 points. A lot has to go right for the stock market to go higher from here. Yes, investors can get more optimistic and stock multiples can go higher. That happened through all of the 1990s as the stock market experienced "irrational exuberance".

I admit that I could be getting more worried than I should be. After all, nothing makes stock prices go up like higher stock prices. Price momentum is very bullish. But it's our job not to just make your portfolio go up when opportunities present, but to be sure your money is there when you need it. So, really, it's my job to worry about all the things that could go wrong.

We do hate trying to be too precise in our predictions as to when a correction might occur. Not because we're afraid of being wrong – I've been consistent over the last quarter century of saying that when information changes I must change my mind. But invariably we are then drawn into a conversation to answer the question, why don't you sell if you know the market is going to go down? Please do remember the past predictions must be updated on a regular basis, thus using current predictions are really just part of the constantly growing narrative.

We have never been like a lot of other advisors who tell you to just hold on through the rough patches. That's nonsensical. But some corrections just aren't made to be timed; there are no tools to consistently and reliably do so. In part we try to predict correction to be confident that they aren't the type we need to avoid (like the ones BMM stepped away from in 2002 and 2008). And, in part, we try to predict corrections so that when they do happen, people aren't overly tempted to sell out at the bottom thus missing out on the biggest rallies.



Small Cap Stocks

Small capitalization stocks are short-term overbought and will be among the most vulnerable if a stock market correction starts soon. Small caps were among the biggest winners of the so-called Trump rally. After such a great run the question is whether it is sustainable for the next year, or so. In order to discern that, first we need to identify the drivers of the rally.

Economic and policy expectations pushed small cap stocks higher. Small caps get less of their profits from overseas, so the strong dollar should help small caps relative to large caps. Also, tax cuts are part of the conversation. A corporate tax cut could improve margins for all companies, but the benefit could fall disproportionately on domestically oriented companies.

Beta, a measure of a stock's volatility, also has helped propel small cap stock prices as the broader market has risen. Beta will continue to benefit small cap stocks so long as the broader market rises, but the movement of the broader market will largely be dependent upon the realization of fiscal policy benefits. Otherwise, the beta of small caps will work against the asset class.

The verdict is ***that small caps deserve exposure in a growth-oriented portfolio, but there are safer equity options for portfolios with a more conservative intention*** because when the market corrects (and it always does), they are going to be hurt more than the broader market.

Bottom Line

Our expectations for 2017 are a bit contrarian:

- Everyone is optimistic that stock prices will rise; we think that leaves us vulnerable to a correction,
- Earnings growth consensus is above 20%; we think half of that is still optimistic,
- People think there are only tailwinds for the stock market for the first half of the year, only seeing seasonal headwinds for the second half; we see immediate headwinds
- Trump's policies are seen as extremely growth oriented; we expect the consequence of higher interest rates, a stronger dollar, and protectionism is going to dampen that growth.

The U.S. economy is going to have a good year and because of that the stock market's downside risk for 2017 is seemingly no greater than that of an ordinary correction. However, the stock market is overvalued and overbought. From current levels, 2017 stock market return expectations should be muted. It is possible that animal spirits will push valuations higher, but that will simply be a bonus on top of what is expected to be a year with returns in the mid-single digits.



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