Market Outlook 2017

In last January's "Oil Wars" newsletter, while we underestimated the ultimate extent of the rebound, we correctly predicted that the stock market would rise sharply by mid double-digits from the corrective lows that kicked off 2016. Our forecast for 2,150 for the S&P 500 proved approximately 4% shy as the S&P closed the year at 2,238. The S&P 500, Dow Jones Industrial Average and NASDAQ Composite rose by 9.54%, 13.42% and 7.50% respectively for the year. In what proved to be a highly volatile year accentuated by a collapse in the price of oil, fears of a destabilizing devaluation of the Chinese yuan, BREXIT and Donald Trump's surprising election as our 45th President, the stock market proved amazingly resilient. Investors who stayed the course and bought the dip were handsomely rewarded, despite the unsettling turbulence.

As we also remarked last January, "volatility is the price we pay to own stocks in order to obtain such worthwhile long-term returns". While mounting pressure to chase the ongoing market rally should instill an upward bias for equity markets, unnerving Trump Tweets and the potential for policy disappointment should lead to continued volatility in 2017. Let's consider the factors that influence our 2017 market outlook and arrive at our annual prognostications.

Interest Rates and the Federal Reserve

Since November's election of President Trump, the yield on the ten-year Treasury has catapulted from 1.77% to a recent high of just over 2.60%. While the yield for this important "risk-free" benchmark has eased back to 2.37% and remains low historically and also low on an absolute basis, the percentage change in yield has been stunning. The move from 1.77% to 2.60% is an approximate 45% move higher. From the July 2016 BREXIT low in the ten-year Treasury at 1.36%, the move to today's 2.37% represents an approximate 75% hike in yield! Bond yield and bond price have an inverse relationship, stirring unprecedented volatility in the bond market and blindsiding safety-minded fixed-income investors.

As expected, the Federal Reserve boosted rates by 0.25% to 0.75% in December and telegraphed its intention to hike rates by quarter-point increments three times in 2017, two to three times in 2018 and three times in 2019. If this trajectory plays itself out, we would see the Fed Funds rate rise to 3% by the end of 2019. For the first time since the Great Recession of 2008-09, the stock market did not throw a tantrum with the prospect for higher rates and took the Fed's guidance in stride. We may finally have reached sufficient economic escape velocity to warrant a decoupling of stock market performance from the intended path towards interest rate normalization. At least for 2017, we expect the Federal Reserve will stick to its script and that baked-in expectation for higher rates will limit monetary-policy-induced-volatility. With inflation set to increase at a still subdued 1.6% annualized rate, the Fed seems poised to hand over the stimulus baton to fiscal authorities and temporarily run a "high pressure economy", as Janet Yellen suggested last October.

Global Economy

Prior to Trump's election, consensus forecasts for U.S. GDP in 2017 hovered near 2%. With the impact of potential fiscal reform more likely to become evident towards the latter half of the year, economists are gradually ratcheting up forecasts with the consensus now expecting U.S. GDP to reach 2.2% for 2017. There is increasing probability that the U.S. economy may actually reach at least one quarterly 3% spurt this calendar year, with even a few bold economists predicting the potential for a quarterly 4% handle on U.S. GDP. Economists have become so accustomed to the New Normal that the potential for lower taxes and reduced regulations to ignite accelerated growth may be overly discounted and not well understood.

However, there are a number of economic realities that may offset the potential gains to be had from Trump's pro-growth initiatives. Specifically, the recent rise in mortgage rates may have a cooling effect on the housing market; the surging U.S. dollar may weigh on U.S. exports; and Trump's propensity for protectionist rhetoric if not outright policy action is troubling. While an unwelcome spike in energy prices cannot be ruled out should the economy run hot, we suspect that Trump's energy-friendly policies would result in increased U.S. fracking and subsequent supply that would keep a lid on price.

Meanwhile, our banking system is strong and perking up as rates move higher and the odds increase for less regulation; household wealth in the U.S. is at an all-time high; the all-important American consumer is employed, confident, spending and likely to benefit from building wage pressures; and the Fort Knox balance sheet of Corporate America is set to finally obtain the mother-of-all-tax-breaks and subsequent waterfall of repatriated cash. With this backdrop in mind, the next U.S. recession will have to wait at least another year or more as the Fed's anticipated rate hikes gradually close the gap between accommodation and restraint.

Perhaps more surprising, the rest of the world seems poised to experience healthier, albeit unspectacular growth in 2017. Recent economic reports out of Europe and China point to an uptick in GDP and even Japan is expected to emerge from its deflationary malaise this year. All in all, 2017 has the makings to be among the strongest, if not the very strongest, for the global economy since the current expansion began in 2009.

Corporate Earnings, Valuation and 2017 Forecast

The consensus earnings estimate for the S&P 500 now rests at $132.61 for 2017 and $148.30 for 2018. The potential for corporate tax reform and other Trump initiatives make it especially difficult to predict earnings for the year. For instance, a reduction in the corporate tax rate down to 20-25% is expected to add between $10-$12 dollars to annual S&P earnings. With the S&P 500 trading at 2,238, this bellwether index started the year trading at an estimated 2017 PE of 16.88x and a 2018 forward PE of 15.10x, very reasonable forward valuations given the economic underpinnings and prevailing low interest rate environment. With full year 2016 earnings expected at $118.07, the S&P 500 likely closed the year with a PE just under 19, an arguably stretched valuation if not for the coming fiscal stimulus. If valuations do not expand and we apply the same 19 multiple to our forecasted 2017 and 2018 earnings, we arrive at hypothetical targets for the S&P 500 just north of 2,500 for 2017 and 2,800 for 2018.

Our base case for 2017 is that the S&P 500 will reach the 2,500 plateau, an approximate 12% gain from year-end levels. With the potential for meaningful tax reform, it is possible that S&P earnings are even higher than the current annual consensus, increasing the possibility that the S&P may trade to even higher levels. As illustrated in our recent e-mail distribution, euphoria has been notably absent from the ongoing bull market. In fact, the losses were so severe during the 2008-09 bear market that a vast majority of investors have become emotionally anchored to that experience and simply do not trust what has become one of the longest bull market runs in history. The outright fear and pessimism that marked the market bottom in 2009 has the propensity for turning into the greed and optimism that will eventually signal the market's top. In the weeks since Trump's election, the markets have turned decidedly higher and it feels like the animal spirits are stirring once again. While we see 2,500 as a reasonable target for the S&P, we would be delighted if the market were to correct some of the initial Trump enthusiasm, thus providing investors a wonderful opportunity to again buy the dip.

In reviewing the consensus 2017 targets for the S&P 500 by Wall Street's clubby analyst community, we can't help but notice the penguin-like clustering of predictions around the 2,300 level for the S&P, implying a scant 3% target for the year. While it remains entirely possible that we have become too bullish in our outlook, perhaps the most important lesson to be learned by 2016's BREXIT and election of President Trump is to be very weary when the consensus outcome seems so ironclad.