2016 RECAP, 2017 OUTLOOK JANUARY 2017

2016: Fear, Greed, and Bad Forecasting In Between

Last year began with the worst-ever start for the stock market and ended with a yuge rally. Further proof was established of the adage that economic and market forecasting exists to make astrology look respectable, as the markets reacted in the opposite manner than what was predicted after the surprise Brexit and U.S. election results. The memorable market extreme will be the mid-year continued plunge in interest rates, despite the Fed's efforts to increase them. Interest rates overseas fell even more, with Swiss government bonds maturing in 48 years having a negative yield. An investor buying at those levels would pay over $2 million now to get $20,000 in annual interest and only $1 million back in 2064. If you know of anybody that bought one of those, please give them my card; I think I can help.

U.S. economic figures continued to lurch forward throughout the year, and markedly improved at the end. Home prices in major metropolitan areas have surpassed the peak from 10 years ago (although not on an inflation-adjusted basis), unemployment has fallen to a level that is about as low as it ever gets, and consumer confidence hit the highest point since before 9/11. This is all good news, but investors' short memories are already on display. In fact, according to the Wall Street Journal, house flipping is back. The number of flippers is the highest since 2007 and the big crisis-era banks are lending to companies that then lend to flippers. Some of the investors are getting loans worth more than the home value and underwriting requirements have been loosened to avoid getting a W-2 earnings statement. The best part is that the banks claim to be protected from big losses because their loans are backed by pools of securitized loans, thereby sheltering them from the bankruptcy of the borrower. I'm not making this stuff up.

POSSIBLE ECONOMIC ISSUES FOR 2017

The expectations have been set high for the economy shifting into a higher gear in 2017. If the much-discussed infrastructure spending looks to move forward and corporate and personal tax cuts are enacted, then all things being equal, the economy probably will pick up the pace of growth. A potential hurdle is that fiscal stimulus like infrastructure spending tends to take time to get going, so there could be setbacks if doubts creep up in the interim. In hindsight, an unintended consequence of the years of low interest rates seems to be that it caused companies to choose to buy back more stock than they normally would have instead of spending the money to try to make more money in the business. Now that the Fed has raised rates a second time, and economic conditions appear more likely to continue to move forward, thereby causing further rate increases, it is assumed that companies will shift their capital allocation back to financing more new projects. A textbook response to having a company being able to get a cheap loan is that it would take it and spend the money on something that could help it grow. What seems to have happened after the Credit Crisis is that since rates stayed lower for longer than most people predicted, it drove asset prices up and reduced forecasted investment returns to levels that were below what people were used to using as a required minimum to pursue a project. These corporate hurdle levels weren't reduced because no one thought that interest rates would be depressed for so long. Therefore, companies didn't invest in certain projects that could have generated returns, albeit somewhat lower, but alternatively chose to buy back and retire stock so that they could generate still-decent guaranteed returns. If interest rates do continue to increase, then we could end up seeing a large amount of corporate expenditures that could propel the economy into a new phase of growth.

POSSIBLE INVESTMENT MARKET SCENARIOS FOR 2017

As has been the case since sometime around 2013, the U.S. stock market is trading at a level that is above its average when compared to the profits the companies make. Fortunately, it's not at nosebleed levels like during prior periods of market mania, and if interest rates continue to remain below average for a few years, then above average stock valuations would be expected. To make this point, in a spring interview, Warren Buffett stated that if everyone thought that interest rates would continue to be zero for 50 years, the Dow Jones Industrial Average would be at 100,000 (it was approximately 18,000 at the time).

If the recent resurgence of economic growth data and consumer confidence continues, then there's a good chance that the stock market won't return to average valuation levels until right before the party ends and the next recession starts forming. This could possibly take several years to play out. For example, the market was already elevated in 1996 – that's when Greenspan uttered "irrational exuberance", but the economy and market kept going for three more years. In other words, just because the market indexes have been hitting new highs (which doesn't really mean anything) or because they are at above average valuations (which is far more important), it doesn't mean that they are doomed to implode right now. That being said, if the good times continue to roll, don't forget that a downturn will eventually occur, and the aging of the population, government debt and deficits, Social Security, and healthcare spending are brewing up a potential mother-of-all downturns in a decade or so.

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