Market Outlook 2018

The stock market enjoyed a stellar advance for the year, with the S&P 500, Dow Jones Industrial Average and NASDAQ Composite respectively climbing 19.42%, 25.08% and 28.24%.

With the S&P 500 having plowed through our 2,500 base-case target for 2017 and now only a few percentage points away from our 2018 target, it's time to dust off James' crystal ball and offer our market prognostications for the coming year. With U.S. household wealth at all-time highs, unemployment scant at 4.1%, GDP expanding at the fastest pace in a decade, inflation and interest rates muted, global economic growth seemingly synchronized and tax reform now set to turbo boost corporate earnings, it's hard not to be bullish about the overall fundamentals. That said, with the vast majority of stocks at all-time highs, the longest streak in history without even a 3% hiccup and valuations arguably stretched, it is tempting to wear our contrarian caps and consider how much of the good news is already baked into the market's cake.

Present consensus estimates for 2018 S&P 500 earnings stand at $146.78 and $161.95 for calendar 2019. At current prices, the S&P 500 trades at 20x 2017 earnings, a forward 2018 PE of 18x and a PE of 16.5x expected earnings for 2019. Especially looking out to 2019, despite the incredible march higher in the market, stocks seem reasonably priced *in a world where the ten-year US Treasury yield rests at 2.4%.* The pressing question of the day is how long Treasury yields can remain so low, especially in the wake of such fundamentally strong economic data. As long as we live in a world where safety is punitive (i.e. losing money safely), stocks will continue to warrant a bid and buying the inevitable dips will remain our friendly mantra.

We might be tempted to end our prognostications there and simply apply a reasonable PE of 18-20 on 2019 earnings and set our S&P 500 price target range at 2,900 to 3,200, a range that would deliver approximately 8% to 19% gains over the coming year or two. However, with the Federal Reserve set to hike interest rates at least three times in the coming calendar year while also navigating the Great Unwind of its massive $4.5 trillion balance sheet, our crystal ball becomes a bit cloudy.

To be sure, the Fed's highly accommodative monetary policy since the Great Recession has forced investors to climb the ladder of risk, chasing yield and return from the most obscure corners of the market. From the parabolic rise in Bitcoin to record inflows into emerging market and junk bonds, from the $10 trillion in global government bonds with yields below zero to the nearly 200 "unicorn" private start-ups valued north of $1 billion, from the $450 million sale of Da Vinci's *Salvator Mundi* painting to Tesla's ability to fund its precipitous cash burn with deposits for a vehicle that won't be available until 2020, investor appetite for risk has not been so glaring since the dot-com bubble of the late 1990s. There is little doubt that the driver behind this excessive risk taking is the Fed-engineered, punitively low level of interest rates. But what the Fed hath given, might the Fed taketh away?

While we don't view the current stock market highs on par with the aforementioned bubbles, it remains true that low interest rates remain a driving force behind today's buoyant valuations. Our recent white paper on interest rates (name of paper) presented the thesis that interest rates are likely to remain lower for much longer due to demographic trends, technology and innovation and the massive U.S. debt burden that acts as a built in defense mechanism against a rapid rise in rates. While our secular thesis remains steady, we also opined that the economy would likely become subjected to bursts of growth that might test our thesis and force interest rates higher on a cyclical basis. With tax reform now the law and the supertanker U.S. economy picking up steam, we may be set to enter such a cyclical period.

As the new Chairman at the helm of the Federal Reserve, Jerome Powell will have to walk an especially delicate tightrope to balance an economy poised to finally reach full escape velocity with investor (dare we say speculator) expectations that rates remain accommodative. Given today's low inflation, even though nominal rates remain historically low, the current rate hike campaign has been compared to previous rate hike campaigns that ended in recession simply on the basis of change in *real* interest rates. With the yield curve continuing to flatten, this argument bears watching and we will continue to monitor the extent to which the Fed's ongoing path to normalization becomes restrictive. As long as inflation remains so muted, the odds of a Fed-induced policy surprise seem low and Powell should be able to carry on in the Bernanke-Yellen tradition, patiently staying the course with normalization's glacial pace.

As a result of the Fed's Great Unwind ($300 billion rolling off the Fed's balance sheet in the coming year) and an anticipated $1 trillion annual deficit, it is estimated that Treasury's issuance of new debt will double in 2018 to $1.3 trillion. As we have discussed in previous articles, the global thirst for yield ought to keep demand steady for our debt, especially since interest rates throughout Europe and Japan remain in unchartered negative territory. With the ECB finally poised to follow the Fed's lead in reducing its quantitative easing campaign and the expectation that yuan stability in China may reduce our largest foreign creditor's appetite for currency intervention, we would not rule out a potential disruption in global demand for our debt just as supply is set to increase markedly.

Pensions and insurance companies ought to pick up at least some of the potential slack created by any slowdown in foreign sovereign demand. Meanwhile, Treasury Secretary Mnuchin's deregulation plans to change the Supplementary Leverage Ratio, excluding Treasuries and cash on deposit at the Fed from the calculation of required bank reserves, has the potential to unleash as much as $2 trillion of balance sheet capacity for U.S. banks to expand trading in the Treasury market. Finally, by limiting the amount of interest expense companies can deduct from their taxes, the new tax law makes it less attractive for corporations to issue debt. As a result, an anticipated reduction in new supply of corporate debt may lead to greater investor appetite for the increased supply of U.S. Treasury debt.
Our white paper and previous articles have pointed to the government's clear incentive to manipulate interest rates. It could not be coincidence that the combination of Treasury deregulation and the most significant tax legislation since the Reagan era will create massive new demand for Treasury debt as deficit spending and Treasury supply is set to increase. Robbing Peter to pay Paul, the baton to soak up supply is being passed from the Federal Reserve to banks and investors.

While the supply and demand equilibrium for Treasury debt seems to be shifting, the end result is that a material spike higher in rates does not seem to be in the immediate cards. We expect volatility to increase in 2018, perhaps significantly, and doubt very much that the record stretch without a 3% correction will last another year. Despite the scarcity of bargains available, we expect continued investor bias to buy the dips. Our target 1-2 year range for the S&P 500 at 2,900 to 3,200 seems reasonable, *as long as interest rates remain so subdued*.