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Weekly Market Flash

Our 2017 Investment Thesis

January 13, 2017

Our Annual Market Outlook will be published next week. Please find below the Outlook's Executive Summary.

- 2016 may earn a place in the record books as one of the strangest years in capital markets history. Very little that was expected at the beginning of the year happened, and much that was not expected came to pass as the year wore on. Risk asset markets lost their footing early with some data tremors from China, but soon channeled their inner Taylor Swift to "shake it off." Ms. Swift's imperative became, in fact, the mantra for the rest of the year. Britain decides to leave the European Union? Shake it off! Donald Trump shocks the entire world of political punditry with his out-of-right-field Electoral College Victory? Shake it off, and then party like it's 1929! Shaky Italian financial institutions were of no concern, geopolitical instability merited little more than a shrug of Mr. Market's shoulders. On the Friday before the U.S. election, the S&P 500 languished 4.7 percent below the all-time high set back in August. Two weeks later the benchmark index set four consecutive records (and has notched up another five since then). Meanwhile, volatility went and crawled under a rock: the CBOE VIX index, the market's so-called "fear gauge", plummeted to multi-year lows in the latter weeks of the year.

- Based on these developments, we see the market today as "priced for perfection." It's the opposite of Murphy's Law – if something can go right, it will. Much of the momentum pushing the market higher in the last two months of 2016 came, in our opinion, from the release of animal spirits – a giddy running with the bulls after the confines of a relatively narrow trading corridor for much of the previous two years. The notional rationale for the bull run was the putative return of fiscal policy as an economic stimulant after the total dominance by monetary policy for the past six years. Corporate tax reform and infrastructure spending were the lead acts in the fiscal playbill – the first expected to add a sizable jolt to corporate earnings per share, the latter to somehow find its way to improving real GDP growth. Unsurprisingly, the main beneficiaries thus far of the so-called "reflation-infrastructure trade" (or, in vulgate prose, the "Trump bump") have been financial institutions, along with energy, industrial materials and related sectors.

- Our main concern with the "priced for perfection" market is that many of the actual catalysts are anything but certain to happen. We are still one week away from the new administration's first day, and there remain far more questions than answers in terms of what the new economic agenda will be, how it will be implemented, and what will get lost or watered down along the way. Corporate tax reform, in our view, does make sense if done properly – lower the statutory rate and widen the base by getting rid of the Rube Goldberg contraption of loophole goodies. Unfortunately, companies love those loopholes, via which the average S&P 500 company pays an effective tax rate closer to the mid-teens than to the statutory rate. As for infrastructure spend: most of it would likely come through tax incentives to private developers rather than new public works projects, and it is not obvious that, even if there were a handful of shovel-ready projects that would offer attractive enough returns for private developers to act on, there would be a direct connecting of the dots to GDP growth. In short, we believe the market is currently overbought.

- Overbought, though, does not necessarily imply the onset of a sharp and protracted reversal. Our 2017 base case does not envision a bear market, mostly because we do not see compelling evidence of any kind of looming economic downturn. In fact, if one strips out the noise of the last two months and the ongoing kerfuffle around the incoming administration, very little appears to have changed in regard to the underlying economic picture. GDP growth turned up in the third quarter to a quarter-on-quarter 3.5 percent and is expected to come in somewhere north of two percent when the Q4 number comes out later this month (which would be a strong increase from the 0.9 percent growth rate of 2015's fourth quarter). Headline inflation is also expected to finally catch up to the Fed's target of two percent, while jobs data has us very close to full employment. Wages continue to outpace inflation, which could in turn provide further upward momentum to consumer spending, the dominant component of GDP. These are favorable macro fundamentals and, we think, should hold the bears at bay for some time yet. More likely, we think, could be another year of corridor trading, with stocks still facing valuation headwinds on the upside while not offering a convincing rationale for investors to sell off wholesale.

- Corporate earnings will have a substantial role to play in determining how much upside there actually is in a market where conventional valuation measures like price-earnings and price-sales are at decade-plus highs. The price-sales ratio, as we noted in a recent weekly commentary, is a rounding error away from 2.0 times, which in turn is not too far from the all-time high of 2.36 times set at the peak of the late-1990s technology bubble. Corporate sales will likely continue to face the resistance of a strong U.S. dollar – though the greenback's torrid pace has waned a little in the past couple weeks. At the bottom line of earnings per share, investors will be looking for double digit EPS growth to justify any kind of similar pace of price appreciation. But global demand, though arguably improved from where it was a couple years ago, remains below trend. At the same time, relatively weak business investment levels in recent quarters may limit operating leverage improvements that would shore up profit margins. On a fundamental level, at least, it is hard to make a convincing case for another year of double-digit growth in domestic stocks.

- In Europe, economic conditions steadily, if slowly, improved over the course of 2016. Real GDP growth in Germany for the year was the highest in five years. Deflation appears to have been avoided, and ECB stimulus measures will stay in effect until (at least) the end of this year. But the political situation in Europe is fragile and could be the source of further instability. Start with Italy, where a failed referendum late last year led to the resignation of Prime Minister Matteo Renzi. While the current caretaker government may last until the current parliamentary term ends in a little over a year, we can expect continued agitation from anti-establishment outsiders – notably the Five Star Movement – to keep earlier elections in play as a potential destabilizing variable this year. France and Germany are already going to the polls, and while the conventional wisdom still holds that (a) Angela Merkel will win her fourth term, and (b) Marine Le Pen will fail to garner enough support to win the second round and ascend to Versailles, conventional political wisdom has had a somewhat poor track record of late. At some point, whether this year or not, the patented EU approach of patching up problems and kicking the can down the road will reach the end of that road.

- China has been somewhat off the radar screen for a while, after all the drama around its currency devaluations in August 2015 and January 2016. Headline growth numbers mostly came in as expected last year, and the latent threat posed by a debt-GDP ratio still over 230 percent goes mostly unnoticed in the daily discourse. But the problems have not disappeared. Arguably the most revealing indicator of all not being entirely well in the world's second largest economy is the steady pressure of capital outflows, resulting in a decline in foreign exchange reserves from over $4 trillion in 2015 to just over $3 trillion now. The People's Bank of China, the central bank, has worked diligently to support the domestic currency through reserve sales (most of which consist of U.S. Treasury securities), but monthly outflows show little sign of abating. Meanwhile, the global economic fortunes of China along with other key emerging markets in Asia, Latin America and elsewhere hinge on the unknown outcome of potential protectionist policy coming out of Washington. It may be another volatile year for this asset class, where higher than average risks may not yield acceptably commensurate risk-adjusted returns.

- Along with the crazy spikes in financial and resource stocks late last year, soaring bond yields were the other notable talisman of the "reflation-infrastructure" trade. Both the 2-year Treasury note, a ready proxy for monetary policy expectations, and the intermediate 10-year note are comfortably at their twelve month highs, and the 2-year yield is higher than it has been at any time since 2009. Of course, one of the iconic images for 2016's quirky scrapbook is the all-time low set by the 10-year yield in July (all-time low meaning "since the American Republic started issuing its own debt in the late 18th century" low). We do not expect to be revisiting that multi-century accomplishment anytime soon, and think it likelier than not that the secular bond bull that began in 1982 is close to its final days. Fixed income portfolios will likely be challenged in 2017. That being said, though, and notwithstanding expectations of multiple Fed moves this year, we do not see bond yields moving towards historical averages any time soon (the average yield on the 10-year bond over the past thirty years, for example, is 5.1 percent). As we noted above, economic conditions still appear not remarkably different from how they looked one year ago. The secular stagnation theme that many observers summarily discarded in the immediate aftermath of the Trump victory has not, in our view, lost its usefulness as a way to explain the lackluster pace of organic economic growth. However challenging, fixed income will continue to be a necessary component of diversified portfolios for risk management and income purposes.

- In summary, while we have profound concerns about how markets will evolve over the coming years – concerns we elaborate in more detail elsewhere in our Annual Outlook – our base case for 2017 attaches a relatively low likelihood to either a robust bull market or the onset of a multi-period bear market. High valuations will continue to rein in upside growth, according to this view, while the macroeconomic climate continues to slowly improve and corporate earnings should at least stay modestly positive, providing support against sustained drawdowns. However, we do regard our base case view as subject to a potentially more volatile dose of X-factors than normal, and the actualization of one or more of these unknown variables could profoundly impact our assumptions and cause us to reevaluate our expectations. We don't expect a massive trade war to send the world back into nation-state fortresses of closed economies, for example. But merely having to articulate that this is a not-totally-out-there possibility raises the mercury on our X-factor measuring stick. Things that have simply not mattered much to markets in recent years – geopolitics being an excellent example – may force themselves back onto investors' radar screens with real consequences. Our recommendation is simply this: plan for the likely, but imagine the unimaginable.

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