U.S. Equity Outlook: Markets in Transition

Jeffrey Saut, *Chief Investment Strategist, Equity Research,* weighs in on what a turning point in 2017 could mean for equity investors.

Winter officially began on Wednesday, December 21, with the arrival of the winter solstice. Recall that solstice means "standing-still sun;" and on December 21 at 5:44 a.m. (EST) the sun "stood still" over the southern Pacific Ocean at the Tropic of Capricorn. At that time, the sun's rays were directly overhead, giving the impression that the sun was truly standing still. No one is quite certain how long ago humans began heralding the solstice as a turning point, but a turning point it is: the sun sets a minute or two later each day from there until the summer solstice on June 21.

Similarly, the U.S. economy and the stock market appear to be at a turning point. Going forward, we look for improved economic growth, moderately higher inflation, a shift toward fiscal stimulus (although it is less clear what the policy adjustment will be), reduced gridlock in D.C., and a less divided government.

TRUMPONOMICS

While many worry about President-elect Trump's potential trade policies, we believe they will be much less austere than his pre-election rhetoric. However, a harsher trade policy should be more than offset by the upcoming economic stimulus and an improving economy.

The new administration will favour tax cuts, deregulation, infrastructure spending and potentially bigger budget deficits, which justifies the bond market's sell-off. The resultant steeper yield curve should mean the outperformance of the financial complex and the underperformance of stable/defensive stocks and bond proxies. "Trumponomics" should lift commodities, including energy, as inflation picks up at the margin.

MARKETS IN TRANSITION

While the economy is likely at a turning point, so are the equity markets. As we have been suggesting for months, it is our belief the equity markets are transitioning from an interest-rate-driven to an earnings-driven secular bull market. This should become increasingly evident in 2017. We believe we saw the "profits trough" in the second quarter of 2016, making quarterly earnings' comparisons going forward look favorable. We would add that if the president-elect is able to lower the corporate tax rate to 15%, it could add another $26 in earnings to the S&P 500. Even if he only manages to get the corporate tax rate down to 25% it would still add approximately $13 in earnings.*

We believe that we are moving into an environment where earnings are already improving and, with the positive equity environment, we expect them to appreciate further and have tilted portfolios accordingly.

CORPORATE TAX RATE AND EARNINGS

TAX CUTS COULD MEAN INCREASED EARNINGS TO THE S&P 500.

LOWERED TO **15%** COULD ADD **$26**

LOWERED TO **25%** COULD ADD **$13**

*Source: Thomson Reuters

Speaking to an earnings-driven stock market, we agree with Richard Bernstein of Richard Bernstein Advisors. He states that the earnings forecast for the S&P 500 (ending June 2017) is roughly $115, with the current S&P 500 price-to-earnings multiple about 24x. "If history were to repeat, then the multiple could compress by two multiple points during that period, which would give one an expected S&P 500 level of about 2,500 ($115 x 22 = 2,530), or about 20% expected return."

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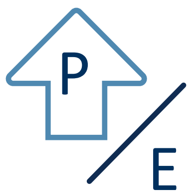
PRICE-TO-EARNINGS: COMPARING MARKET ENVIRONMENTS

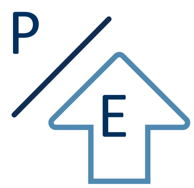
With falling interest rates, investors are more willing to expand their investment time horizon – and price-to-earnings multiples expand – due to fewer shorter-duration investments offering competitive returns.

INTEREST RATE-DRIVEN MARKET
(FALLING INTEREST RATES)



PRICE/EARNINGS
MULTIPLE EXPANSION

EARNINGS-DRIVEN MARKET
(RISING INTEREST RATES)



PRICE/EARNINGS
MULTIPLE CONTRACTION

MARKET LEADERSHIP

Because the equity markets are undergoing a transformation or turning point, investors should expect a change in the market's leadership. For months, we have opined that this leadership shift favours small-capitalization stocks, emerging markets, capital goods, industrials, healthcare, technology and financials. This implies that, in a rising interest-rate environment, commodities and industrials (machinery, steel, mining and energy) should be overweighted in portfolios. Healthcare remains interesting, despite its post-election rally, because it still has decent upside to get back to the valuation levels attained in 2015. Additionally, companies with significant amounts of cash offshore could benefit if the new president can actually manoeuvre repatriation tax legislation into existence.

The quid pro quo is that the interest rate-sensitive sectors (bond proxies) should be underweighted. We have also counselled that low-volatility stocks, or defensive names, have been driven to historically expensive valuations and consequently should be reduced in portfolios. Other potential casualties could be industries that benefit from large government subsidies. Even the FANGs (Facebook, Amazon, Netflix and Google) could suffer due to their expensive valuations. To wit, as economic growth increases, it should bring stronger earnings growth to a broader base of companies with, potentially, a concurrent contraction in the FANG's "growth premium."

BULLISH ON EQUITIES

The equity markets have rallied hard on the belief in a pro-growth administration, reduced regulation, lower taxes, increased infrastructure spending, a reset on trade toward the benefit of American companies, and the reflation trade. If this optimistic scenario comes to fruition, the Penn-Wharton Budget Model targets between a 1.1% to a 1.7% increase in GDP growth beginning in 2018. If true, GDP growth could ramp to approximately 3%, suggesting

SECULAR BULL MARKET

"If past is prelude, we should have another seven-plus years in this bull run."

CYCLES LAST	COMPOUND AT	ANTICIPATED
14-15	**16%**	**7+**
YEARS	PER YEAR	YEARS REMAINING

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stocks are not all that expensive. Verily, we have never wavered on the belief that we remain in a secular bull market. Such bull markets typically last for 14 – 15 years and tend to compound at around 16% per year. If the past is a prelude, we should have another seven-plus years in this "bull run." Will there be pullbacks? Of course there will be, but pullbacks should be viewed within the construct of a secular bull market.

DOW THEORY

Dow Theory is the interrelationship between the Dow Jones Industrial Average and the Dow Jones Transportation Average. We are one of the last practitioners of Dow Theory after the passing of our friend Richard Russell (Dow Theory Letters) last year. In the final analysis, what has happened is that the Dow Jones Industrial Average broke out to the upside in the charts from a 14-month consolidation in July of 2016. In the process, it registered a Dow Theory "buy signal." Dow Theory is not always right, and it is subject to interpretation, but it is right a lot more than it is wrong.

DOW JONES INDUSTRIAL AVERAGE

DOW THEORY'S PRIMARY TREND = EQUITY MARKET IS UP

Source: Yahoo Finance and Raymond James

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