Seeking Alpha α

My Outlook For 2017

Dec. 30, 2016 10:01 AM ET113 comments
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Summary

- The dividing line between a bullish and bearish outlook for 2017.
- Comparing the short-term positives with the short-term negatives.
- Comparing the long-term positives with the long-term negatives.
- How do we position for the coming year?

In what has become a traditional year-end exercise, I sit down with a blank notepad and draw a line down the middle of the paper. On the left-hand side, I write down all of the positives that come to mind with respect to macroeconomics, as well as the fundamental and technical aspects of the financial markets. I write down all of the negatives on the right-hand side. I then identify whether each positive and negative is more relevant in the short term or long term. I define short term as the next quarter and long term as the next year. The short term impacts my trading strategy, whereas the long term impacts my investment strategy. Given how rapidly things change today, I see no point in building an investment strategy beyond one year.

In this process it is important to avoid confirmation bias, or the tendency to focus predominately on data that supports one's current outlook. This exercise would then serve no purpose. There is evidence to support both bullish and bearish narratives, but one side will undoubtedly win out over the other in 2017. I would prefer to be on the winning side, as it will pave the way to a more profitable year. As such, I welcome bulls and bears to highlight the positives and negatives that I have left out of this exercise, in hopes that a more collaborative process yields a more accurate outlook.

The Dividing Line

As our financial markets and economy are gradually weaned off of the medicinal drip of unprecedented monetary stimulus, investors seem certain that the transition to fiscal stimulus will be a smooth one, and that its impact will be equally as potent. We see evidence of this from the surge in stock prices since the presidential election, as well as in the recent rise in business and consumer confidence. Monetary policy was extraordinarily effective at inflating the value of financial assets, but it was clearly not as effective at strengthening the underlying fundamentals of the economy. Will fiscal policy be successful where monetary policy was not in dealing with the structural problems that plague our economy? In turn, will fiscal policy strengthen market fundamentals to the extent that it not only validates current valuations, but lifts them ever further to support a bullish outlook? This is what seems to be the dividing line between a bullish and bearish outlook for the broad market.

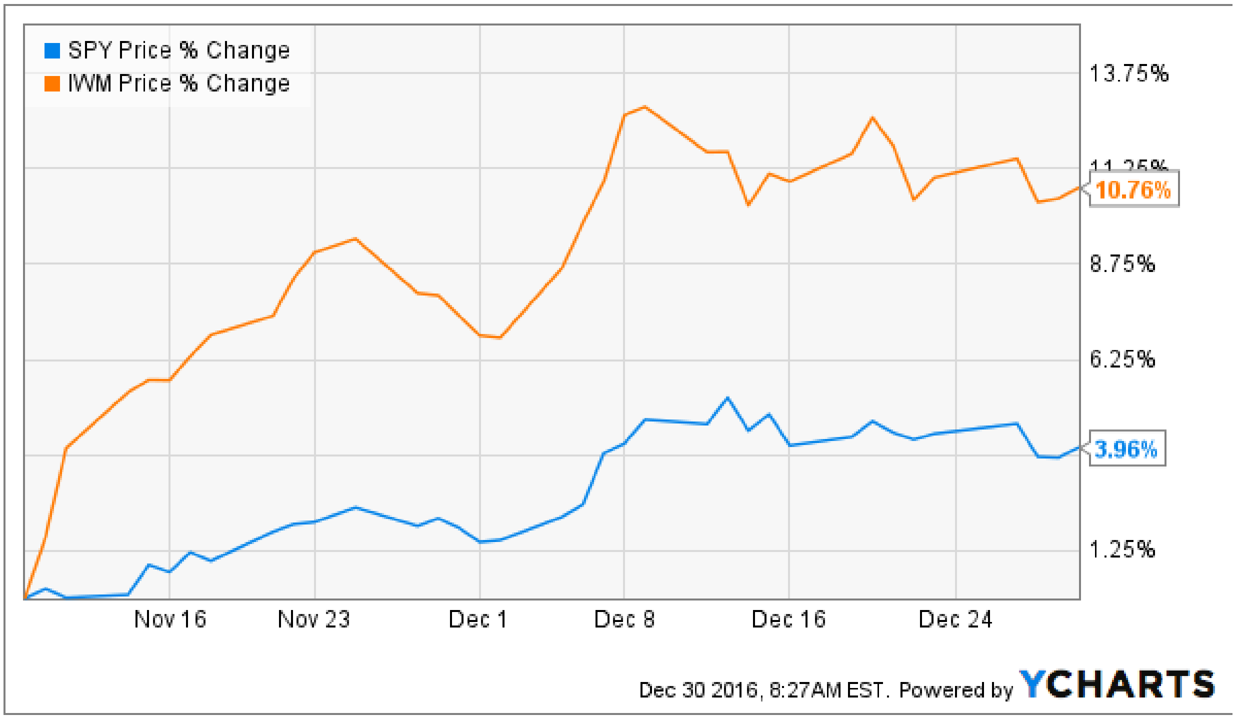
Short-Term Positives

The Trump administration has proposed a series of pro-growth initiatives that it asserts will restore the rate of US economic growth to a sustainable 4%. These proposals have lifted consumer and business confidence, as well as investor sentiment, with the hope that faster rates of consumer spending and business investment will follow.

What has followed is an increase in demand for risk assets, which has translated into higher stock prices, further strengthening the wealth effect that influences consumer spending. The combination of rising home values with higher stock prices has lifted US household net worth to a record $90 trillion.

The major stock market indices have achieved new all-time highs over the past two months, with the Dow Jones Industrials (NYSEARCA:DIA) closing in on 20,000. More importantly, the Dow Jones Transportation Average recently broke out and soared to new all-time highs, which for those who subscribe to Dow Theory, confirms the new all-time high in the Dow Jones Industrial Average and indicates a new bull market may be underway.

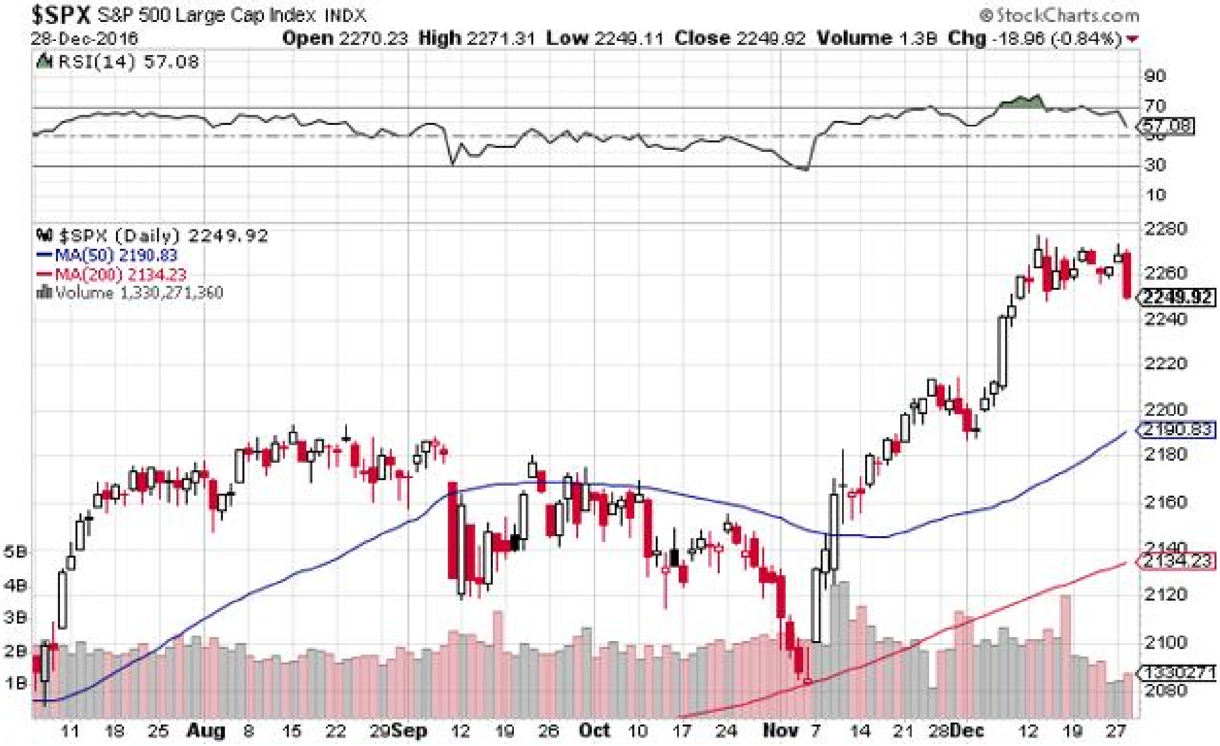
Additionally, the Russell 2000 index (NYSEARCA:IWM) has broken out to new all-time highs after underperforming the S&P 500 (NYSEARCA:SPY) for nearly three years. The recent outperformance by small caps has historically been indicative of a healthy market, as investors are willing to take on more risk by increasing exposure to lower quality companies.



So we have strengthening consumer and business confidence, improving investor sentiment and a series of significant break-outs and new all-time highs for the major market averages. All of these positives point toward higher prices in the short term. Yet there are also headwinds in the short term that can't be ignored.

Short-term Negatives

We need rising levels of confidence in order to see increasing flows of new money into the stock market, but too much too fast can lead to an overbought condition, which is where we find ourselves today. The S&P 500 was more overbought in mid-December than it has been since January 2011, as can be seen by the relative strength index momentum indicator, or RSI, in the top half of the chart below.



One reason for this overbought condition could be the dearth of sellers in the market as we approach the end of the year. Investors want to delay taking profits until next year, when they expect to be taxed at a lower rate on capital gains. This means that we could see significant selling pressure in January when profit taking ensues, which is a short-term negative.

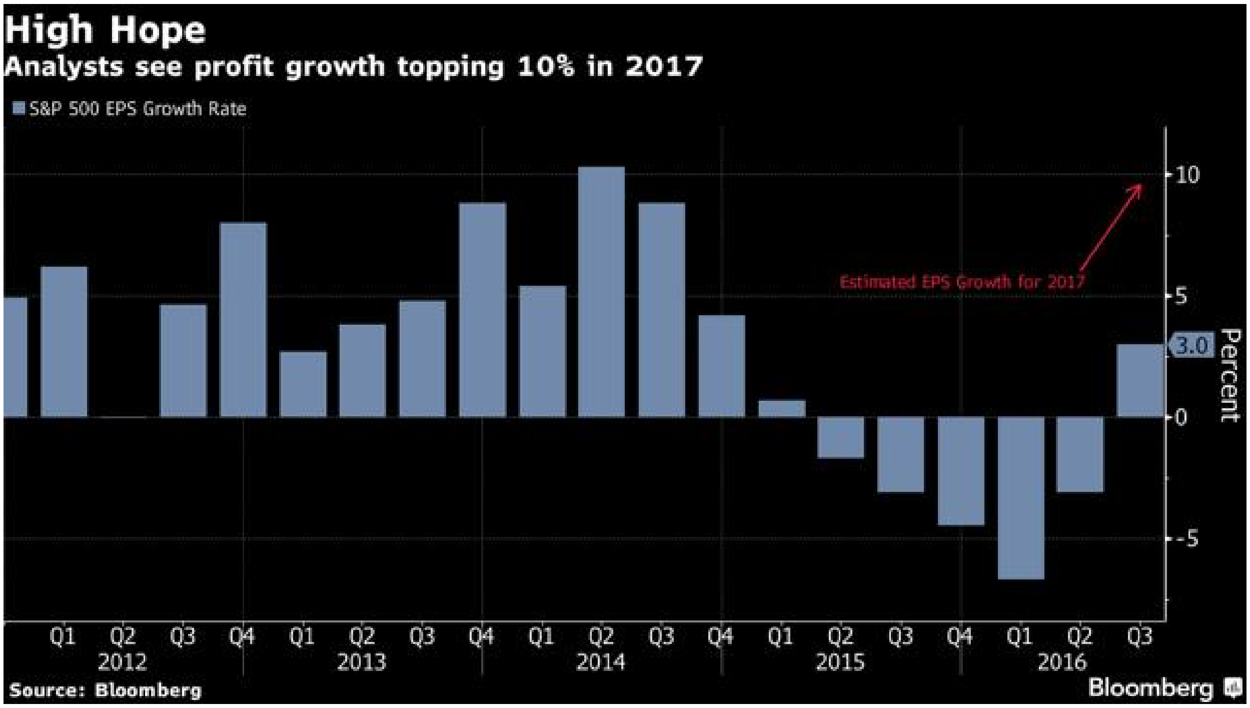
We also have extreme levels of bullishness in surveys like the National Association of Active Investment Managers, which is near its highest level on record, and the American Association of Individual Investors, which is well above its historical average. These are contrarian indicators, signaling lower prices in the short term.

What troubles me the most in the short term is the growing divergence we have seen between the S&P 500 index and the Goldman Sachs Financial Conditions index, which measures how loose or tight financial conditions are in the real economy. There was a very close correlation between these two indices up until the presidential election, but now they are moving in opposite directions. Making matters worse, the chart below is only updated through November 16. Since that time we have seen the S&P 500 rise an additional 70 points, while a stronger dollar and rising interest rates have led to a further tightening in financial conditions.

When I look at the battle between the positives and negatives in the short term, irrespective of my long-term outlook, it leads me to the conclusion that we will see lower prices. The market has discounted a lot of good news that has yet to be clearly defined or materialize. Therefore, I expect to see a correction similar to what we saw at the beginning of 2016. Whether or not this presents a buying opportunity for investors, as it clearly did last year, depends on one's long-term outlook.

Long Term Positives

The most significant development, which is positive for the market's long-term outlook, is that the profits recession has come to an end. S&P 500 corporate earnings rose on a year-over-year basis in the third quarter for the first time since the first quarter of 2015. Consensus estimates are for profits to rise 3.2% in the current quarter, followed by earnings growth of 11.5% in 2017. This would be a major step forward after three years of nearly zero earnings growth.



The upside to corporate earnings could be far greater if the Trump administration's tax proposals are enacted. Reducing the effective corporate tax rate to 20% could add as much as $10 to the consensus estimate of approximately $132 for the S&P 500 index. Lower tax rates on corporate cash that is repatriated from overseas could also lead to a continuation of the torrential pace of stock buybacks, if history repeats itself, which would lift the earnings reported on a per-share basis. Also serving as a tailwind to profits would be a reduction in regulations, which is likely to be the first step taken by President Trump when he takes office.

Trump has also proposed middle-class tax cuts. A tax cut that increases disposable income for middle-class households would be more stimulative to real economic growth than any other. This is because it would lead to a reacceleration in the rate of consumer spending growth. It would also lead to faster rates of corporate revenue growth.

Lastly, there is broad consensus that some form of infrastructure spending needs to take place to stimulate the economy. Regardless of whether this is financed by the private sector or the federal government, it will be an additional stimulant to the rate of economic growth and corporate profitability.

The tsunami of fiscal stimulus being proposed, if enacted, would inevitably lead to higher interest rates and a stronger dollar. Higher interest rates would result in more outflows from bond funds and other types of fixed-income securities that don't have maturity dates. Some of these flows would move into the stock market, fueling even higher prices. A stronger dollar also gives foreign investors another reason to buy US stocks.

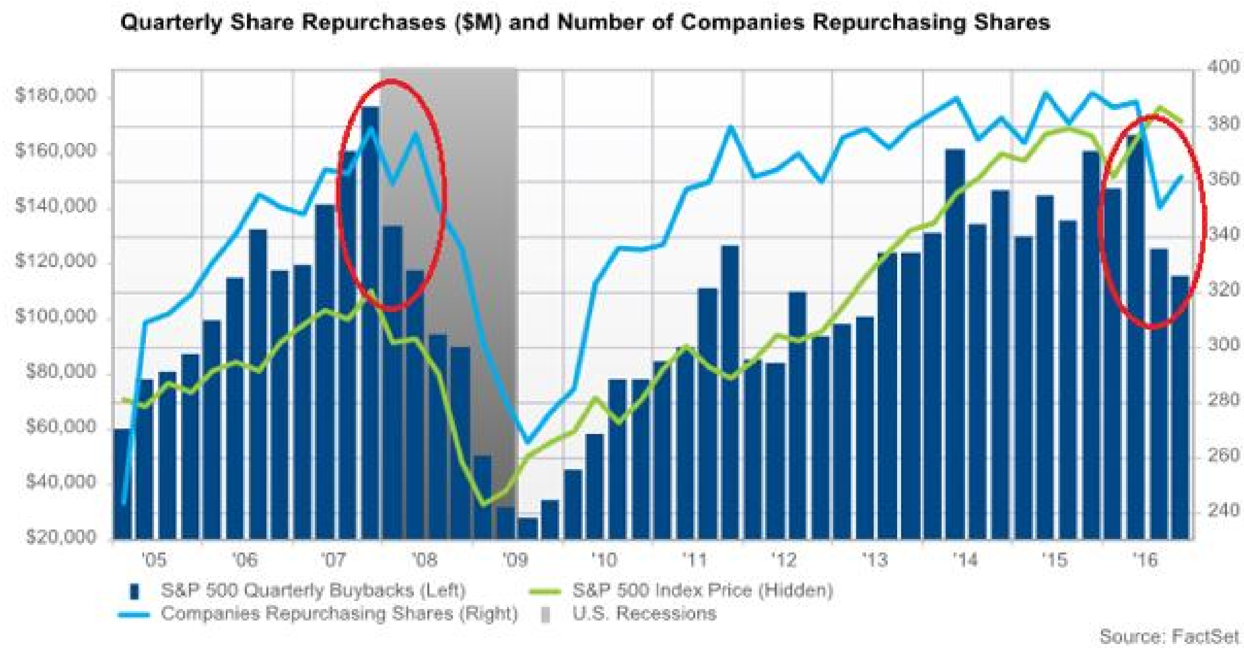
This is a powerful lineup of catalysts for a bullish market outlook in the year ahead, but it is important to recognize that what transpires, should it transpire, will likely be very different than what has been proposed. There are also headwinds that oppose each of these tailwinds, which need to be considered.

Long-Term Negatives

What concerns me on the macroeconomic front more than anything else is the steady decline in real incomes, as measured by average hourly earnings, over the past two years. This is the fuel that drives consumer spending, which accounts for two-thirds of our economic output. If tax cuts are enacted that don't offset this decline, especially if fiscal stimulus stokes inflation, then we will not see faster rates of economic growth. Nor will we see a double-digit increase in corporate earnings.

Additionally, if fiscal stimulus leads to tighter financial conditions through increased borrowing costs and a stronger dollar, it will reduce corporate profitability. Our export growth will slow and US products and services will be less competitive overseas. It will also make it more expensive for middle-class households to buy cars and homes. Coca-Cola (NYSE:KO) has forecast that the rising dollar will reduce its pretax profit by as much as 9% next year. Cisco Systems (NASDAQ:CSCO) reported during its latest earnings call that it is seeing weakening demand due to "incredible currency headwinds."

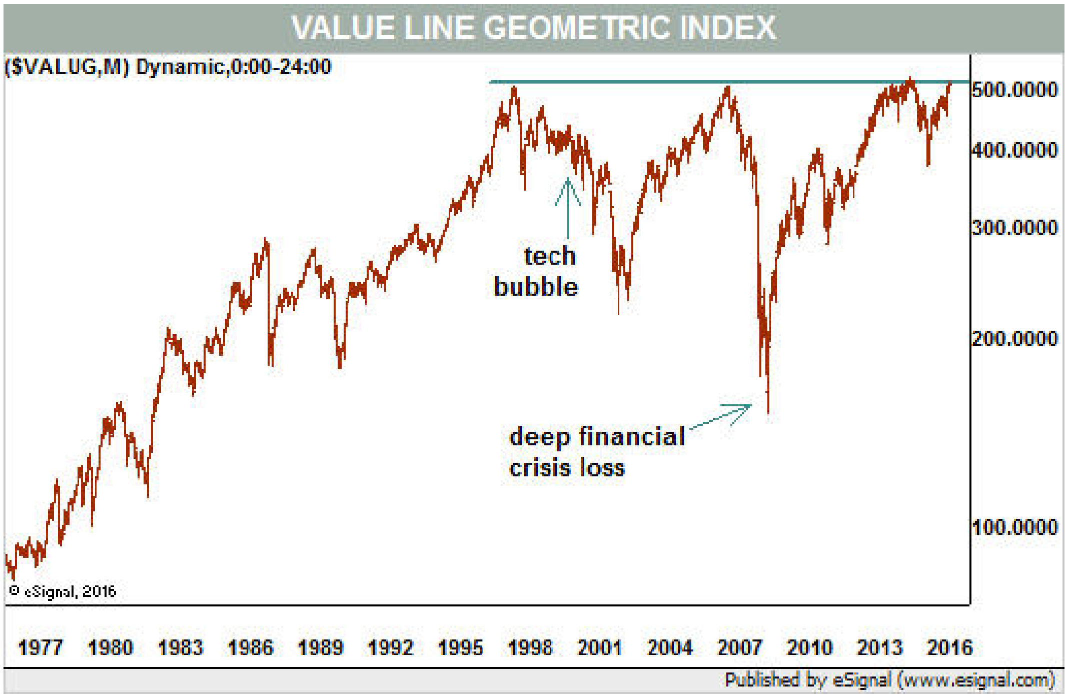
Tighter financial conditions could also be playing a role in the slower pace of stock buybacks. It is important to remember that corporate America has been the most influential buyer of US stocks for several years now, and a slower pace of buying could be a significant headwind for the market next year.



The percentage of companies in the S&P 500 that are employing buybacks to shrink their outstanding share count on a year-over-year basis peaked at 65%, which is the same peak percentage we saw in 2007. Now it is declining along with total shares repurchased and the number of companies that are purchasing.

We also need to be cognizant of the rising debt and deficit levels that will accompany Trump's pro-growth initiatives. There will be members of his own party that will vehemently oppose further debt-induced spending, and a battle over raising the debt ceiling again is inevitable. Consider the fact that household, corporate, Federal and state/local debt has increased by more than $2 trillion over the past year, whereas the size of our economy has grown an approximate $450 billion. We are drowning in debt, which will continue to be the most significant headwind to growth in the future. A rise in market interest rates will exacerbate that headwind.

On the technical front, there is still one chart that give me pause. The Value Line Geometric Index is an equal-weighted index of the 1700 stocks that Value Line analyzes. As such, it emphasizes median stock performance rather than average stock performance, and it has been unable to break above the overhead resistance it met in 1998, 2007 or 2015.



Lastly, there is the issue of market valuation, which is extreme by any measure. The Russell 2000 index is by far the most absurdly valued index, with earnings having declined at a 7.8% annualized rate over the past five years, while the index value has nearly doubled. It is also important to note that the price-to-earnings multiple for this index is advertised at 46 times, but in order to arrive at that figure, one must exclude all of the companies that have no earnings. Including them leads to a P/E multiple well over 200.

One of the oldest, as well as most accurate, valuation systems is provided by Value Line. It reports each week what is known as Value Line's Median Appreciation Potential, or VLMAP, for the 1,700 stocks it follows. This number is the median price appreciation potential over the next three to five years for all of the stocks in its universe. It currently stands at 30%, down from 40% just one month ago. This doesn't sound like a bad return over a four-year period, but the figure is always overly optimistic. What makes it relevant today is that it is lower than it was in October 2007, and has rarely ever been lower. It was as high as 185% in March 2009. Valuations tell us more about the potential for future returns rather than the likelihood of price declines, but in this instance it is clearly a headwind worth noting for the year ahead.

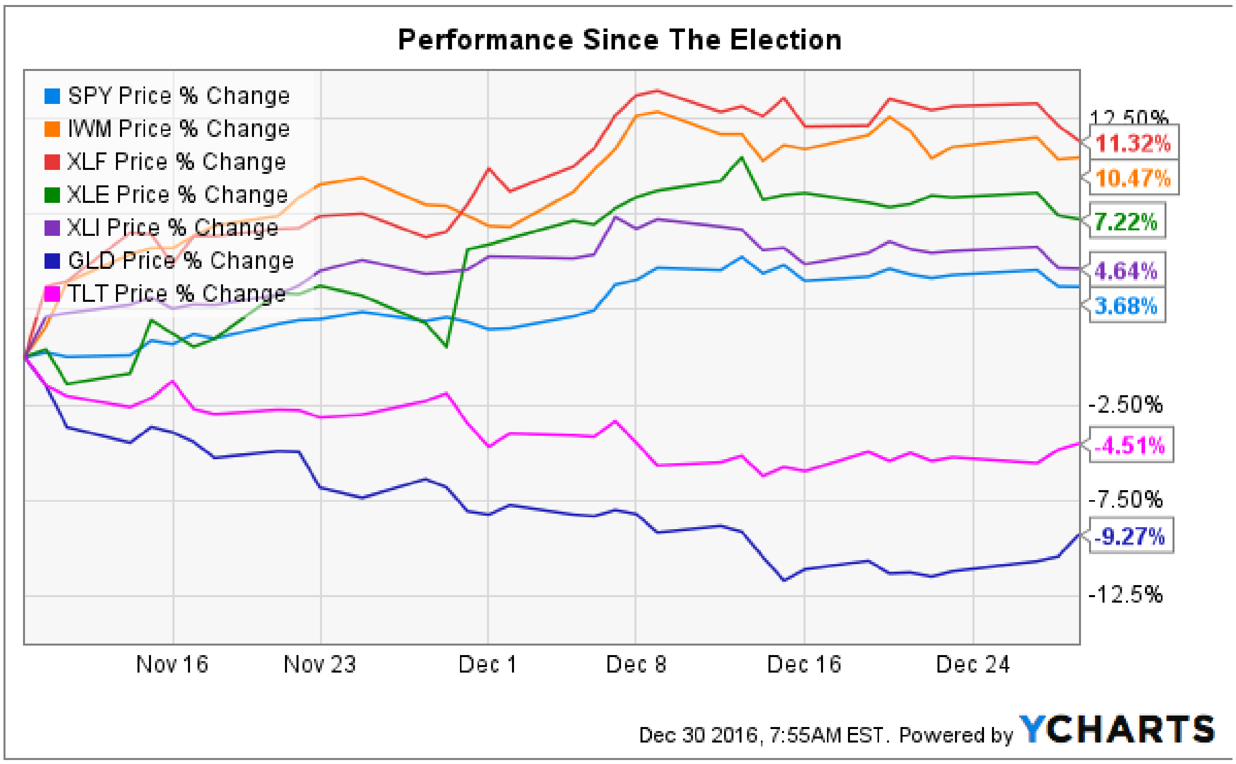
Conclusion

Economic expansions and bull markets do not last forever. They run in cycles. Regardless of how much monetary and fiscal stimulus is provided to manipulate and extend the natural progression of the business cycle, both inevitably end. I don't know if the current expansion and bull market will end in 2017, but both are undeniably long in the tooth.

While it is a tremendous challenge to accurately predict the direction of the market over the coming year, it is much less so to identify when the risks are increasing, or decreasing, from a long-term investment standpoint. Based on my assessment of the positives and negatives, the risks are substantial, while the potential for return is well below historical averages. I am speaking about the broad-market indices when I discuss risk and return potential.

Whereas the market looks extremely susceptible to a decline in the short term, the next 12 months are far more difficult to discern. It is entirely possible that a tsunami of debt-induced fiscal stimulus powers the economy and the market for another year or more. I think this is the less likely scenario, but it is one for which investors need to prepare.

What seems more likely to me is that we do see stimulus, but it is not a tsunami. The transition from monetary to fiscal policy is more disjointed than the market is currently anticipating. The recognition of this could be the catalyst for a correction in the market over the short term, and that is how I am positioned from a trading strategy standpoint. If stock prices decline, I anticipate that long-term bond prices (NYSEARCA:TLT) will rise and gold (NYSEARCA:GLD) will regain its luster. Those indices, sectors and stocks that rose the most since the election would be the most vulnerable to price declines, especially the Russell 2000 and the materials (NYSEARCA:XLB), industrial (NYSEARCA:XLI) and financial (NYSEARCA:XLF) sectors.



I also suspect that fiscal stimulus, primarily in the form of tax cuts, will have a greater impact on the stock market than the real economy in 2017. It depends on how the tax cuts are structured. As a result, fiscal policy may fend off a bear-market decline in the stock market for another year, even if the rate of economic growth does not rebound.

It would be a whole lot easier to forecast a price target for the S&P 500 at the end 2017, along with an estimate for earnings to substantiate it, but there are too many variables at play this year for me to have any conviction, so I will not pretend. I have suggested in the past that the S&P 500 could fall as low as 1575 in a bear-market decline, and I continue to believe that this is a reasonable downside target based on fundamental and technical factors. Yet the timing of when that might happen, should it occur, is impossible to determine.

Therefore, I am preparing for the worst, while hoping for the best, and remaining tactical in my investment strategy from a long-term investment standpoint, so that I can capitalize on whatever opportunities the markets present. This means maintaining lower levels of stock exposure, reducing position sizes and being more surgical in my selection of investment ideas. It also means shortening my time horizon on new investments and maintaining more liquidity than normal.

Let us hope that 2017 is a prosperous year for us all!

Disclosure: I am/we are long GLD, TLT AND SHORT IWM.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

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