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Stocks And Bonds - 2017 Could Be A Very Volatile Year

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Summary

- The huge bond correction.
- All-time highs in stocks.
- The Fed is likely to act often.
- Europe supports the dollar.
- Equities and debt in for a wild ride.

Many followers of the stock market held their collective breath as the ball dropped in Times Square on New Year's Eve. Stocks have been on a tear since the massive selloff that took equities lower by 11.5% during the first six weeks of 2016. In November, a Presidential election result that many pundits said would crater stocks turned out to turbocharge them. The Dow Jones Industrial Average came within a few points of a historic milestone, the 20,000 level and the other indexes posted impressive gains. The Dow was 7.94% higher in 2016 with the S&P500 adding 3.25% and NASDAQ gaining 1.34%. The gains were impressive considering where markets were on February 11, 2016.

Meanwhile, Bonds spent the first half of 2016 making higher highs then in July they suddenly turned south as the chances for a Fed interest rate hike loomed large. The 30-year Treasury bond closed 2016 with over a 10% loss.

Many market participants braced for big volatility on the first trading days of 2017 but as the market did all throughout 2016; it surprised and bucked the conventional wisdom once again. All of the pent up selling that was waiting for the New Year and lower tax rates did not appear last week leaving many, including yours truly, scratching their heads and wondering what is next for stocks and bonds.

The huge bond correction

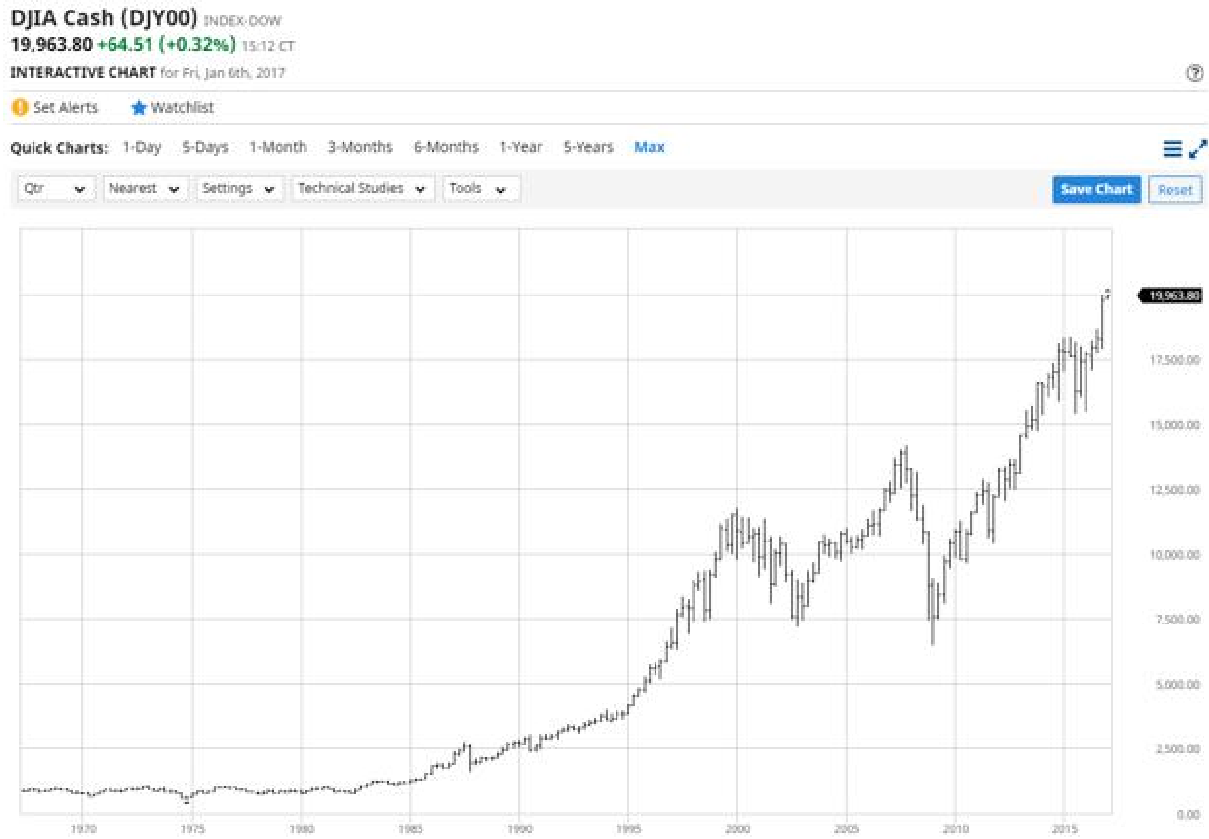
The rally in bonds was almost as long as my three and one half decade career. However, starting in July there have been some cracks in the armor of the bull market.

Source: CQG

As the weekly chart of the 30 year Treasury Bond shows, the government debt instrument fell from highs of 177-11 during the week of July 11 to lows of 148-04 in December. The move lower of over 16% was dramatic and bonds were a big loser in 2016 on a year-on-year basis. However, markets rarely move lower in a straight line and over the past two weeks the long bond has recovered to the 152 level. It is possible that the bond market will now wait for further action from the U.S. Federal Reserve on the short-end of the interest rate curve before resuming its slide. In any case, the price action in early 2017 has been a reversal of fortune for bonds which could turn out to be support of stocks.

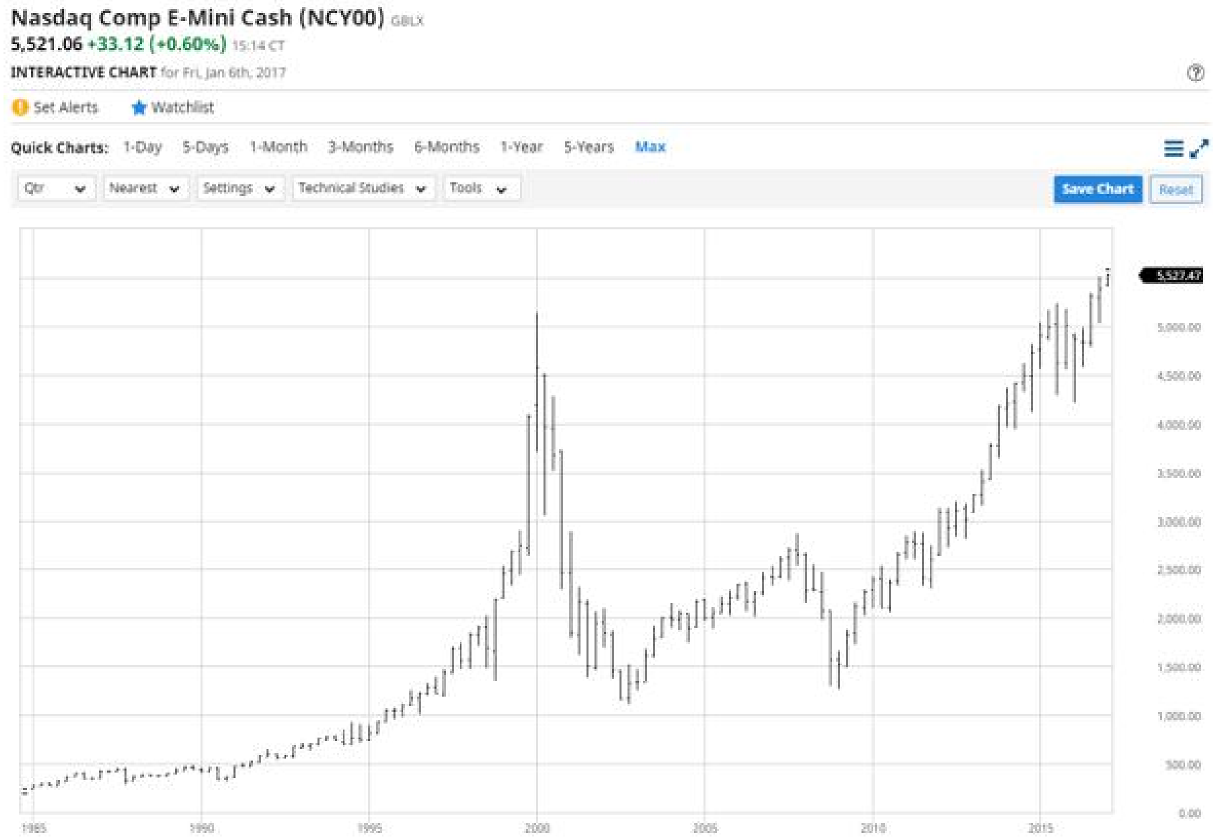
All-time highs in stocks

Stocks have moved into the New Year at the highest levels in history.



Source: Barchart

Unlike at the start of 2016, the Dow Jones Industrial Index remains very close to all-time highs at just under 20,000 at the end of last week. On Friday, the index came within 0.37 points of the milestone.



Source: Barchart

The NASDAQ was also at all-time highs at the end of last week.

Source: Barchart

The S&P 500 is also at its highest level in history. Meanwhile, stock valuations are also at historically high levels.

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Current Shiller PE Ratio: 28.16 +0.10 (0.35%)
4:09 pm EST, Fri Jan 6

Mean:	16.71	
Median:	16.05	
Min:	4.78	(Dec 1920)
Max:	44.19	(Dec 1999)

Shiller PE ratio for the S&P 500.

Source: http://www.multpl.com/shiller-pe/

At 28.16 times earnings, the S&P 500 equity valuations are at historically high levels. Meanwhile, equity prices keep chugging along to the upside albeit in dangerous territory.

The Fed is likely to act often

The U.S. central bank hiked the Fed Funds rate at their December 14 meeting for the second time in 90 years. The short-term rate now stands at around 63 basis points which is a historically low level. However, the Fed guided markets to expect three more 25 basis point rate hikes in 2017. It is likely that the bond market will wait to see if the central bank acts and it will not be easy for them to hike rates. Interest rate differential between the dollar and euro as well as other currencies are already wide and the dollar broke out to the upside in late 2016.

A stronger dollar is problematic for U.S. multinational companies as it makes U.S. goods in dollars less competitive on global markets. Like a game of dominoes, if the dollar rises too high it could damage earnings leading to a massive stock market selloff in 2017. The Fed must walk a fine line over the months ahead. On one hand they risk a runaway dollar and problems with U.S. corporates and on the other, they risk a spike in inflation as GDP begins to grow with the incoming administration.

President-elect Trump pledged the biggest infrastructure building project in the nation since the Eisenhower Administration in the 1950s. It is likely that the House of Representatives and the Senate will arrange for legislation during early days for the new President to fulfill his campaign promises to the American people. Rebuilding the roads,

airports, trains, bridges, tunnels and a security wall on the southern border of the United States will result in an increase in economic growth. The Fed is likely to find itself behind the curve when it comes to inflationary pressures on the economy. The central bank could face an ugly choice between inflation and a raging dollar.

Europe supports the dollar

Even without more rate hikes in 2017 the dollar looks pretty sexy when compared to the euro currency. Interest rates in Europe remain at 40 basis points and even long-term rates are sitting at historical lows across the continent.

Source: CQG

The monthly chart of the dollar-euro currency relationship displays a compelling bear market trend. The euro fell to the lowest level since January 2003 in December at $1.03675 but has since recovered to over $1.05. However, Europe continues to face issues that will keep their currency weak regardless of whether the U.S. increases rates or not in 2017. The ongoing immigration wave from Syria, Iraq and other troubled nations continues to increase rates of unemployment and terrorist threats. Negotiations surrounding the Brexit referendum of 2016 will cause uncertainty and pressure on the euro. Most importantly, elections in Germany, France and the Netherlands in 2017 could threaten the future of the European Union and if the elections of 2016 are any indication, the future of the E.U. is

anything but certain at this point.

Source: CQG

The monthly chart of the dollar index shows that the greenback broke out to the upside above 100.60 in November 2016. While the dollar is pulling back at the start of this year, the long term chart still shows that the path of least resistance from a technical perspective is higher. The prospects of a continuation of a rise in the dollar and increasing interest rates via Fed rate hikes in 2017 will spell wild volatility with a capital V for stocks and bonds in the months ahead.

Equities and debt in for a wild ride

While stocks sit comfortably at all-time highs and rates are still close to historical lows, it is easy to become comfortable and complacent with markets. Historically high equity valuations, a central bank with its finger on the rate hike trigger and the unknown of a new administration will eventually take a toll on the stock market.

All of the evidence is there for a very volatile year across all asset classes. The volatility in 2017 could make the variance in 2016 look tame by comparison. Market activity is a reflection of the political and economic events that take place around the world. The time is now to prepare for markets that are likely to present us with hair-raising moments in the weeks and months ahead.

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Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours.

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