**Market Commentary - January 2017** View this email in your browser

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# The Best and Worst Case for Stocks in 2017

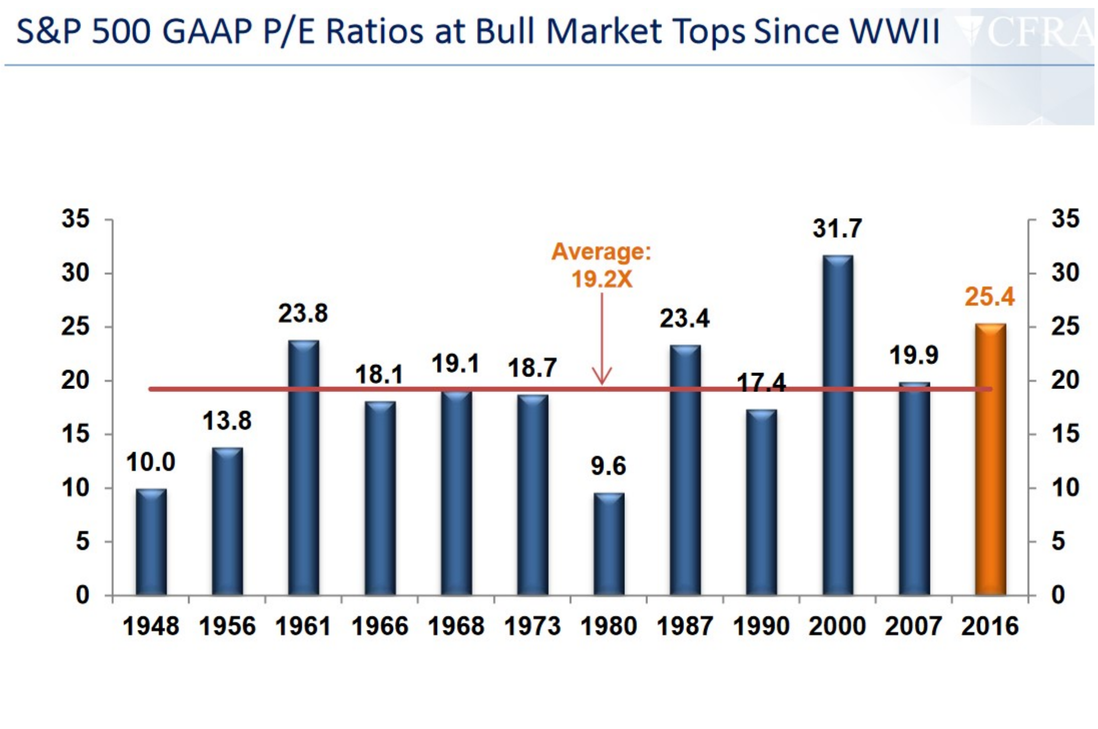
Predictably, with the start of each new year, market pundits forecast annual stock return gains of 10% for the year. Unfortunately, consistent returns of this magnitude are not possible. Therefore, our goal here is not to mimic other forecasters but rather to describe two very different scenarios for stocks in 2017--the potential best case and worst case for stocks.

**First, the worst case:** President Trump's huge spending programs could result in sharply higher economic growth but also cause much higher inflation, especially in wages. Why wage inflation? Our economy's potential growth depends on how many people are working, relative to the total workforce, and how productive they are. Recently, demographics (population trends) have turned negative in most developed countries. This change in the workforce population has served to make employees scarcer, and coincidentally productivity growth has been slowing since the late

'90s. **To offset this negative demographic trend, our economy will require much more productivity growth in the future or significant increases in wage inflation could result.**

The scenario described above would likely cause the Fed to raise (normalize) interest rates at a much more rapid rate than currently assumed. Rapidly rising rates could cause investors to aggressively sell bonds (higher rates damage existing bond prices) at greater intensity than we have seen since the election. And once established, a bond market rout could cause an inflation-driven bear market in stocks. In turn, the U.S. economy would likely experience a recession sooner rather than later. A lot of dominoes have to fall into place for all this to occur but it is not out of the realm of possibilities.

Also, keep in mind that stock valuations are already full. The following bar chart shows that **GAAP** P/E ratios are well beyond normal cycle peaks.




Source: CFRA, S&P Dow Jones Indices. Past performance is no guarantee of future results. Data: as of 12/9/16.

**Alternatively, in the best case:** President Trump's policies may produce more modest **non-inflationary growth** which could then accelerate corporate revenue and earnings. Today's 2017 profit growth estimates are already impressively high at 12% (although recovering energy companies account for a large chunk of this). What if anticipated 12% profit growth in 2017 actually turns out to be 15% growth because of a stronger than predicted economy and lower corporate taxes (not to mention a double digit earnings gain in 2018)? Additionally, repatriation of corporate overseas cash could lead to more share buybacks and higher dividend increases.

**Will these strong profit gains encourage investors to assign a higher P/E multiple to the market?** And if so, how much higher can the ratio climb? Bear in mind that each P/E multiple point increase will result in an approximate 6% price gain for stocks. Sharp earnings gains coupled with P/E multiple expansion could create an excellent year for stock prices.

**These two possible outcomes may seem extreme but investors should be aware of "tail risk" (unexpected, usually negative, outlier events) and how their portfolio would be impacted. Next year's economic and market news will probably fall between the two described scenarios as will investment returns. Although the prospects for the market have improved since the election, we continue to think the post-election market rally is based largely on hope, not identifiably improved fundamentals. Valuations remain rich. If/when the stock market corrects and Trump's policies and their beneficial results become clearer we may increase risk in portfolios but for now the preferred course is to stay conservative with a wait-and-see approach.**

# Other Key Issues For 2017

**Rising Interest Rates:** Rate normalization and a steepening yield curve will continue to pressure bond prices well into 2017. The 10-year Treasury bond yield rose from a low of 1.32% to 2.60% near year's end. While rate normalization is a healthy and necessary trend, large price declines could cause collateral damage across many markets.

**Corporate Credit Spreads on the Rise:** Just as interest rates declined to near record lows in 2016, corporate and municipal credit spreads compared to like maturity Treasury bonds were among the narrowest ever. Already high and rising debt loads combined with rising rates makes 2017 a higher risk timeframe across these markets. Should the Trump administration be successful in lowering individual tax rates as expected, municipal bonds yields will need to rise (prices decline) to offset the rate modifications. In our view, credit risk is a primary risk for fixed income investors.

**Growing Emerging Market Debt Instability:** Unsustainably high debt levels among emerging market corporations (and many governments) coupled with currently narrow credit spreads makes them a high risk investment offering little upside potential. Higher rates, a strong dollar and the pending unwind of Fed monetary policy (QE) could play havoc on these bonds.

**Continued Pressure on Commodity Prices:** While the second half of 2016 saw a modest recovery in commodity prices we believe they will remain under pressure for the next several years. Falling commodity prices are deflationary and particularly destructive to EM countries.

**Political Risk and Voter Disappointment:** A lack of progress on tax reform, infrastructure spending and/or the regulatory rollback promised by the Trump administration could quickly lead to frustration and disillusionment among voters and investors. Political risk (and the threat of ill-advised late night Twitter rants) will remain elevated for the next several years.

**Keep it simple in 2017. Eight years into the housing collapse and subsequent recovery, we are convinced that a conservative posture will serve investors best and this is especially the case with the bond market. Rising rates and the unwind of extraordinary Fed monetary policy (QE) makes continued discipline of great importance.**

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