Traub Capital Management 2017 Outlook

January 7, 2017

Introduction

In spite of tailing down in the last week of 2016, the US domestic equity markets had quite a run since November 8th. I suspect that everyone with any stock market assets is aware of the large rise since just before the election. Up to November 8th, the S&P 500 index for the year was volatile and showed a net gain of just over 2%. This small gain was in-line with our forecast made at the beginning of last year: that being for a low single digit gain. Since November 8th to year end, the S&P 500 is up about 7 1/2%. Add that to the 2+% gain for the first 10 months and you get a 9 1/2% gain for the year. Add in another 2+% dividend yield gives a total return of almost 12% and above our forecast. In spite of the higher return than we forecast, our typical client portfolio was well positioned with a substantial chunk allocated to equities. We still do, however, believe that there is more room to run. You can see more of the details for this belief in the following paragraphs.

Comment [S1]: The election was November 8th.

Understanding the 2017 Outlook

For 2017, the economic outlook continues to be reasonably good. We are projecting growth of the US economy to be over the 2.5% consensus opinion and a rise in earnings of the S&P 500 companies to reach the consensus earnings of $132 per share - a substantial 12% increase from the trailing earnings of $118 per share for 2016.

Four items count for most of the improved earnings picture. First is the increased price of oil. The oil price has risen from the lows of $25 per barrel to the current level of $53 per barrel. The increase in the basic oil price accounts for a substantial proportion of the profit improvement in the S&P500. For 2017, with the price of oil back over $50 per barrel, the S&P 500 energy companies are projected to erase the low earnings of 2016 and get back to the earnings level achieved in 2015 when crude oil prices last averaged over $50 per barrel.

The second factor for improved earnings would be the improved lending environment and the improved earnings of the financial sector. The prospect of somewhat reduced regulation of that sector going forward also portends some gain in earnings in 2017.

Third would be share buybacks. These buybacks are not completed yet, and they account for a shrinking supply of equities. A shrinking number of company shares outstanding will add to the improved earnings per share picture.

Finally, there is the improved economic picture, not only domestically, but also on the international front. Europe is beginning to pull out of its zero growth funk. The climate in Japan is improving. China has avoided the dreaded “hard landing” with growth of 6.5% in 2016. Growth will slow in China in 2017 on a percentage basis, but will remain very strong on an absolute basis since the overall economy of China is so much larger than it was just a decade ago. Prices for basic materials, such as aluminum, iron ore, steel and copper are trending up and that will help the economies of the emerging countries.

Where the equity markets will be at the end of 2017, however, is not based primarily on the outlook for 2017, since 2017 will be history by then. At the end of 2017, equity markets will be looking to 2018 and 2019. We expect earnings growth to be waning by then, but overall earnings should remain at a relatively high level – high enough to justify a higher value for the S&P 500. We do not foresee a large chance of a recession by 2018. A recession by 2018 would likely require something done to the economic picture that would be astonishingly dumb on the part of the country's leadership. In spite of many people not being enamored with Mr. Trump and some of the various things he has said, he has not yet done anything on the economic front that is detrimental. We certainly hope that continues. Not that consumer sentiment is a good indicator of economic expansion, but the consumer sentiment metric has definitely improved since Mr. Trump's election, so at least a lot of people think there is hope for good economic growth.

Interest rates will continue to rise as is widely anticipated, but the shape of the yield curve should remain positively sloped and sufficiently so, that banks will be able to make money in their "usual way". That is by borrowing short term funds at a low rate and loaning them out at longer duration for higher rates and pocketing the difference.

A positive interest rate yield curve generally portends a positive outlook for the economy. The balance of signs for the domestic economy is also good. Inflation is beginning to creep up, but it is still below the 2% target of the Federal Reserve. Unemployment continues to drop and overall employment continues to improve in the labor market. We are starting to see some wage inflation as the number of unemployed workers declines and employee demand remains high.

2017 Forecast

The stock market should move up a bit by the end of 2017 based on what is seen ahead for 2018. Our take is as follows. The major contributors for improved earnings in 2017 are the increase in oil pricing and the increased earnings from a better lending environment for the financial sector. We believe these are events that will play out in 2017, but whose big improvement will not carry forward for 2018. The average earnings increase for the other eight market sectors is 6% for 2017. Our estimate for domestic economic growth is 2.5% for 2017. We think that the interest rate increases in 2017 will dampen economic growth in 2018 to about 2%.

Generally, corporate earnings growth averages a bit more than overall economic growth, so we estimate 2018 earnings to be up about 4 to 5%. The equity markets follow earnings, so our forecast is for a mid-single digit increase in the overall equity markets. We have also seen fairly large stock buybacks from companies. With interest rates trending up and generally higher prices of their stocks, we expect to see lower levels of corporate stock buybacks. The buybacks have been helping to increase the earnings per share of the remaining stocks, and this avenue of earnings improvement is likely to be available for 2018, but as a diminished contributor.

We Do Not Expect to Be "Right"

Investing is not an exact science and if we knew for sure just where the markets would be, our investing program would be pretty easy. But, alas, neither we, nor anyone else for that matter knows for sure, so we need to position our portfolio investments based on both the mean value we foresee going forward as well as for the possibility of deviations from that mean value. We see a greater probability for returns to be somewhat above our mean value than for returns to be substantially lower than our mean estimate.

There are two factors that would lead to better returns. First, we could see a higher price/earnings multiple. Using trailing earnings as the denominator, today's P/E ratio at 20.6x looks high compared to the 10 year average of 16x. Using projected earnings as the denominator, today's P/E ratio of 16.9x looks somewhat high compared to the 10 year average of 14.4x. However, there is a mitigating variable in both comparisons and that is interest rates. The 10 year average yield on the 10 year Treasury note is 2.9%. Today, the 10 year Treasury note yields just 2.4%. Lower yield supports a higher earnings multiple and on that basis, with prevailing lower interest rates, a P/E ratio on forward earnings of 16.9x is not much out of line. It is also interesting to note that the correlation is not high when comparing P/E ratios at the beginning of any given year and the subsequent year equity return. Looking over the last 75 years, that correlation coefficient explains only 5% of the variance.

Driving the increased P/E ratio would be improving investing sentiment and positive flows of cash into the equity markets. This is a distinct possibility. In spite of the year-end rally and the overall pickup in consumer sentiment, investor sentiment has only returned to its long term averages of bullishness. A pick-up in sentiment would put more cash to work in equities. It would also flush funds out of bonds which would be amplified by the modest decline of bond prices we foresee due to the generally higher interest rate environment. Cash flows to bond investments have been strongly positive since 2009. The cumulative positive cash flow to bond investments during that time is about $1.5 trillion. It would not take very much of that flowing back to equities to boost equity values and P/E multiples.

Second, there is the Trump economic package. Virtually all the rhetoric on the Trump economic package is speculation. However, even if some of tax cuts or fiscal stimulus actually makes it into reality, the result, certainly in the short term, would be a plus for corporate earnings.

To be substantially below our mean estimate, the US equity markets would need to foresee a recession in the domestic economy, or there would need to be an exogenous negative crop up. Generally, the third or fourth increase in the Federal Funds Rate starts to indicate an overheated economic picture and an inverted yield curve where long term interest rates are below short term rates. An inverted yield curve gives banks an incentive not to lend money and leads to a slowdown in economic activity.

The Federal Reserve will probably get to the third and fourth increase in the Federal Funds rate early this year. However, the increases we have seen have been very small – in the range of ¼%. Those increases have actually helped make the yield curve a bit steeper as long-term rates have risen more than the ½% increase in short-term rates so far. So even a couple more increases of the short term Federal Funds Rate is not likely to result in an inverted yield curve, which is the typical culprit in triggering an economic slowdown or recession.

The most likely exogenous variable would result from the very large debt burden in China, which could trigger a financial crisis there. The ratio of China's debt has expanded to over 30% of its GDP and the country has implemented restraints on capital outflows. China has successfully dealt with debt at this level for several years, but it is not likely that it can do so forever. We do not expect a financial crisis on that front in 2017 or in 2018, but by 2019, it becomes increasingly likely.

The second most likely exogenous variable would be a collapse in the price of oil, which would have a major negative impact on the earnings of energy companies. At the close of 2016, OPEC has structured an agreement to lower the world's available oil supply by a percent or so. This supply constraint would bring oil supply and demand in to close balance and would provide a support for the current oil price of about $53 per barrel. Should the OPEC agreement fall apart, it would be possible to see oil back to $25 per barrel. As with the Chinese debt burden, we do not foresee this scenario playing out in 2017, but it is a small possibility.

The result of the probabilities is that we do not expect to meet our exact forecast. The actual returns should be higher in most scenarios and lower in a few. The uncertainties and their trigger points are larger this year than in the past and we cannot handicap those factors with great certainty. This means that our forecast "average" will most likely be wrong, but we will continue to monitor the economic scenario to make the right calls as the year progresses.

Portfolio Positioning

Fortunately, the positioning of your portfolio will not be substantially different if we foresee a small equity increase or a bit larger one- or even a small decline. We would continue to search for what we consider to be value stocks (or funds that own stocks) whose market price does not reflect the underlying value of those companies. We were fortunate this year to have identified many such opportunities, and there are still some out there, particularly among non-US, and emerging market equities, where the stock market gains have been more modest.

Conclusion

For 2017, the likely direction for the equity markets is up, and quite possibly up more than our forecast of mid-single digit returns on equities. The chance for a US recession to derail the equity advances is very slight and we do not foresee any exogenous factors that will cause a major impact. Your portfolios are positioned accordingly.

As always, we thank you for your continued support of Traub Capital Management and please do not hesitate to give us a call to discuss any of the above or to reflect how the current economic outlook impacts on the positioning of your individual portfolio.