2017 Stock Market Outlook: Why You Need To Be Cautious

By Ky Trang Ho
December 17, 2016

What do the major Wall Street players see coming down the pike in the New Year? Here are stock market outlooks for 2017 from seven strategists at some of the biggest investment firms, overseeing billions in client assets.

1. **Caution is Warranted**

By John Velis

Bulls argue the election outcome has changed the game for the better. Deregulation, cutting taxes, and an infrastructure investment program all herald a pro-growth scenario. Forward-looking measures of economic growth are trending upward after a couple years of so-so readings.

Volatility is low. The rise in bond yields is positive, signaling the end of deflation and higher returns to capital. Cyclical and inflation-related equities — energy (XLE) and materials (XLB), industrials (XLI), financials(XLF) have rallied hard. Earnings expectations for these sectors are strengthening.

*Traders work on the floor of the New York Stock Exchange (NYSE) in New York, U.S., on Monday, Dec. 12, 2016. (Michael Nagle/Bloomberg)*
Yet caution is warranted because markets are betting big on the best possible developments in fundamentals. First, it’s unclear what form the new president’s policies will take and how much his policies will be accepted by Congress. Trump’s program is slim on details and potentially worrisome.

Furthermore, there is an argument that the long-run potential of the U.S. and other major economies is structurally and historically low, capping any upside to growth from policy. It’s not positive for risky assets to have an economy generating rising inflation while also being constrained by low to mediocre growth.

The Fed would face a difficult choice between keeping monetary policy loose to support demand and tightening to quell inflationary pressure; it may become the object of political pressure in either scenario. Reckoning with these risks will act as a break on any market upside.

Finally, beware of analogies between 1981 and 2017 when stocks took off under Ronald Reagan. Interest rates were historically high and set to fall for several decades. The opposite is true now. Stock market valuations were orders of magnitude cheaper than they are now, too.

John Velis is vice president of Global Macro Strategy for State Street Global Markets with $40 billion under management in Boston.

2. The Stars Seem Aligned for a Positive 2017 for U.S. Stocks

By Andrew B. Wetzel, CFA

Investors believe that on balance, Donald Trump’s policies on tax and regulatory reform and infrastructure spending will lead to improved growth. This fits nicely with the trend in earnings and expectations for earnings growth in 2017. The seven quarters of year-over-year (Y-O-Y) declines in S&P 500 (SPY) earnings, which were largely driven by the energy sector, bottomed out in Q2 2016 and Q3 2016 saw earnings per share (EPS) grow by 2.75%. The current consensus expectation is that EPS for the S&P 500 will grow 12% in 2017.

Since the election, the market has quickly priced in the assumed winners and losers of the Trump era. Banks have rallied on higher interest rates and an expectation that the Dodd-Frank Wall Street Reform and Consumer Protection Act will be dismantled. Steel stocks (SLX) are up significantly on the idea that a Trump administration will limit cheap imports from China and South Korea. Engineering and construction stocks and associated construction equipment manufacturers have rallied on expectations that Trump will be able to push through a massive infrastructure package.

On the flipside, stable, high-yielding stocks in the consumer staples (XLP), REIT (VNQ) and utility (XLU) sectors have underperformed. Other recent assumed losers are technology (XLK), apparel
manufacturers and other companies that manufacture products overseas, as fears of a heavy-handed approach to trade relations begin to creep into the market.

If growth picks up too quickly in 2017, the Fed will have to become more aggressive with the pace of interest rate hikes. Higher U.S. interest rates and continued low-interest rates in other developed countries will likely lead to a stronger U.S. dollar. U.S. dollar strength would pressure overseas profits and create a headwind for emerging market economies.

All of this could derail the earnings growth investors currently expect in 2017 and higher interest rates, all else equal, should pressure valuation multiples, potentially providing a double whammy for U.S. stock investors.

The one piece of advice that has worked in the past is to beware of chasing hot trends. These only last so long. The yield trade turned in 2016. The Trump trade will likely see a countertrend move at some point.

Andrew B. Wetzel, CFA, is a senior vice president and portfolio manager at F.L. Putnam Investment Management Company with $1.4 billion under management in Wellesley, Mass.

3. The Only Certainty in 2017 is Uncertainty

By Michael Sonnenfeldt

The year will begin with a new administration as well as the likelihood of the rise of interest rates. Our nation’s fiscal policy, a key driver for the equity markets, has yet to be made known. But polling data suggests infrastructure spending to generate working class jobs is the single most important policy initiative expected by the electorate.

If taxes are reduced, and infrastructure spending is expanded, the deficit is almost surely going to rise, causing an increase in interest rates. Despite the opaqueness of the equity market unknowns, the fact of the matter is public equities have been falling out of favor with the high-net-worth for some time now, even as markets have risen to new highs since the election.

Our members’ investment holdings show that the aggregate allocation to public equities dropped by five percentage points this year, to 19% of total assets. This was before the post-election “bump.” This marks the lowest allocation our members have devoted to public equities since 2011.

The decline also pushes it from the second-most-favored asset class to third behind real estate (VNQ) and private equity. This is a notable shift downward, reflecting both a myriad of concerns about the
public equity market and, not coincidentally, a surge in relative attraction to both real estate and private equity.

Following the trends of our members, large and mega-cap stocks are also losing favor. One year ago, TIGER 21 Members skewed towards preferring large-cap stocks. But this year only 39% of members mentioned large and mega caps as making up the majority of their portfolios. Mid-cap stocks now make up 17% of their equity allocations.

Perhaps the biggest lesson of 2016, one which certainly carries over into 2017, is that there is no safety in safety. The traditional assets investors sought refuge in for predictable cash flow, dividends or distributions have all been bid up to the point where their returns are no longer considered as attractive or safe.

Still the fact remains that in a low-interest rate environment if you are trying to stay “even” by sitting on the sidelines and not making any investments, you are probably going backward on an after-tax, inflation-adjusted basis.

Michael Sonnenfeldt is founder and chairman of TIGER 21 with $45 billion under management in New York City.

4. Energy, Pharma, Defense and Materials Should Benefit From New Stimulus

By Humberto Garcia

As we approach 2017, we may be witnessing a generational shift of the pendulum away from globalization as nationalist fervor rolls across borders, and populist ideologues lead their political parties to power. This trend, experienced notably in the UK Brexit referendum and the U.S. presidential election, emerges from broader roots: World Trade Organization data show an increasing tendency and velocity toward trade restrictive measures worldwide.

In the U.S., the Keynesian embrace of fiscal stimulus as a solution to low growth could encounter headwinds as the two-toned flag of tax cuts and deregulation must withstand the countervailing forces of trade retaliation and a strong dollar, which may inhibit export growth.

Also, the pervasive short-term focus of boardrooms may lead companies to squander the corporate tax windfall on share buybacks and exuberantly-valued mergers and acquisitions. Peak market activity is already visible in deal multiples. And a cash infusion from the repatriation of capital could inflate valuations further. Tax policy should attempt to steer them toward business investment.
Domestically-focused sectors in the U.S. should benefit from the new stimulus, particularly energy (XLE), pharmaceuticals (PPH) and defense systems (ITA) and material providers (XLB). Construction (ITB) and basic materials equities should also get a boost, though the public infrastructure spend could hit a snag in recalcitrant deficit hawks. Still, today’s clarion call to “Rebuild America” drowns out yesterday’s cry against “pork barrel” spending. And the days of congressional backroom dealing and earmarking may not be gone.

Fixed-income markets have suffered from the expectation that fiscal spending will lead to inflation and higher interest rates. I am not altogether convinced that the full extent of fiscal spending plans will come to pass. I remain generally positive on bonds, diversified geographically but more in the U.S., with an increased focus on high-yield issues in favored sectors.

Finally, there is heightened tail risk amid the current political uncertainty and it makes sense to keep a modest amount of cash on the sidelines. Someone disabled the smoke detector in the high-risk assets room. So unexpected shocks may offer good entry points for investors.

Humberto Garcia is head of asset allocation at Leumi Investment Services Inc./Bank Leumi with $11 billion under management in New York City.
5. **It’s the End of the Beginning of the Global Economy**

By Bob Baur, Ph.D.

In 1942, Winston Churchill addressed the British House of Commons after the first Allied victory over Hitler’s forces during World War Two. To spur optimism, yet acknowledge reality, Churchill said, “This is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning.”

“The end of the beginning” is an apt metaphor to describe the current state of the global economy, which is in a mild, but synchronized, upturn. To begin with, the United States is only now emerging from a protracted recovery, which is the first phase of a business cycle. And with the U.S. embarking on the second phase, a sustainable expansion, we see several positives for not only the U.S. but also the global economy.

While surprising, the election of Donald Trump could mean boosts to growth from both fiscal stimulus and tax reform. The latter, particularly, could unlock the missing piece of the recovery up to this point, capital spending, particularly if U.S. companies can begin to repatriate offshore cash.

Question marks start appearing when we turn to Trump’s stance on trade. During the campaign, Trump assailed various trade deals and promised to add tariffs to Chinese imports. Any potential anti-trade action would have disappointing implications for China, the U.S., and emerging markets.

In China, we’re on the lookout for faster nominal growth with a limited fiscal stimulus. A more stable economy, easing deflationary pressures, and strong credit and money supply are all factors that bode well in 2017.

Europe and the UK have fared better than expected since the Brexit vote. Expect some uncertainty around the time Britain triggers Article 50 to begin the EU departure process. That said, the current environment suggests the Bank of England has finished its policy easing and could hike rates in 2017.

For the Eurozone, we expect growth to be around 1.5% for 2017, with some upside potential. The real hurdle for Europe will be from the political realm. A rise in Euro-skepticism could cause significant questions for the European project.

U.S. stocks have worked well for seven years and continue to do so. Watch for higher stock prices through the first months or half of 2017, and for U.S. stocks to outperform other world regions. In fixed income, sovereigns could struggle. So corporate credit could be attractive, even if yields rise a bit.

*Bob Baur, Ph.D., is chief global economist at Principal Global Investors with $380 billion under management in Des Moines, Iowa.*
6. **Difficulties are Ahead for 2017 and Beyond**

By Todd Moll

We are starting the year at price-to-earnings (P/E) levels that are above long-term averages and have historically shown muted equity returns. This recovery may likely be the longest on record. But we are certainly in the late innings. Investors should expect returns to be in the 6%-8% range for equities for the foreseeable future, but no recession on the horizon.

There may be short-term catalysts coming from tax cuts and infrastructure spending initiatives. But this will simply accelerate returns forward, rather than being a long-term secular (lasting) catalysts for future returns. Fiscal stimulus at a time when we are approaching full employment should be less impactful to the broad economy than if we were staring at double-digit unemployment.

While these fiscal stimulus initiatives may help stock market participants in 2017, balanced and fixed-income investors will find total returns difficult, as increases in inflation and inflation expectations would be the likely outcome of this stimulus. The rate on the 10-year Treasury note has made a huge move higher since the election, causing bond prices to fall. This is something many investors have not seen in a very long time. The possible reaction to this is somewhat uncertain.

*Todd Moll is chief investment officer at Provenance Wealth Advisors with $1.9 billion under management in Fort Lauderdale, Fla.*

7. **Cautiously Optimistic With a Defensive Posture**

By Michael K. Farr

The 2% average economic growth we’ve seen since the end of the Great Recession has been fueled by an unprecedented amount of monetary stimulus. Short-term interest rates have been held near zero for eight years. As one consequence, asset prices, to include everything from stocks to bonds to houses, have surged.

A $35 trillion increase in household net worth since 2009 has contributed greatly to the modest but consistent economic growth. Is it likely that investors will avoid any and all repercussions of Fed policy as it unwinds this unprecedented experiment?

The markets and the conventional wisdom seem to be telling us that fiscal stimulus, including tax cuts and increased spending on infrastructure and defense, will combine with a regulatory overhaul to propel the economy into the next gear. The bulls believe that these initiatives will be more than enough to
offset monetary-policy normalization. Liberated from crippling high taxes and regulatory burdens, they say, corporate America will be free to invest, hire and prosper. The prosperity will trickle down.

But here’s the problem with the conventional wisdom. Eight years of easy money have created massive dislocations in the financial markets. Most importantly, the economy has effectively reset to very low-interest rates. The low cost of money has pulled forward future demand for goods and services and lowered the investment returns we can expect in the future.

Faced with still-high debt levels, rising interest rates and weak prospects for investment returns, consumer savings rates are likely to continue rising. The federal government, for its part, will struggle to contain rising deficits resulting from fiscal stimulus and the soaring cost of entitlements. Businesses will face higher interest costs on debt used to buy back stock.

There are other headwinds that are likely to cap economic growth. The improved economic outlook in the U.S. has led to strength in the dollar. A rising dollar causes increases in the trade gap. And these increases affect the economy both directly as well as through a drag on corporate earnings. Moreover, Trump’s proposed policies, which are inherently inflationary, could cause a spike in energy and other commodity prices.

The stock market seems to be pricing in all the benefits of Trump’s policies and none of the potentially ugly side effects. Rising inflation and interest rates, a stronger dollar, higher energy prices, and rising budget and trade deficits are clear and present dangers to the economy, corporate earnings, and stock prices. The markets aren’t pricing them as such.

Michael K. Farr is CEO and founder of Farr, Miller & Washington LLC with $1.3 billion under management in Washington, D.C.