Your weekly market update

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Market Update

16 December 2016

The Trump train has been fuelling animal spirits in equity markets since the election. However Federal Reserve Chairwoman Janet Yellen made it clear that the fiscal reforms Trump has promised will cost an estimated $5.2 trillion and push American debt levels to their highest ever. Yellen also made it clear that the Fed will actively intervene with interest rate hikes beyond the current plotted path of slow and steady with small incremental interest rate increases to ensure the economy does not run too hot. Her comments this week along with a 25 basis points increase brought a sobering effect.

North American markets look overvalued but there are factors that could push equities even higher.

- A repatriation tax holiday could make $2.1 trillion available for dividends, buybacks, and M&As.
- Economic growth and inflation could push earnings higher, further inflating stock prices.

It seems that everyone agrees on the fact that this market is overvalued and borderline irrational.

The S&P 500 has jumped 5.4% since Trump won the elections. This year's positive return will make it number eight in a row for the S&P 500 as it has been rewarding investors since 2009.

John Maynard Keynes said it best:
"The market can remain irrational longer than you can remain solvent."

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Today we'll analyze what's fuelling this bull market, how long can it last, and what the short and long term catalysts and risks are that we have to consider.

There are three main positive market drivers to consider: a repatriation tax holiday, growth, and inflation.

Many expect now that Trump will become president, that a tax holiday will be voted in allowing corporations to repatriate the cash stashed abroad at a much lower tax rate than the current 35%. The more than $2.1 trillion abroad, if and when repatriated, would give a boost to buybacks and dividends pushing the market even higher. Given that S&P 500 corporations have been buying back around $130 billion of their own stock and paying out $105 billion in dividends per quarter in the last few years, the additional $2.1 trillion could push the S&P 500 further up and also increase M&A activity. It's very difficult to say how much farther this could push stocks, but it would surely postpone a bear market.

The trend in economic growth has, thankfully, changed. After a few quarters of slowed growth, we have seen a pick up in economic activity.

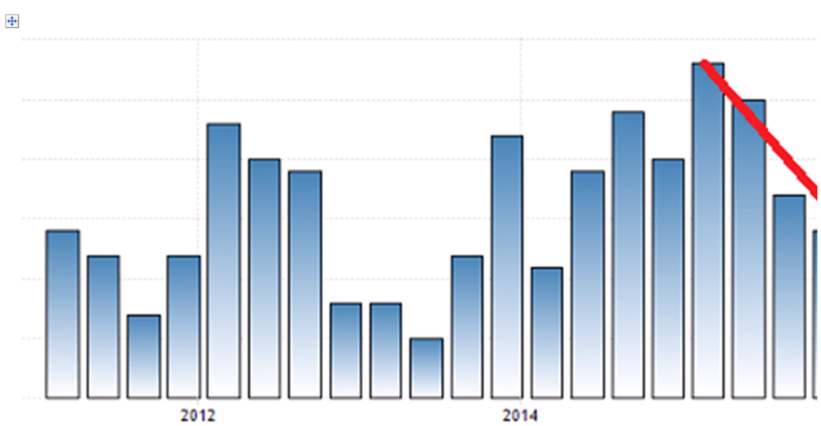

Figure 2: Annualized U.S. economic growth. Source: Trading Economics.

The forecasts are also positive and with the economy expected to grow at 2.5% in the next few quarters, it should push stocks higher or at least keep them at the levels we're seeing today.

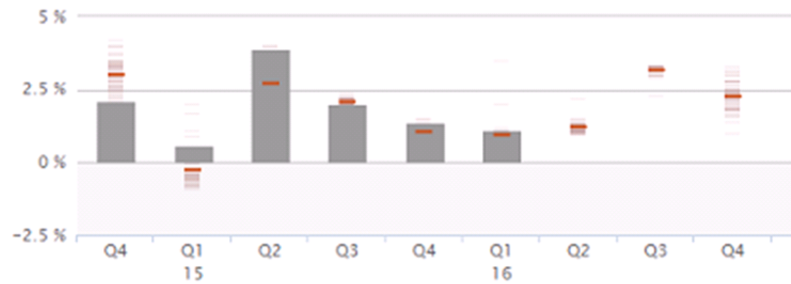

Figure 3: Economic forecasting survey. Source: Wall Street Journal.

Improved growth should make earnings grow which should allow for greater buybacks and higher dividends. Earnings are expected to grow at double digit rates in the upcoming quarters as economic activity is picking up and oil prices have increased.

Growth Expected to Continue in 2017

For the fourth quarter, analysts are projecting earnings growth of 3.0% and revenue growth
analysts are projecting earnings growth of 0.1% and revenue growth of 2.2%.

Analysts currently expect earnings and revenue growth to continue in 2017.

For Q1 2017, analysts are projecting earnings growth of 11.3% and revenue growth of 8.1%

For Q2 2017, analysts are projecting earnings growth of 10.5% and revenue growth of 5.8%

For all of 2017, analysts are projecting earnings growth of 11.4% and revenue growth of 5.8

Figure 4: Analysts earnings growth estimates. Source: FACTSET.

For the S&P 500 to grow further, it’s extremely important that these very positive expectations are met because, if not met, stories about market overvaluation, high PE ratios, shrinking dividends and dim economic outlooks could soon take over which will lead to a sharp correction leaving the Trump train derailed and animal spirits fleeing.

The third driver for stocks is inflation. Inflation is supposed to be good for stocks as in theory, stocks provide a kind of hedge for it. Corporations can transfer increases in input costs into higher prices. Inflation also increases the value of the underlying assets and inventories corporations own. However, if the Federal Reserve sees inflation as too strong an interest rate hike beyond the standard 0.25% will be more than likely next year.

Figure 5: U.S. inflation rate. Source: Trading Economics.

However, inflation is still below the Fed's target of 2% and below historical levels. Similarly to economic and earnings growth, inflation or better, the expectation for higher inflation pushes stocks higher.

<u>Conclusion</u>

Current sentiment for the S&P 500 jump are increased positive expectations. This is perfectly normal as we don't invest for the present, but instead invest for the future. This bull market will continue as long as there is enough liquidity to fuel it, be it coming from repatriation or low interest rates, as long as economic growth expectations aren't refuted by hard economic data leading into a recession, and as long as inflation levels keep rising. It is important to note that lesser than anticipated economic data and specifically corporate earnings do not materialize at the same level as expectations are then we will go from euphoria to pessimistic outlook. The anticipated liquidity coming from trillions of dollars sitting offshore is the most significant driver.

The fact that nobody can predict how long the optimism will last means the entire market outlook could change tomorrow or two years from now.

Investments that don't offer a sharp -20% plus correction based on bad news, or a potential -50% decline if America goes into a recession are key. At present investors are too jubilant and are ignoring the potential pitfalls. However, hard economic data always sobers even the most hardened. It seems that nobody wants to miss the party and no one is asking what happens when the lights go out.

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