Market Outlook 2018

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Last year's stock market performance was nothing less than spectacular. The Dow Jones Industrial Average (DJIA) rose 25%, the S&P 500 increased 19%, and the tech-heavy NASDAQ was up some 28%.

Entering its ninth year, the current Bull market is now the second oldest on record. Furthermore, its pace and breadth is unprecedented. Consider this: the DJIA took 14 years to go from a level of 10,000 to 15,000 but then only 3 ½ years to reach 20,000 (last year) and is already over 25,000 at the beginning of this year.

The market-rich performance is due to several factors, including historically low interest rates, heightened economic liquidity (due to an accommodative Federal Reserve as well as other developed world central banks), accelerating economic improvement, high corporate profit margins and increasing corporate earnings. If there ever was a Goldilocks market--this is it.

Market performance now stands to get a further boost due to the late-2017 tax cut legislation passed in Washington, which will benefit corporate earnings as well as accelerate company share buy-backs. The tax measure also includes incentives to encourage corporate America to "repatriate" some $1.5-$2 trillion in cash held-offshore. It's estimated some 1/3 of this cash will go into stock buy-backs, resulting in less stock supply and increased share earnings—U.S. stock supply is now at a level of some twelve years ago in large part already due to multi-year stock buy-backs by corporate America.

The S&P 500 hasn't suffered a meaningful pullback since prior to the election, and volatility indicators continue at record lows. Remarkably, during 2017 the market finished higher every month. Looking at the ninety-year data available for the S&P 500, this has never happened before.

In addition, stock market volatility continues at record lows. The S&P 500 hasn't suffered a downturn of 5% or more since June 26, 2016--the longest streak since May 1996. The market has now gone about 410 calendar days without a 3% dip. This trend is historically unprecedented.

U.S. stock market strength is also playing out globally. International equities performance increased 25% in local currency terms over 2017, with China up 45%, India 41%, Europe 15%, and the UK 13%. Emerging markets, which have lagged in the recent past, were up some 37% in 2017.

This synchronized global equity outperformance is due to the economic fundamentals now driving all economies. Initially, the US stock market reacted the strongest following the economic collapse of some ten years ago largely because the Federal Reserve was the first central bank to inject liquidity into its financial system. Other central banks subsequently followed suit, led by the ECB and then the Bank of Japan, and now a decade after the financial crisis nearly brought the global economy to its knees, synchronized global economic growth is underway, with the International Monetary Fund (IMF) currently projecting global economic growth in 2018 at a robust 3.7%.

World-wide, corporate revenue and earnings growth are up year-over-year, and global manufacturing activity is expanding, with higher rates of new orders, exports, productivity and jobs. Furthermore, worldwide business optimism is now at its highest level in some three years, with earnings growth and business hiring reaching multi-year highs. In addition, positive sentiment among U.S. firms is now at its highest in some five years—and such positive economic indicators are being reflected in consumer confidence, now at a 17-year high in the U.S.

In a broad-based rally powered by industrials, materials, and financials, the DJIA reached the 25,000 level on January 4th. The first two-week trading sessions of 2018 have witnessed the stock market averages attain almost daily higher levels, causing some market watchers to already boost their year-end market projections. In fact, at the time of this writing, the S&P 500 is now up 4.2% in 2018 and some 10% in just the past month. Sector performance has been wide-based, including energy stocks, which have moved upward because of a larger than expected drawdown in crude inventories--the price of oil is now trading above $64/barrel, a three-year high. Only the more interest rate sensitive REITS and utility stocks have not participated in the continued upswing.

The jobs report of January 5th disappointed but did not impact the first week equity rally of the year. The second week of the year proved to be even more bullish than the first one for stocks. The last two trading sessions of last week were particularly bullish, as all of the major indices surged to all-time highs thanks to a broad and healthy rally. Market internals remain generally positive, although evidence of trading weakness emerged later in the week. For example, on both the NYSE and NASDAQ the number of new stock lows increased, rising to 27 on the NASDAQ and 40 on the NYSE, and the ratio of stocks rising above their respective 200-day moving average fell off, despite the broad rally. I suspect some of last week's late surge was in part due to short seller covering, i.e., stock traders having to buy stocks they had "bet" would decline and then subsequently having to buy in order to avert further stock loss, thus pushing up the overall market.

So far this year, only the bond market has really traded off, with the ten-year treasury yield increasing 15 basis points during the first nine trading days of 2018. Let me clear, the current non-stop upward trajectory pace of the market is unsustainable. At some point this year, a market correction is now almost unavoidable. In fact, a correction would be healthy for the market. But having said this, I see the market finishing the year higher from here—interesting, historical measures indicate how stocks perform during the first month of any year generally indicate how the market finishes eleven months later, i.e., if stocks end higher in January, then they typically finish the year higher. This is called the January Effect and has been accurate 73% of the time since 1929.

Many Wall Street analysts are forecasting further equity gains in 2018, typically ranging between 5-10% as measured by the S&P 500. I see the market up 10-12%--maybe more--for 2018. I come to this conclusion after much soul-searching and analysis. My bias mid-late year 2017 was to raise some cash in client accounts in 2018 and become more defensive. One area that has given me particular concern is the fact that so-called "retail" investors have been exhibiting a heightened level of bullishness. For example, the American Association of Individual Investors now indicates a bull-to-bear ratio of 80%. This is very high and such levels typically should be viewed as a contra-indictor, meaning excessive levels of either a bull or bear ratio typically heralds a looming change in market direction.

Having said this, another indicator I watch, the so-called Sentiment Trader Smart Money Index (think institutional money), indicates concern but is not historically out of balance. Also, the popular media has not focused on the bullish trend the way it has done during prior market tops (this phenomenon can actually be measured). The bottom line is this: there is just too much market liquidity, too much improving economic indicators coupled with the tax cut that results in a market that is not overly stretched at this time.

Why do I conclude this? What drives stock prices the most is corporate earnings. And what causes investors to make relative judgments about where to invest their money, meaning whether to invest in commodities, bonds, stocks, cash, etc, is what particular asset class present the highest relative value. Gold typically is a measure of economic uncertainty, and I view it as a risk alternative, not meaningful at this juncture; bond yields today are historically low in an improving economic environment and have been under-performing stocks of late; cash simply means falling behind the 2%+/- the prevailing rate of inflation.

Through the third quarter of last year, the S&P 500 Index experienced four straight quarters of at least 8% higher earnings per share growth—a feat not seen since 2012 when the economy was still in its acceleration phase from the 2007-2009 recession (a period when the rate of stock earnings growth should typically be at its strongest). The fact that corporate earnings are strengthening of late is a key market indicator regarding the resurgent strength of the market.

The market is always forward-looking, meaning smart investors don't make judgements based on rear-view mirror forecasting. They project out. Now, let's consider corporate earnings for the fourth quarter 2017. It will begin in earnest starting the week of January 14th. Generally-speaking, the S&P 500 is expected to report 12% higher per-share profits for the quarter. I view this as overly optimistic but looking in the weeds of projected earnings for the 4th quarter reveals an interesting trend—that is, earnings estimates generally are improving over the last several weeks. This is a very good sign. Earnings for the 4th quarter of 2017 should be quite good and supportive of the market trend-line.

But be prepared for funky earnings numbers--that is, lower GAAP results. Not to get overly technical but the tax legislation will result in many companies having to take so-called deferred asset charges as well as increased tax payments—but this is a one-time event. I am a trained GAAP earnings analyst. That's how I was taught in 1982-1986 as a credit analyst at First Chicago, but because of the recently-passed tax legislation I think this particular time one needs to look beyond GAAP earnings, and I think the market will do just that.

Prevailing domestic earnings estimates for 2018 appear to understate the benefits accruing as a result of the new corporate tax law--consensus earnings estimate for the S&P 500 is currently being pegged as increasing by $3 per share because of the December-passed tax measure, with the current year-end consensus for the index being $148.86 (in early November, the consensus number was $145.68). Using the more conservative $3/per share incremental number results in a forward P/E number of 18.7. It seems probable the actual impact of the tax legislation will be more like $9-$11/share, producing a projected year-end P/E ratio of 17.8. The historic P/E average for the S&P 500 is 16.7. Given the current rate of inflation, prevailing low interest rates, and projected economic growth rate, the market is not currently over-valued.

The Bottom Line

The U.S. stock market continues its secular bullish trend as does the global economy. Secular bull markets last on average about 14 years and experience annualized returns of over 15%. We have now entered the ninth year of this particular secular bull trend line and it will likely last several more years. Caveats to this outlook include political misjudgments, particularly in trade policies--should the U.S. turn more protectionist, this could substantively impede the current bull advance.

At this stage of the cycle, I prefer cyclical sectors—think industrials, technology, financials, health care. Areas to be relatively under-weighted include telecom, REITS and utilities, or rather those more interest rate sensitive, as I see bond yields increasing in 2018 due to an already tight labor market, wage growth pressure, and increased consumer demand.

The stock market has now outperformed the bond market every year for the past six years and this year will again likely do so. I continue to deemphasize bonds on a relative basis because of the improving economy and the likelihood of increasing interest rates. However, both bonds and cash should still be an integral part of any portfolio.

An important note regarding bonds—the ten-year Treasury is currently at 2.55%. If it starts approaching 3% in a short time frame, that could result in bond investors rapidly seeing their fixed income holdings experience negative returns and in turn cause them to pile into stocks. If the market accelerates to a point where it enters the so-called “euphoria zone,” that would cause me to start going to cash in client portfolios. In my judgement, the real risk to the market at this time is not a sudden sell-off—which can happen anytime—but a rapid stock “melt-up,” resulting in a blow-off correction. The possible situation warrants a close monitoring.

Last year, large companies outperformed small and mid-cap ones in large measure due to a weakened U.S. dollar; however, smaller company performance should improve this year because a lower tax environment and growing economy offers them heightened advantage. The Fed will continue to lead the more developed world in increasing interest rates—perhaps 3-4 more boosts to the Fed Funds Rate in 2018, and this should help strengthen the dollar, which in turn reward smaller companies on a relative basis.

Value companies typically outperform their growth counterparts at the later stage of an economic cycle but I see growth continuing to do well and such value sectors as financials (likely) and energy (possibly) outperforming this year because they have lagged the past several years.

International stocks should be an integral component of most portfolios in 2018 because of the synchronized economic global economy and also because international stocks valuations continue to lag U.S. stocks. This trend also includes emerging markets.

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I caution clients not to expect a repeat of last year, where every month was positive and volatility low. As mentioned above, last year's consistent trend upward with low volatility was an historic aberration. I see the likelihood of a 5-10% or more correction to be heightened and express my warning because investors have been lulled into a consistent return environment and a sudden market sell-off, or multiple-week downturn, should be an expected occurrence and not viewed as atypical. This begs the question: if you expect a sell-off at some point this year, why not go to cash now? Answer: one can never predict a sell-off or for that matter a buy-back environment and market timing is a fool's errand. The macro picture remains solid and investor returns should be viewed as a multi-year occurrence—do not focus on the day-to-day picture.

Good luck to all is 2018!

Please contact me directly at any time (603-319-4563), or mark@newcastleinvestments if you have any questions regarding this investment outlook or any other matter. We truly appreciate your confidence in our services and are here to serve you.
