# WILL THIS SIXTEEN BE SWEET?

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## KEY TAKEAWAYS

- In the spirit of the exciting NCAA college basketball tournament, we have compiled our "Sweet 16" for the markets.
- We have identified 16 keys for stocks - many of them policy related - for the rest of 2017 and assessed their implications for the market.
- While the policy path is uncertain, we believe stocks have the potential to deliver solid gains in 2017.

The "Sweet 16" is set. So in the spirit of March Madness and an exciting NCAA college basketball tournament that has already brought us two shockers in second round exits by Duke and Villanova, we have compiled our "Sweet 16" for the stock market. Specifically, we have identified 16 keys - many of them policy related - for stocks for the remainder of the year [Figure 1] and assessed their implications for the market. While the path for several policy-related areas is uncertain, we still expect a solid year for stocks in 2017 - potentially even slightly above our year - end S&P 500 target of mid-single-digit gains,* depending on that policy path. Look for a deeper dive into some of these market drivers in our "Final Four" next week.

1 16 KEYS FOR STOCKS FOR THE REST OF 2017


Source: LPL Research 03/20/17

## OUR "SWEET 16" FOR THE MARKETS

**Economic growth:** We continue to expect near 2.5% growth in U.S. gross domestic product (GDP) in 2017, roughly in line with long-term averages, supported by improving business investment, steady consumer spending gains, and pro-growth fiscal policy. Our favorite leading indicators, including the just-released Conference Board Leading Economic Index (LEI), the Institute for Supply Management (ISM) Manufacturing Index, and the yield curve, suggest a low probability of recession over the next 12-18 months. Economic data have broadly surprised to the upside in the U.S. in recent months and are improving overseas.
**IMPLICATION=POSITIVE**

**Fed policy & interest rates:** We expect the Federal Reserve (Fed) to hike interest rates twice more in 2017 following last week's (March 15, 2017) well-telegraphed 0.25% hike. The Fed's acknowledgement of the improved economic outlook and its plan to hike rates gradually are encouraging. While a better growth outlook may support further gains for stocks even if accompanied by rate hikes, there is still a possibility that the Fed spooks markets by speeding up its timetable.
**IMPLICATION =MIXED**

**Inflation:** The Consumer Price Index (CPI) posted a 2.7% year-over-year increase in February 2017, accelerating from January's 2.5% reading amid increases in energy prices. CPI excluding food and energy (core CPI) rose 2.2% from a year ago, decelerating from January's 2.3% gain but still above the Fed's 2% target. While core CPI may continue to drift higher, headline CPI could level off and decelerate over the second half of 2017, assuming oil prices stay in the $50/barrel range, reducing the likelihood that inflation disrupts markets. Bottom line, though further acceleration in inflation presents some risk to stocks, we expect it to be contained.
**IMPLICATION=MIXED**

**Geopolitics:** Europe passed a test in the Dutch elections last week (March 15, 2017) as the anti-European Union party failed to wrestle power from current Dutch Prime Minister Rutte; but French elections in April may spark another wave of structural concerns in the Eurozone. China's debt problem remains a risk, but when it will matter to markets is impossible to predict. Finally, military conflicts overseas could disrupt markets at any time.
**IMPLICATION=UNCERTAIN**

**Earnings:** Earnings are one of the biggest keys for stocks to produce additional gains in 2017. The latest reading near 58 for the ISM Manufacturing Index, historically a good earnings indicator, suggests continued earnings growth (above 50 indicates expansion). Fourth quarter earnings season was generally good, with high-single-digit S&P 500 earnings gains and supportive guidance that helped 2017 estimates hold up relatively well. Additionally, better economic growth and supportive fiscal policy later in the year offer potential upside.
**IMPLICATION=POSITIVE**

**Valuations:** We acknowledge rich valuations are a concern. On a trailing four-quarter basis, the price-earnings ratio (PE) for the S&P 500 is over 19, several points above long-term averages in the 16-17 range and above where most bull markets peaked. Longer term, higher valuations have historically translated into below-average returns. However, valuations are not good predictors of near-term stock market performance, and moderate inflation and low interest rates are supportive of above average valuations in the short term.
**IMPLICATION=LONG TERM NEGATIVE**

**Sentiment:** Our analysis of investor sentiment reveals signs of increasing worry. From a contrarian perspective, this could be a positive sign. First, the recent American Association of Individual Investors (AAII) Sentiment Survey had more bears than bulls for the second straight week. Also, the National Association of Active Investment Managers (NAAIM) essentially reported its lowest equity exposure for active managers since the week of the U.S. election. Bottom line, there are signs of optimism, but we

are not seeing the type of exuberance observed at previous stock market peaks.
**IMPLICATION=MIXED**

**Technicals:** The technical indicators for U.S. equities continue to exhibit bullish momentum above shorter and longer-term moving averages, while the S&P 500's price near all-time highs increases the potential for a sustained bullish trend. As long as the index remains above its 200-day moving average, the long-term price trend remains bullish for stocks.
**IMPLICATION=SHORT TERM & LONG TERM POSITIVE**

**Corporate tax rate:** The current rate (35%) is one of the highest in the world and encourages companies to relocate overseas. Bringing the rate down, potentially to 25%, would help keep U.S. companies from moving offshore and boost corporate profits and U.S. economic growth. Some estimates suggest S&P 500 earnings could get a more than 10% boost in 2018, although offsets to keep the budget deficit in check will be needed.
**IMPLICATION=VERY POSITIVE**

**Capital expensing:** To incentivize capital investment, tax reform may include a provision to allow immediate depreciation of capital expenditures. Bigger upfront depreciation depresses companies' taxable profits, thereby lowering their tax bill. This measure, which stands a reasonable chance at approval, would stimulate capital spending and lift U.S. manufacturing if enacted, but would have to be paired with the elimination of the deductibility of interest expense.
**IMPLICATION=POSITIVE**

**Interest deductibility:** Current tax policy enables companies to deduct the interest paid on their debt to lower their tax bill. Eliminating the deductibility of interest on debt as House Republicans have proposed would help pay for lower corporate tax rates and offset the lost tax revenue from full capital expensing. Although it may be politically messy by hurting the biggest borrowers, we believe this provision stands a fair probability of being enacted as a revenue raiser paired with full capital expensing.
**IMPLICATION=NEGATIVE**

**Trade policy / border tax:** The House tax plan included a provision that essentially taxes imports, but not exports in order to encourage U.S. production - called a border adjustment tax. Although the proposal could be a big source of tax revenue to help pay for the corporate tax cuts, we do not expect this plan as proposed to make it through Congress because of the outsized impact on certain industries. The concern is that a tax on imports could contribute to escalating trade tensions with China and Mexico. The proposal appears to lack the sponsorship to become law, though a watered down version or targeted and temporary tariffs are possible to bring the fairer trade Trump has promised to pursue.
**IMPLICATION=POSSIBLE NEGATIVE**

**Repatriation:** A policy with bipartisan support, a lower tax rate for companies to bring cash back from overseas would generate additional tax revenue (the cash is otherwise trapped) and likely drive additional capital investment, as well as shareholder-friendly dividends and share repurchases. Repatriation is very likely given the tax revenues that must be raised to offset lost revenue from a lower corporate tax rate or fund infrastructure projects.
**IMPLICATION=POSITIVE**

**Infrastructure:** President Trump has proposed $100 billion per year in infrastructure spending via public-private partnerships. Bipartisan support makes some sort of program likely, but we are skeptical that this level of spending will be achieved given the limited number of attractive revenue-generating projects and constraints from the deficit hawks in Congress. Plus, the impact of the spending may be a couple years away.
**IMPLICATION=POSSIBLE MODEST POSITIVE**

**Healthcare reform:** From an economic and broad stock market perspective, the importance of the Affordable Care Act (ACA) lies in its tie to corporate tax reform because tax reform cannot happen until the first phase of the healthcare overhaul is completed. What the replacement will look like, of great interest to healthcare sector investors, is uncertain though the basic

principles are coming into view.
**IMPLICATION=POSSIBLE NEGATIVE**

**Financial service reform:** President Trump has already taken steps to overhaul the financial services regulatory framework through executive orders. Changes will take time, but the end result is likely to be more lending and less friction in capital markets, both good for the economy and potentially equity markets. The downside is of course the possibility we are sowing the seeds of the next crisis.
**IMPLICATION=SHORT TERM POSITIVE**


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