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INVESTMENT MANAGEMENT

U.S. Equity Outlook: Trump Won, Now Back to Fundamentals

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With the U.S. presidential election now behind us, we see a number of positive signs for the U.S. equity market in the fourth quarter and next year, though not without risks which must be watched closely. Although the Trump win initially registered as a surprise in the markets, we believe the focus should now return to stock fundamentals.

Fiscal reform has historically buoyed equities

The election result has appeared to demonstrate Americans' desire for economic stimulus. Although much remains to be seen about policy details, a Republican president with a Republican majority in Congress should be better positioned to pass fiscal policy reform than a Democrat in the White House with a Republican-led Congress. As such, we think political uncertainty may actually be diminishing.

In addition to less uncertainty overhanging the market, the possibility of fiscal policy reform could act as another reason for optimism in the equity markets. Since 1906, the S&P 500* has delivered a series of bear market cycles lasting on average 17 years, followed by bull market cycles of an average duration of 14 years.[1] Looking at the most recent, from 1966 to 1982, the stock market compounded at 4% annualized.

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[1] Bloomberg, Robert Schiller

* **Past performance is no guarantee of future results.** This index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. See disclosures for index definition.

Then, in 1982, fiscal policy reform helped fuel the market's most recent bull run that eventually peaked in 2000. Compare that to today. Since 2000, the market has grown at an annualized rate of approximately 4%. We are 16 years into this bear cycle, and the prospect of fiscal policy reform is now on the table. While we should not expect the types of returns the S&P 500 experienced in the 1990's, perhaps a change in fiscal policy could act as a catalyst to jumpstart the next bull rally.

A rebound in earnings growth should drive multiple expansion

With the election behind us, we believe the markets are beginning to focus on company fundamentals. Due to the rebound in the price of oil from its low in early February, certain sectors that were in recession last year, namely energy, materials and industrials should be poised to see improvement in 2017, given easier year-over-year comparisons. And consensus 2017 S&P 500 earnings in general are showing a 13% improvement over 2016 earnings,[2] which is positive.

With the potential for better earnings and reduced uncertainty, multiples can expand. On an absolute basis, the market isn't cheap; the stock market's price-to-earnings (P/E) ratio is trading above historical valuations. But consider that the long-term average valuation levels represent a period of much higher interest rates than we have today. Since 2009, taking the current low interest-rate environment into account, we believe the S&P 500 "fair value" relative to bonds remains at a discount. While antithetical, if interest rates begin to rise, we would expect that discount to narrow because it would signal the potential for higher growth.

We also see potential for P/E expansion on improved revenue growth, which could be spurred by a modest rise in inflation. Conventional wisdom says that inflation is bad for stocks. However, historically, slowly rising inflation has bolstered revenue growth, which in turn has led to an initial period of multiple expansion.[3] Of course, once interest rates rise to a certain level, bonds should become more competitive with stocks, causing P/Es to contract. But, we're not there yet.

We favor growth over low-growth stocks

We view the current opportunity set not as growth versus value, but rather growth versus low-growth. We believe stocks with sensitivity to economic acceleration are most likely to benefit. Financials, industrials, and select health care stocks look especially attractive to us, as these areas have been some of the more beaten-down sectors of late. Conversely, lower volatility, dividend yielding stocks, such as consumer staples, utilities, and telecommunications, are more likely to underperform. These stocks tend to be trading at high valuations currently, as investors have sought bond surrogates in the low yield environment of the past few years.

Risks we're watching

Although we are generally optimistic with regards to the market's fundamentals, we're monitoring possible headwinds along several fronts. The potential for a trade war remains on our radar but there won't be any clarity on this issue for a while. In the near-term, we continue to watch for vulnerabilities to an earnings recovery, for example, retreating oil prices or a spike in the US dollar, which could hurt exporters and multinationals' profits, as we saw in the second half of 2014. Fast-rising inflation could also create headwinds for equities, as would a Fed that moves aggressively to raise rates. From a global perspective, we prefer the U.S. to Europe, where political uncertainty is set to increase with key elections across the Continent in 2017. In the emerging markets, we're avoiding any short-term, knee-jerk reactions to the U.S. election.

[2] Bloomberg

[3] Factset, Robert Schiller, MSWM Global Investment Committee

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