Market Review
April 22, 2017

Market Outlook

The merry month of May may not be so merry depending on the outcome of two elections: in France on May 7th and Iran on May 19th. While early polls in France indicate the moderate independent Emmanuel Macron trouncing Marie Le Pen (64% to 36%) my opinion of polls are akin to a former Canadian Prime Minister's. In Iran, the incumbent President Hassan Rouhani will be up against his major opponent Ebrahim Raisi. I don't know enough to suggest who might be the better candidate from a Western perspective. Those and other geo-political risks notwithstanding, I think generally both the Canadian and US economies are in relatively good shape even after taking into account the March pause in some US data and the growing worries that President Trump's tax legislation (supposedly being announced this week) and other proposed measures may get stalled in Congress.

Assuming none of the proposed legislation is passed, the question then becomes "Is the US economic recovery to date sufficiently resilient to continue on its growth path?" I conclude "yes" but perhaps at a slower rate than currently expected. In support of that view Leading Indicators, Real Per Capita Income and Real Wages and Salaries per Payroll Employee continue on their upward path. Consumer Confidence (as measured by the Conference Board) has exceeded 2005 – 2007 levels but is still below 2000 levels. Unemployment rates are down to levels not seen for a decade or more as the number of jobs not able to be filled is climbing, but again still not back to 2000 levels. Housing continues to be a positive. However, I admit that the auto industry looks like it has peaked for this cycle and at best may remain flat but more likely may decline. Also a number of other indexes such as the US Manufacturing PMI, the Non-manufacturing PMI index and others showed a decline in March (weather elated?). So at this point, excluding any major geo-political upset and/or a more than expected spike in interest rates, I think the US economy can continue to grow into 2018 and possibly 2019. (the latter guesstimated by Yardeni Research Inc.).

As for interest rates, given my growth scenario one would have expected interest rates to continue to rise especially in view of the two further anticipated increases in rates by the Fed this year. But that's not what has been happening. For example, in Canada and the US, rates for the 2 – 30 year Government bond maturities peaked March 10th at 0.84% and 1.35% for the 2 year, 1.27% and 2.10% for the 5 year, 1.81% and 2.57% for the 10 year and 2.48% and 3.16% for the 30 year. As of April 21st, yields had declined to 0.72% and 1.18% for the 2 year, 1.01% and 1.77% for the 5 year, 1.46% and 2.23% for the 10 year and 2.13% and 2.90% for the 30 year. One possible answer is in that the latest US CPI reading showed a decline in growth, showing a 2.4% increase Y/Y compared to a 2.7% Y/Y increase for the prior month. Food which has a 13.7% index weighting declined 0.3% (for the first time since June 2016) and energy which has a 7.2% weighting declined for the second month in a row, (March being -3.2%) after rising for more than a year. On a global basis, food outputs and other commodities such as cotton are increasing. Also, in spite of OPEC's determination to reduce overall oil over-supply including a recommended six month extension of the current production reductions, the US shale producers are doing the opposite. This indicates a continuation of over-supply conditions and a possible decline in the price of WTI and Brent as compared to some $60.00 – $70.00 2018 forecasts that are "on the street".

Another answer may be that the economic growth we have seen to date will not be sustained and will slow down. Or as suggested by a Bay St. icon (David Rosenberg) "The unemployment rate is a lagging indicator and that it is typical for a recession to start six months after the rate hits its cycle trough". He also suggests "When consumer confidence peaks that tends to mean households are satiated and pent-up demand has been satisfied. Recessions on average begin about a year later". My response is that as mentioned many times before, given that "this recovery may go on longer than normal given the severity of the last recession" and the relatively slow recovery to date, the unemployment rate may stay lower for longer. Also I observe that Consumer Confidence while higher than 2007 levels is still well below 2000 levels and therefore, could still move higher.

As for the TSX, its outlook in no small part depends on one's outlook for 57.8% of its index (as of March 31st). For example, Banks were 23.8%, Energy 21.4%, Insurance 6.6% and Gold 6.0%. I am positive on banks, insurance and gold but still cautious on energy depending on how well OPEC discipline is maintained and the resulting WTI and Brent prices.

As for the S&P 500, I look at its current valuation from two perspectives. The first assumes that no favorable tax or any other legislation is passed this year. The second assumes that some is, particularly the tax cuts. In the first scenario, the consensus forecast for earnings and price earnings multiples are 18.0 for 2017 and 16.0 for 2018. This compares to a post 2000 high multiple of 18.4 reached in about 2004. Therefore, I conclude that in this scenario the S&P is fully priced and could pull back 5% - 10% for any reason, economic and/or geo-political. In the second scenario, tax cut legislation could produce incremental earnings of between $8.00 and $13.00 per share in 2017 and 2018 depending on what is passed and its effective date. Assuming it results in potential ’17 and ’18 EPS of $142.00 and $150.00, the multiples decline to 16.5 and 15.7. Still not super cheap (long-term average 13.9) but less elevated thus leaving room for a further modest multiple expansion and continuing earnings growth.

Summary

While being fully aware of some of the risks going forward, I remain optimistic about the stock markets’ outlook in either scenario but lean to the view that tax cut legislation is likely to be passed this year. I would use any weakness as a buying opportunity.

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