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Dow Approaching 20,000, Now What?
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The November and December rally may have caught some by surprise, but the market is suggesting better days are ahead and have bid stocks up to all-time highs. There are some definite tailwinds, but there could be a few headwinds facing stocks as we head into 2017.

With President-Elect Donald Trump's pro-growth business agenda, we believe there is more room to the upside for stocks. Earnings will be in focus and could see a significant tailwind if certain tax reforms pass, particularly the corporate tax rate. If Trump can deliver on his promise to slash corporate tax rates to 15%, this expense will move directly to the bottom line delivering higher earnings. Several analysts estimate this could add $6-8 to adjusted net earnings of the S&P 500 index. We stand by our call *(Return to Fundamentals: Earnings and Multiples - November 9, 2016*) of $130 EPS for 2017. The market has bid stocks up in anticipation of higher earnings.

Another policy change that should help move earnings higher is the repatriation of overseas cash. An estimate of over $200 billion is sitting outside of the US, avoiding taxes. Trump has promised legislation to remove certain taxes allowing this money to move back to the US. This would certainly help earnings. Companies will likely use this cash to repurchase outstanding shares, thus diluting the total shares outstanding which will add earnings per share. But companies could also use this cash to pay dividends or expand their CapEx budgets, which would help support current earnings multiples.

Valuations have historically risen when inflation and yields fall. Conversely, multiples fall when inflation and yields rise. We do not believe there is room for multiples to rise in this market environment, and we believe we will be entering a period where multiples contract, albeit modestly. Multiples are currently approaching 20 x forward earnings, which is historically at the upper-end of the market valuation range. This suggests the markets are relatively expensive. The last cycle to buck this trend was August 2010 – January 2011 when both CPI and the 10-year yield moved higher with multiples expanding. However, this was a time when the economy was rebounding from the great recession of 2008-2009.

Therefore, forecasting a slight multiple contraction going forward is warranted given the Federal Reserve has stated they see 3 rate hikes in 2017 and are anticipating higher inflation. But multiples should be muted with a rotation out of bonds to stocks. Managers have moved to a "risk-on" stance, evident in higher beta names with small capitalization stocks leading the way, and are fleeing the "safety" of bonds. We believe this rotation will continue and keep multiples relatively high and muted, for now.

We stand by our call that the S&P 500 will move to 2400, or 18.5 times $130 EPS (the anticipated 2017 adjusted earnings of S&P 500 index). But we will be watching a few areas of concern going forward. First, continued strength in the US Dollar, which is up considerably since the election. A strong dollar makes US goods costlier overseas and imports cheaper in the US. This is counter to Trump's economic plan and could hurt multinational companies, canceling out the aforementioned tailwinds. Second, if President Elect Trump stands firm on protectionism, we could see reverberation through the global economy affecting both earnings and Gross Domestic Product numbers negatively. And third, geopolitical risk from hardline stances on certain foreign policy relations by the new administration could result in volatile swings in the markets, presenting both risk and opportunity.

Any number of these risks are currently outweighed by the prevailing optimism for significant tax reform and a pro-business agenda facing the markets. For now, we continue to hold on for the ride, maintaining our allocations and looking for opportunities.
