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Volatility Rising, but Equities Still Attractive

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Markets reacted positively last week to the long awaited outline of President Trump's tax reform. Affectionately known as the "reflation trade", risk-on sectors reengaged and outperformed, but small cap stocks and the technology sector were the brightest stars. Reaching the close on Friday, the Nasdaq Composite gained 1.1% and S&P 500 moved up 0.4%. Based on investor optimism, tax reform may be the key to a continuing bull market.

Following the latest collapse of the GOP's attempt to overhaul health care, a refocus on tax reform should come as no surprise. In fact, we have been asserting that tax reform would be the most significant pro-growth initiative prior to the 2018 midterm elections. Still, the devil is in the details. Yes, it may sound cliché, but many features and specifics surrounding President Trump's proposal are limited. Be that as it may, most members of Congress appear supportive of the core objectives; corporate tax structure and reducing taxes to middle-income Americans.

The anticipation of tax reform has been growing since the election. From our view, we believe stock prices have enjoyed premature appreciation in the hope of tax reform before the end of 2017. However, passage of such a bill won't likely occur until sometime in 2018. Nevertheless, it will [likely] be a boon for the economy and for equity markets. To put this in perspective, a corporate tax reduction and repatriation could add as much as $8.00 to S&P 500 earnings in 2018. This implies double digit returns assuming dividends remain above 2.5%. More importantly, fiscal stimulus provides a much more sustainable economic growth than monetary stimulus.

Now, before we get ahead of ourselves, economic data for the remainder of 2017 will likely be volatile. Lest we forget, many areas were devastated by hurricane Irma and Jose. It will be months before we fully understand the impact of these storms. However, the economic data points for third quarter will likely be depressed before rebounding in the fourth quarter and the next few years. Natural disasters create significant disruptions and unwelcome outcomes. On the other hand, we expect these unfortunate situations to create a net positive for economic acceleration as the rebuilding takes hold, thus allowing corporations to improve capital expenditures and raise wages. It's been a long time coming, but these factors could lead to a pickup in inflation over the next 12 months.

So, how does all this affect the markets? Historically, October has often been associated with negative surprises for investors. The major stock market crashes in 1929 and 1987 and the Asian currency crisis in 1998 were calamities that created financial devastation. Fortunately, we don't anticipate similar events happening any time soon, but volatility levels are likely to pick up in the coming months. Why? Elections in Japan, tax reform in the U.S., ongoing tensions in North Korea our Federal Reserve unwinding its balance sheet and the potential for uptick in inflation. Periods of capriciousness can seem like a calamity for many investors so it's worth saying that investing is a long-term strategy and market cycles are rarely devoid of volatility.

The current economic expansion by some measures is long in the tooth but should remain on track. Signs that it is coming to an end would likely include some combination of average hourly earnings accelerating to 3% - 4%, the GDP price deflator rising to more than 2.5%, corporate operating rates climb more than 80% or the Treasury yield curve become inverted. All of this may sound like jargon but they data points suggest no risk of contraction in the economy.

Finally, we have heard from many clients about bonds and their perceived safety. After Treasury yields fell to new 2017 lows last month, bond markets have been faltering in recent weeks with the yield on the 10-year Treasury rising 25 basis points. This means bond prices have been falling. As the Fed begins continues tightening and unwinding its balance sheet, economic growth should solidify and this promotes consumer and investor confidence. As those things occur, bonds tend to weaken in price and rise in yield. We anticipate yields experiencing additional pressure as these conditions improve.

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Should 10 Year Treasury yields break above the 2.5% barrier, in coming months, they could move more quickly to 3%. Such an occurrence means current bond holders would experience a rapid decline in the value of their bonds. For these reasons, we have strategically reduced our allocation to bonds over the last year. The same factors putting upward pressures on bond yields are also acting as tailwinds for stock prices. From here, we expect equities to outperform bonds over the coming year.

Technical Perspective - Among our market indicators, our technical composite saw good gains last week as breadth and trading indexes both pushed further into bullish territory. For NYSE measures, a rising number of stocks above their 150-day moving average was offset somewhat by flat net up/down volume. However, CBOE measures had a strong gain on improving put/call ratios. Market internals were helped by relative strength in small caps and Energy, Transports versus Industrials, and weakness in Utilities. External indicators were little changed as weakness in emerging versus developed markets, and international versus U.S. Treasuries, offset strength in crude oil.

Our investment strategies remain over-weighted to equities and we don't anticipate immediate adjustments. As we move into the last quarter of 2017, expect an uneven climb for equities and some sector rotation as rebuilding efforts begin in areas affected by natural disasters.

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