MARKET COMMENTARY

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Ain't No Mountain High Enough

It is a cliché that financial markets advance by climbing a wall of worry. However, it doesn't seem like a stretch to say that the stock market scaled a mountain of pessimism in 2016.

Who can forget the harrowing start to the year that saw markets plunge 13% in the first 20 days of January? China debt fears, global deflation, secular stagnation worries, the Brexit and the United States election surprises were the dominant headlines of 2016. Not surprisingly, given that long and gloomy list of variables, investor sentiment was morbid for much of 2016. In fact, according to the American Association of Individual Investors, the percentage of investors who said they were bullish about the stock market fell below 20% for four different weeks last year. To put this in context, since July 1987 there have only been 27 other sub-20% readings out of a total of 1,536 observations. Even in the depths of the 2008–2009 Great Recession there were only two such readings, and the low of 18.92%, on March 5, 2009, was registered a mere four days before the market bottomed.

While the overall environment was pessimistic in 2016, our analysis of the underlying economic fundamentals allowed us to remain positive. Paradoxically, while individual investors expressed bearishness toward stocks, they responded to consumer sentiment surveys by saying that they were increasingly feeling optimistic about their personal financial situation. Why? Because, as we have stated, they had spent years paying down debt and increasing savings. Importantly, we also correctly attributed many of the economic fears as short-term, negative side effects of a supply-driven oil price war. As the year progressed, economic growth strengthened as the oil shock subsided, lessening its effect on the manufacturing sector, while the increasingly confident consumer began opening up their pocketbooks. While many attribute the fourth-quarter U.S. equity market rally to the election, we would like to point out that there were other important factors behind the surge, such as the fact that recent global economic growth has surprised to the upside versus expectations at a level not seen since late 2013. Indeed, the Citigroup Major Economies Economic Surprise Index spent most of 2016 scaling the aforementioned mountain of pessimism. So it was improving economic data and a potential pro-business agenda from the U.S. President-elect Donald Trump that served as the backdrop for the market's advance in the fourth quarter. Perhaps most importantly, as we opined, overly pessimistic investors were forced to rethink their skepticism and were the "buying fuel for the fire" that pushed U.S. stocks to record highs.

A Shifting Macro Backdrop

The marquee event of the fourth quarter, however, was the election. Without delving into the divisive world of politics, here is our nonpartisan economic takeaway: in the aftermath of the Great Recession, increased rules and regulatory laws were put in place to lower the risk of a future financial crisis. A focus on safety was a benefit that Americans wanted, and this search for safety occurred at the same time that America's consumers, banks and government were practicing austerity and rebuilding their balance sheets.

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Perhaps Americans are now perceiving and connecting (rightly or wrongly) the cost of these actions to slower growth, a toll they are no longer willing to bear. It now appears that there has been a pivot to a growth focus with fiscal spending as the new elixir. This may lead to a different set of future costs such as inflation, less safety and protectionism, to name a few. And this is not just a U.S. phenomenon – government spending, tax cuts, protectionism and nationalism are rising all over the globe (think Brexit).

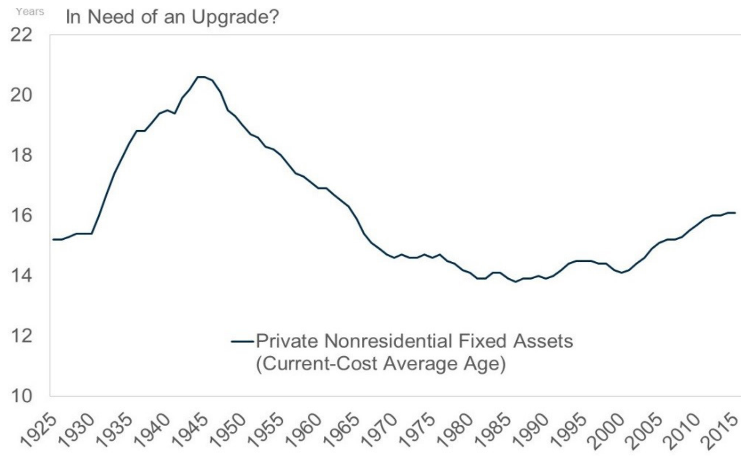

Chart #00061
Source: Bureau of Economic Analysis, Bloomberg L.P., Northwestern Mutual Wealth Management Company

The 2017 Economic Growth "Bean Counting Exercise"

We continue to believe that the underlying economic fundamentals point to ongoing, and likely rising, growth in both the U.S. and abroad in 2017. Thanks to the aforementioned balance sheet having been rebuilt, the U.S. consumer is now experiencing rising wages that are bolstering income and spending ability. U.S. banks, perhaps under a lighter regulatory touch, may be compelled to incrementally loosen their purse strings and lend more. And after years of contraction, U.S. fiscal spending looks set to be increased, which could mean a short-term boost for gross domestic product growth. As a sidebar, how many are aware that U.S. government investment recently drew down by the most since the 1950s?

The big growth wildcard is U.S. business investment. If U.S. policymakers can clarify and reform the tax code, corporations may finally start spending to meet what we believe will be rising demand. Interestingly, after the election, surveys of CEO confidence finally started to match the optimism reflected in consumer confidence polling. While a large amount of the recent business investment drawdown can be attributed to the aforementioned oil slump, business investment has nonetheless been lacking for much of the recovery. In fact, according to the Bureau of Economic Analysis, the current-cost average age of U.S. nonresidential fixed investment – which encompasses corporate structures, equipment and intellectual property products – is as old as it has been since 1964.

Investing in the Changing Trends

While we continue to believe rising economic growth will ballast U.S. equities in 2017, the current valuations will serve as a headwind to future performance. Much as we noted in our third-quarter review, we believe that international options, namely the eurozone and Emerging Markets, provide value for investors. We often hear the comment that there are no cheap asset classes, but we believe that analysis is overly simplistic and will likely be proved wrong in 2017.

In the depths of the Great Recession, U.S. equity markets plunged alongside their earnings per share. The result, according to many experts, was that a simplistic review of the popular price to trailing 12-month earnings ratio never showed the market as "cheap." Even after the S&P 500 fell by nearly 50% to the mid 600s in March 2009, many prognosticators predicted that the index would fall further because it still traded at 15 times trailing earnings. Even more noteworthy, by September 2009 the S&P had recovered to 1,057 and many were screaming that it was overvalued. Why? Because it traded at 23 times trailing 12-month earnings. This simplistic analysis missed the fact that earnings were at a cyclically depressed $45 per share, which represented a fall of 50% from their pre-recession level of $90 per share.

We believe the "no cheap market" commentary crowd may be making a similar mistake in its current analysis of the international market, most notably when it comes to the eurozone and Emerging Markets. While U.S. earnings have smartly recovered to a more "normal" $107 per share and taken the market with them, MSCI eurozone earnings remain at just 50% of their pre-recession peak and are 32% off of their early 2011 recovery high. Similarly, emerging market earnings are off 32% from their pre-recession peak and 41% off of their 2011 recovery high.

Unfortunately, there is no guarantee that earnings in the eurozone and Emerging Markets will revert back to their peaks, as has been the case in the U.S., but there is certainly room for an earnings recovery. Under our base-case scenario of improving global growth, international markets may become favored over other investments and fund flows will follow as their earnings recover to more historically normal levels.

The Bottom Line

Yearly financial forecasts are exercises that are subject to many tweaks. Every day we analyze incoming information and update our outlook within our long-term-focused framework. Certainly, new and unexpected opportunities will present themselves this year and new risks will emerge: 2017 will not be without its surprises, and diversification remains the best way to combat this uncertainty.

At the top of our list of 2017–2018 worries is the fear that markets are not prepared for potentially higher interest rates. We continue to believe that this economic recovery ends like nearly all others, with some part of the economy in excess (think housing in 2005–2006). We are still likely to be some time from the end of recovery because nothing appears to be currently in excess. However, it is not too early to begin pondering if and when the Federal Reserve will be forced to tighten at a faster pace to stomp out the excesses that ultimately will develop. After all, we are now threatening to add fiscal stimulus to an economy that is already on a firm footing. We also note that 2017 will likely witness other central banks around the globe, such as the European Central Bank and Bank of Japan, beginning to more aggressively discuss doing less. These actions could serve to upset the bond and stock markets in the coming year.

And lastly, no matter your political leaning, it is likely that everyone can agree that the new administration will follow a different playbook than that of recent presidencies. At a minimum, there will be change from the prior eight years. This could serve to heighten volatility as the global economic landscape evolves in 2017, and beyond.

Happy New Year.

Standard and Poor's 500 Index® (S&P 500®) is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Bank of Japan (BOJ) is the central bank of Japan.

Brexit is a term for the potential or hypothetical departure of the United Kingdom from the European Union.

The Citi Economic Surprise Indexes track actual economic data relative to forecasts of market economists.

The eurozone, officially called the euro area, is a monetary union of 19 of the 28 European Union (EU) member states which have adopted the euro as their common currency and sole legal tender. The other nine members of the European Union continue to use their own national currencies.

The Bureau of Economic Analysis (BEA) is an agency in the United States Department of Commerce that provides important economic statistics including the gross domestic product of the United States.

The European Central Bank (ECB) is the institution of the European Union (EU) which administers the monetary policy of the 17 EU eurozone member states.

The American Association of Individual Investors is a nonprofit organization with about 150,000 members whose purpose is to educate individual investors regarding stock market portfolios, financial planning, and retirement accounts.

MSCI Inc. formerly MSCI Barra, is a United States-based provider of equity, fixed income, and hedge fund stock market indexes, and equity portfolio analysis tools. It publishes the MSCI BRIC, MSCI World and MSCI EAFE Indexes.

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