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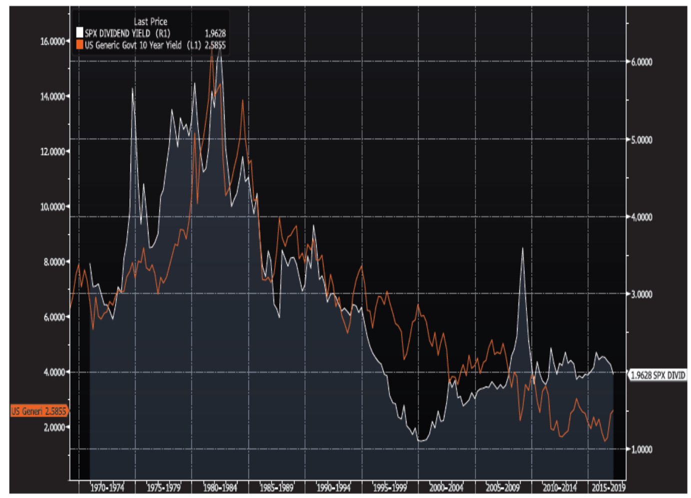
The Sleeping Tiger Awakens?

2017 began with enthusiastic anticipation of increased corporate profitability due, in part, to a more regulatory friendly and fiscally supportive U.S. government. Meanwhile, equity valuations are tiptoeing into "expensive territory", and bond prices have tipped over the top of the price hill as yields move higher. The most likely scenario we see for financial assets is less-than-average gains in the coming few years. Barring "animal spirits" driving financial asset prices upward without guard rails, average equity returns of less than the long-term historical average between 1928 and 2016 of 9.5% (Federal Reserve database in St. Louis – FRED) and fixed income returns made up of the coupon are more or less our starting point assumptions for capital market returns.

The Standard & Poor's 500 Index, made up of companies such as Apple, Exxon Mobil, Microsoft, and JPMorgan, is currently valued at a price to earnings multiple of approximately 22.2 times 2016 earnings at February 2017 month-end and 18.1 times 2017 estimated earnings (*2/28/2017 Dow Jones Indices S&P 500 Earnings and Estimate Report*). 2017 earnings for the Standard & Poor's 500 Index are estimated to grow by 25%, according to S&P Dow Jones. Over the last few years, corporate earnings estimates provided by Standard and Poor's have come down each year as the year has progressed, and equity multiples have therefore moved upward. Given what appears to be an awakening of "animal spirits" enabling recent positive equity market returns, these increasingly higher equity valuations coincident with higher interest rates suggest to us that earnings growth, or lack thereof, will matter. In addition, the chart below shows the degree to which the Standard & Poor's 500 Index dividend yield and the U.S. 10-year Treasury yield are currently at the low end of the range for the period 1970 to present.



Source: Bloomberg
Right Axis – S&P500 Index
Left Axis – U.S. 10-year Generic Treasury

Brexit and the United States elections are just the latest in a series of world events that leave the investment landscape vulnerable to a diverse range of outcomes over 2017 and beyond. Whether it is how Congress addresses the U.S. public debt levels, policy reform for healthcare, taxes, and government regulation, or foreign politics including the mid-May French elections, these issues carry catalytic potential. Either the "sleeping tiger" as John Kenneth Galbraith so well described the United States as it moved from inaction to purposeful action may have awakened and is yet to roar as U.S. economic growth accelerates, or the "hare" may be slow in passing the baton from monetary-induced growth to fiscally-stimulated sustainable longer-term inclusive growth. Planning for an increased range of economic and political outcomes, given higher financial asset valuations with lower yields for stocks and bonds, seems to us a prudent option for investment portfolios during the coming year.