

U.S. EQUITY STRATEGY 2017 YEAR AHEAD: EUPHORIA OR FISCAL FIZZLE?

“2017 may be the least certain in years, with higher-than-usual risks and a binary set of outcomes that have dramatically contrasting results: euphoria or fizzle, significantly higher or lower than the base case. As the likelihood of pro-growth policies waxes and wanes in the coming months, we see potential for big market swings. Risk/reward will be more important than absolute targets.”

– Savita Subramanian, head of U.S. Equity and Quantitative Strategy

Our view**Year of the Rooster: An erratic bird with fat tails**

The upcoming year could be anything but normal. Looking ahead, we see fat tails and a binary set of outcomes. We have an S&P 500 year-end 2017 target of 2300 that assumes a gain of about 4 percent from current levels. However, the target and the recent rally depend on policymakers’ ability to deliver growth next year against a backdrop of elevated valuations, slow growth and limited scope for credit expansion. President-elect Trump’s comments on trade and Congressional Republicans’ comments on deficits and spending could drive big market swings in the coming months. Under such conditions, risk/reward will be more important than absolute targets.

Bull case: From skepticism to euphoria

Euphoria, which typically marks the tail end of a bull market, has been absent in this cycle. However, since Brexit and the U.S. election, a new wave of optimism has driven stocks higher. With 2016 on pace to be the weakest year of global growth since 2009, it would not take much to see improved results in 2017, especially if U.S. fiscal stimulus and tax reform provide a boost. The case for a traditional, euphoria-driven end-of-bull-market rally is easy to argue for, and 20 percent or greater annual returns are the historic norm, putting the S&P 500 at 2700 in our bull case.

Bear case: Fiscal fizzle, stagflation and the “r” word

If policymakers cannot deliver growth, the markets will be disappointed, given the expansion we have seen in stimulus beneficiaries. Buybacks are slowing, cost-cutting is reversing and elevated valuations and leverage ratios – together with weak sales growth – provide a bearish perspective. Protectionism is more likely to turn nascent inflation trends into stagflation. While it is not the base case, three of our top five leading indicators suggest a recession within 12 months. Applying typical (not extreme) recessionary returns to current S&P 500 levels yields a bear-case scenario of 1600 for the S&P 500.

The real game-changer: Tax reform

Tax reform is a priority for President-elect Trump, has widespread Republican support in Congress and can be enacted through the up-or-down budget reconciliation process, which cannot be filibustered. We expect S&P 500 EPS to be \$129 in 2017, which is 9 percent year-over-year; however, proposals for lower tax rates could add \$8–11 to non-financial EPS next year. The treatment of foreign profits, and the end of interest rate and other deductions, could cut that benefit in half over time. The market is not exactly pricing in the benefit: companies with high

effective tax rates have seen relative multiples compress.

Sector schizophrenia

A barbell approach to sectors makes sense, given a bifurcated view and how rapidly sentiment, positioning and valuations have swung to the reflation/growth side. Within defensive sectors, overweight Health Care but underweight Staples; of the bond proxies, overweight Telecom but underweight Utilities. Within cyclical, overweight Financials and Consumer Discretionary but underweight Materials.

Size, style and theme recommendations for 2017

Within size, we take a similar barbell approach: We like small and large caps, but would avoid mid caps. Consistent with an outlook for accelerating profits in 2017, value should be preferred over growth, but dividend growth stocks should be favored over high dividend yield stocks. On quality, the secular case remains intact but could be at risk on a cyclical basis.

The most contrarian theme: Long-term fundamental investing

The shift toward data-driven, fast-money strategies leaves a gaping opportunity for long-term, fundamental investment strategies. While active managers could continue to face challenges, lengthening one's time horizons might help. The risk/reward of stocks improves with time, and fundamentals win out over short-term signals over the long haul.

Key calls

- **Markets** – Revised 2016 year-end target for the S&P 500 of 2100; 2017 year-end target of 2300; long-term target (year-end 2025) of 3500. Note that 2017 could be a binary year where the bull case yields 2700 and the bear case 1600.
- **EPS outlook** – 2016 EPS of \$118.50 (flat year over year); 2017 EPS of \$129.00 (+9 percent year over year); 2018 EPS of \$137.00 (+6 percent year over year).
- **Policy impacts** – Over the next 10 years, President-elect Trump has called for \$1 trillion in infrastructure spending and our economists expect \$2–3 trillion in tax cuts. Beneficiaries:
 - Infrastructure-exposed stocks in sectors such as Industrials and Materials may benefit, but it is important to be selective: U.S. stimulus beneficiaries have re-rated twice as much as other stocks
 - Lower taxes for individuals should accelerate consumer spending, benefitting Consumer Discretionary stocks
 - Corporate tax reform (net impact of lower U.S. tax rate, repatriation and taxation of foreign profits) could add \$5–6 to annual EPS over time
- **Sector Preferences** – Our recommendations are neither cyclical nor defensive, but represent barbells.
 - Overweight: Health Care, Financials, Telecom, Consumer Discretionary
 - Marketweight: Real Estate, Tech, Industrials, Energy
 - Underweight: Consumer Staples, Utilities, Materials