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October 2017 Update: Stay the Course, Open an Umbrella, or Build an Ark?

The equity markets have done well in 2017, especially the higher growth in foreign markets. Will the good investment news continue? No one knows for sure, but we continue to exam the long-term fundamentals that drive equity investments vs. short-term market pull-backs related to daily news events.

Hurricane Disasters sadly are a growth stimulus. It is estimated $200 billion+ needs to be spent on recovery for the recent catastrophic storms. While the immediate effects in jobs and lost economic production are negative, the rebuilding should be a positive economic stimulus. A key problem is finding enough skilled workers. This has already been an issue for many home builders with fewer foreign (especially Mexican) workers they relied upon for skilled construction labor.

Ignore Chaos in Washington

I suggest ignoring the noise of politics and look to the real world of economic and corporate earnings. As InvestmentNews reported "Global economic momentum is strong. The biggest risk is being too worried about political risk."

The current strong earnings have little to do with anything "Trump" If there is a reduction in corporate tax rates this could be a bonanza to investors since would directly increase bottom line profits. Eliminating regulations can encourage some growth. Badly needed infrastructure spending would have benefits - however this is unlikely to be passed soon - with the expected fight how to pay for it.

U.S. Fundamentals

S&P500 Earnings continues solid growth

FactSet 10/6/2017 reports for Q3 2017 the estimated earnings growth rate for the S&P500 is 2.8%. Seven of nine sectors are expected to report earnings growth, led by the energy sector. This estimated earnings growth has come down from 5% since September 5th due to the huge declines of major insurers from the catastrophic losses from recent hurricanes and the earthquake in Mexico. If the insurance industry were excluded, the estimated earnings growth rate for the S&P500 for Q3 would improve to 4.9% from 2.8%.

Companies with more global business overall have the highest estimated earnings growth rates, benefiting from higher foreign GDP growth. For companies that generate less than 50% of sales inside the U.S., the earnings growth rate is 7.9% vs. 2.8% of the overall S&P500 index.

This higher foreign growth can especially benefit U.S. exporters, if Trump doesn't start a trade war trying to protect uncompetitive U.S. industries.

Final Q3 Earnings Growth of 6%?

While the estimated growth rate for Q3 is 2.8%, historically this is conservative, and usually, most companies beat estimates. There are potential legal reasons for analysists and companies being conservative in their estimates.

On October 6, 2017, FactSet estimates the actual reported earnings growth rate for Q3 will more likely be about 6%.

Future Earnings Growth Estimates

As of 10/6/2017 FactSet reports while analysts estimate for Q3 is 2.8%, growth is expected to rebound after Q3 with earnings growth estimates (that are usually beaten) as follows:

Q4 2017	11.1%	Q1 2018	10.5%
Q2 2018	10.3%	Full 2017	9.2%

These could change dramatically with a serious global crisis or increase by more economic stimulus by more deficit spending on the military, hurricane relief, tax cuts, or other factors. There seems to be the risk is more of a “melt up,” than a meltdown as some are reporting. President Trump has often said he loves debt. However, while he files bankruptcy to avoid, it is a serious long-term issue for the U.S.

Valuation Concerns – On the surface, the S&P500 index looks a tad pricey. However, remove Amazon, Netflix, and Facebook with their high price/earnings (P/E) ratios that distort the average, and look at the “S&P 497.” If you then adjust the P/E ratio for the net cash of $343 billion on the balance sheets of Apple, Cisco, Alphabet, and Microsoft, the resulting

P/E ratio of the “S&P497” will be considerably lower. (Wall Street Journal)

We have never recommended any “dumb” index funds with no stock selection based on individual company outlooks. Just because a company is in an index, does not make it a good investment.

Both in the U.S. and globally, smaller companies have the potential for faster growth and with so many more smaller companies than large, good research can potentially find hidden gems. Smaller companies’ stocks are often more volatile with less trading volume, but over the long term have rewarded investors.

Economic Outlook (JP Morgan October 2017)
“This economic expansion has been like a healthy tortoise – slow but steady. In fact, as of September, the expansion is in its ninth year, making it the third longest expansion since 1900. Growth accelerated in the second quarter after slowing in the first, and rebuilding following a series of natural disasters should add to growth. That said, U.S. growth may be limited moving forward by structural constraints.

“Growth should accelerate and stabilize through the end of 2018, reflecting a pick-up in exports, inventories and government spending. Stronger investment spending and an improving global economy should be tailwinds, and the prospect of fiscal stimulus seems to be back on the table in the form of tax reform, despite low unemployment and political turmoil. Regardless, weak productivity and labor force dynamics should prevent any sustained rise in growth above 3.0%.”

International equities: Passing the baton from the U.S. to International

As JP Morgan reports October 2017:
"International equities have underperformed U.S. equities by over 150 percentage points since March 2009, a result of economic and earnings challenges overseas. However, the future is already looking brighter for international investing.

“Four factors suggest that international equities’ outperformance so far this year is set to continue: more attractive valuations, acceleration in growth outside of the U.S., faster earnings growth abroad and possible currency tailwinds. Investors should make sure they have enough exposure to this improving growth story overseas, especially as the U.S. is in the later innings of its own expansion.

“U.S. earnings in the next 12 months are expected to be at a record high. However, earnings in both Europe and Emerging Markets (EM) remain far below their 2011 peaks. A long cyclical recovery in Europe and an improving banking system should lift European earnings while EM profits should rebound on firmer commodity prices. Both European and EM earnings appear to have more room to grow than in the U.S.

“The Eurozone is growing particularly fast, thanks to a weak currency, rising confidence and considerable pent-up demand, while other developed markets like Japan, Canada and the U.S. continue to accelerate.

“The UK appears to be weathering the impact of the Brexit vote better than many had feared, thanks to more competitive exports on a weaker currency. Meanwhile, a rebound in demand for commodities continues to be a positive for Latin America, Canada and Australia, while Chinese contribution has ebbed slightly in recent months as authorities try to restrain financial speculation.”

We have been increasing our allocations for clients to carefully selected foreign investments options as part of our recommended diversified equity portion of portfolios.

China Takes Over Asian Economic Leadership – potentially positive for Asian growth

China's new world order: Xi, Putin, and others meet for Belt and Road Forum CNN

“After Trump abandoned the Trans-Pacific Partnership (TPP) China, Russia and Asian nations are taking over economically in Asia.” This could be beneficial to some Asian companies in some of our recommended investments.

"The Belt and Road Forum is China's answer to Davos or the G20, centered around the colossal One Belt, One Road (OBOR) trade initiative, which takes its inspiration from the ancient Silk Road trading route. What we hope to create is a big family of harmonious co-existence,' Chinese President Xi said.

"Xi announced an additional $124 billion in funding for the OBOR initiative, including loans, grants and $8.7 billion in assistance to developing countries. Some $1 trillion has already been invested in OBOR, with another several trillion due to be invested over the next decade.

"OBOR spans more than 68 countries and up to 40% of global GDP. It is China's push to put it in a position of world leadership as the US under President Donald Trump takes a more protectionist approach and gives up the mantle of globalization."

“Others in attendance were Russian President Putin, Turkish President Erdogan and Philippines President Duterte, alongside a host of other world leaders and top ranking officials. Joining them was a small delegation from North Korea, despite recently strained ties between Beijing and Pyongyang over the latter's nuclear program.

"Addressing the forum after Xi, Russia's Putin appeared to take aim at the US, which is not involved in the OBOR initiative. 'Protectionism is becoming the new normal,' Putin warned, adding that the 'ideas of openness and free trade are increasingly often being rejected (even) by those who until very recently expounded them.'"

"Prior to Donald Trump's election as US President, it could be expected that Washington's Trans-Pacific Partnership (TPP) -- a free-trade alliance of 12 Asian and Pacific economies -- would act as something of a counterbalance to rising Chinese power. Trump, however, pulled the US out of the deal a day after taking office."

Time to start ark building? Or at least grab your umbrella?

I believe this is a time to invest especially in global growth companies using managers with a long-time track record of outperformance vs. risk.

However, for those who are more risk averse and want to lock in some of the recent large market gains, I continue to suggest shifting to our more defensive "participate yet protect" strategies which I can review for clients based on their objectives and risk tolerance. We avoid most bonds that have high-interest rate risk but recommend a variety of other alternatives.

As Wealth Management points out, "Occasionally markets go through periods of extreme volatility and declines. It's easy to ride out small fluctuations when you have a long-time horizon. But in the case of large declines, experienced investors like to seek protection or hedge. In fact, for active investors, hedging might be considered as another form of diversification."

Higher Interest Rates Eventually?

To the surprise of many, interest rates have continued near historic lows. This is due to even lower rates in many foreign markets and the continuing strong demand for U.S. Treasury debt.

These low rates are not expected to go on forever. If Trump "busts the budget" with his proposed lower taxes (mostly for the wealthiest and corporations) and higher spending on the military, "The Great Wall," and infrastructure, this may be the catalyst that leads to higher interest rates. In addition, there is pressure to fund the rebuilding of Puerto Rico and funding for hurricane relief in Texas and Florida. This increased spending can be good for the economy and stocks, but risk a surge in interest rates and losses for bond values.

Therefore, we do not recommend most bonds. If a bond has a duration of 7 years, it would be expected to lose 7% in value for each 1% increase in interest rates – absent other factors.

Since 1950 the stock market has done fine even with rising interest rates, provided the annual growth in earnings exceeds the 10-year Treasury yield which is now at about 2.3%.

Investor Action Recommendations

The outlook is on balance favorable but with risks. Potentially, foreign earnings may be poised for stronger growth than those in the U.S. A well-diversified portfolio should span geographies as well as sectors of the market.

Recommended Equity Strategies:

"Participation Yet Protect" equity growth strategies: This helps maximize potential market gains with a widely diversified portfolio. Instead of "dumb" index funds with no stock selection based on individual company outlooks, or similar ETF's (only make sense for traders, not investors), we suggest managers with long-term track records of outperformance compared to the category they invest in, and compared to the risk taken (Alpha vs. Beta in investment terms) – not just raw returns.

Avoid most bonds other than some forms of secured floating rate debt that can benefit from higher interest rates.

We also recommend alternatives without stock or bond market exposure for more cautious income, or participation in part of equity gains without downside risk backed by a strong insurance company[1].

[1]All guarantees are based on the claims-paying ability of the insurance company