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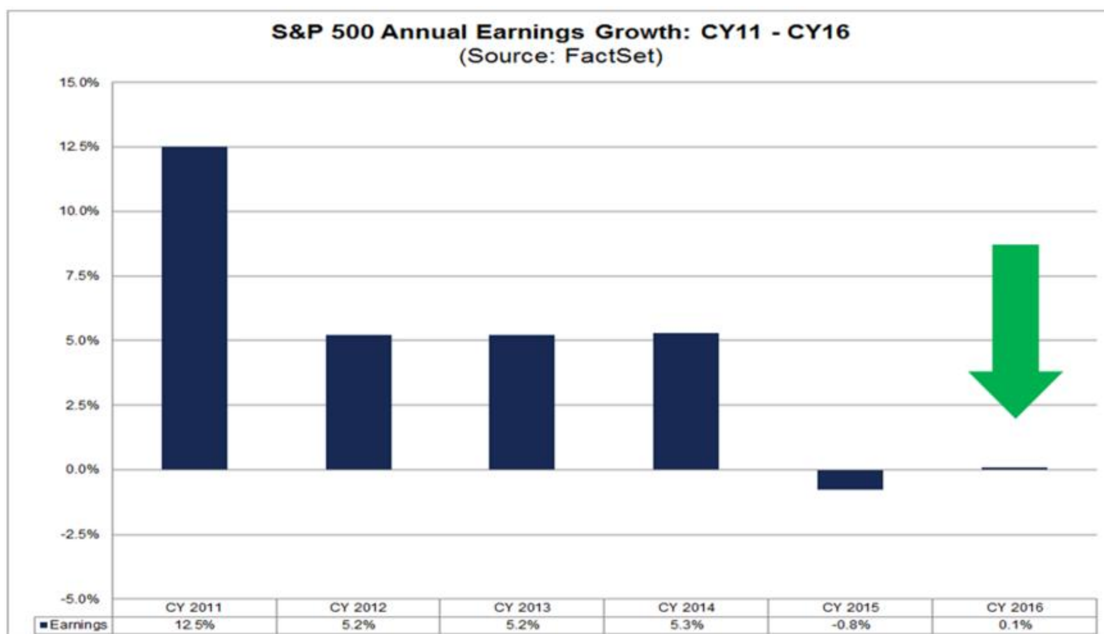
Archer 2017 Update and Outlook:

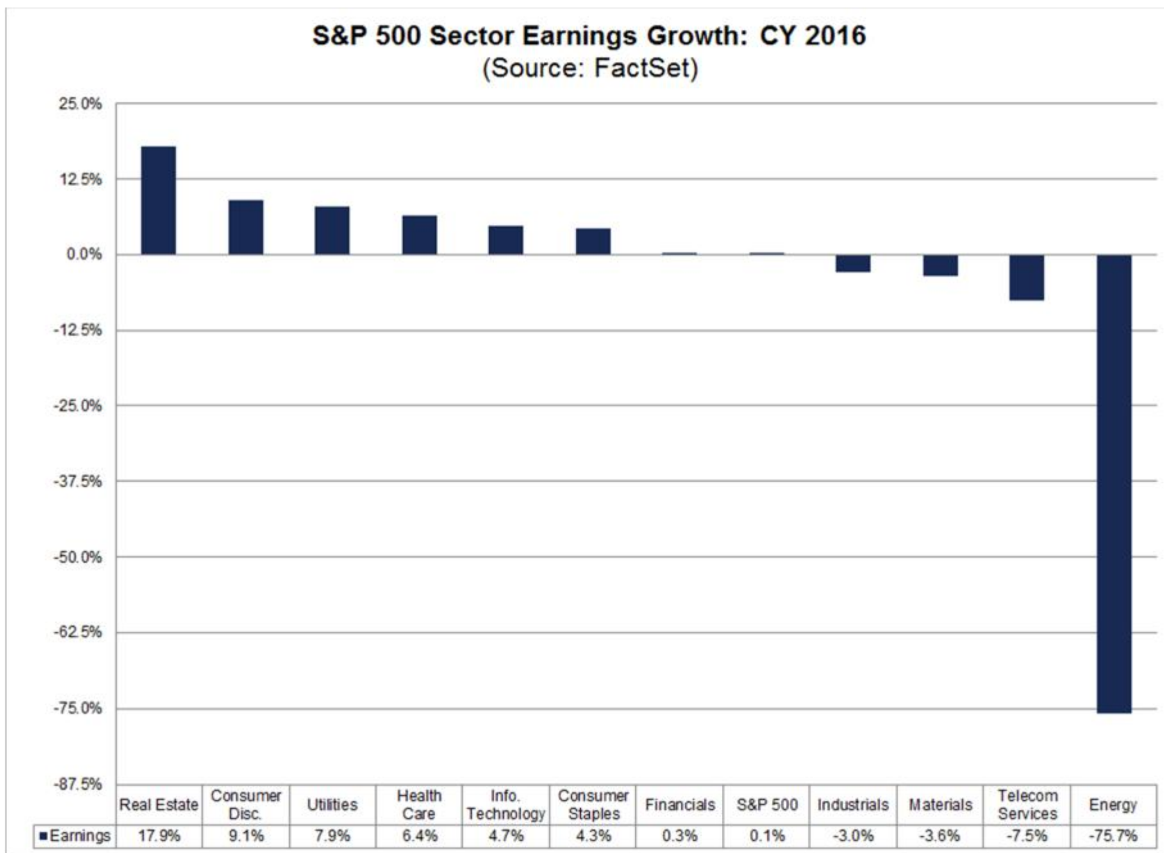
At the start of 2016 we anticipated the market to move higher by 5-7%. We looked pretty accurate until the election turned in results that many were not expecting. The water under the bridge kept moving so let's do the same. Typically from November through April of an election year we see an average 10.3% return in the market since 1926. From November 2016 through this writing on January 4, 2017, we have seen returns of approximately 7.5% in the S&P 500! Whether this takes some steam out of 2017 total return or not is yet to be determined. We will examine why the market should move higher and what role interest rates will play in 2017. Most importantly what will earnings report in 2017? Will earnings break out of this 2015-16 Rip Van Winkle nap?

If you recall in October, confidence in the stock market was waning even with unemployment at anemic levels. We heard doom and gloom consistently out of the talking heads on TV. Now with the election behind most of us, we can focus on earnings growth in the US. Yes, with this President, we are going to see constant headline risk (or Twitter risk), but with this comes some relief in regulation for the financial industry. Any bull market needs financials to perform well if it is to be long-lived. In this case higher rates and less regulation may propel financials higher.



The previous table shows how weak earnings were in 2016. Much of this was attributable to energy as shown in the table below. For 2017, we see Energy returning some of its earnings growth which could propel overall earnings much higher in 2017. In fact, the current estimates are for some double digit earnings growth for the S&P 500 in the latter half of 2017.

However, one statistic we just can not ignore is the prognostication coming from the elite on Wall Street. We know how accurate they are every year! (Hear my sarcasm). For 2017, the experts are predicting a 5% return on the S&P 500. Now that number may not seem too far-fetched. However, for the last 17 years these same experts have predicted 9.6% returns on average and the end result was only a 4.2% return. This is not even close. They have been overly exuberant about returns.



The reason I mention this exuberance about returns: 2017 will represent the smallest gap between the most optimistic estimates and least actual results since 1999. We all know how 1999 ended. I think these estimates tell us there is going to be much more volatility in the stock market in 2017-18. There will be some bumpy rides as everyone jumps and climbs with every headline or tweet.

We can see in the next graph the volatility we experienced in 2015 and 2016. I don't like looking in the rearview mirror, but it is important to note that 5% moves up or down in the market are to be expected in 2017 and beyond.

Let's move on to interest rates. We have seen the yield on the 10 year Treasury Note move up 100 bps to over 2.5% since the election. Many are speculating a move upward in interest rates would ruin any chance of the stock market moving higher. Not so fast. Stocks and interest rates can sometimes go up together as they did in the mid 50's up to 1970. The one thing we don't want to see is interest rates move too high too fast. We expect the Fed to move rates higher at least twice in 2017 and probably three times. This will be a positive for financial institutions and property and casualty insurers. Likewise, deregulation could boost profits for financial firms and many other companies. The table below shows 12 episodes of bond yields rising and the stock market rising as well. Often times, interest rates are moving higher because the economy is doing well; as is the case this time. The US Manufacturing PMI for December came in at 54.7% which says the economy is doing better than OK. With numbers strongly above 50, we see little chance of an economic downturn in the first half of 2017.

	Dates	10-Yr. Bond Yield	S&P 500	Stock Market/ Bond Yield Action	© 2016 The Leuthold Group
1	May 2, 1958	2.89	43.69	Stock Market Up:	38.5 %
	July 31, 1959	4.41	60.51	Bond Yields Up:	152 Basis Points
2	January 11, 1963	3.80	64.85	Stock Market Up:	44.7 %
	February 11, 1966	4.86	93.81	Bond Yields Up:	106 Basis Points
3	January 27, 1967	4.47	86.16	Stock Market Up:	25.8 %
	November 29, 1968	5.78	108.37	Bond Yields Up:	131 Basis Points
4	November 5, 1971	5.72	94.46	Stock Market Up:	26.8 %
	January 5, 1973	6.42	119.73	Bond Yields Up:	70 Basis Points
5	March 3, 1978	8.04	87.04	Stock Market Up:	60.1 %
	November 28, 1980	12.72	139.33	Bond Yields Up:	468 Basis Points
6	November 5, 1982	10.48	143.02	Stock Market Up:	19.1 %
	July 22, 1983	11.43	170.35	Bond Yields Up:	95 Basis Points
7	April 18, 1986	7.09	242.42	Stock Market Up:	38.9 %
	August 21, 1987	8.77	336.77	Bond Yields Up:	168 Basis Points
8	October 2, 1998	4.31	1002.60	Stock Market Up:	46.1 %
	January 14, 2000	6.69	1465.2	Bond Yields Up:	238 Basis Points
9	June 13, 2003	3.13	988.61	Stock Market Up:	34.1 %
	May 5, 2006	5.12	1325.76	Bond Yields Up:	199 Basis Points
10	March 20, 2009	2.65	768.54	Stock Market Up:	53.3 %
	April 2, 2010	3.96	1178.10	Bond Yields Up:	131 Basis Points
11	June 1, 2012	1.47	1278.04	Stock Market Up:	44.1 %
	December 27, 2013	3.02	1841.40	Bond Yields Up:	155 Basis Points
12	July 8, 2016	1.37	2129.90	*Stock Market Up:*	*2.9 %*
	December 2, 2016	*2.40*	*2191.95*	*Bond Yields Up:*	*103 Basis Points*
				Average Stock Market Gain (Excl. 2016):	**39.2 %**
				Median Stock Market Gain (Excl. 2016):	**38.9 %**
				Average Bond Yield Increase (Excl. 2016):	**174 Basis Points**
				Median Bond Yield Increase (Excl. 2016):	**152 Basis Points**

With PMI here at home approaching the mid 50's and world PMI above 50 now we could start to see inflation creep in and move above the average Consumer Price Index (CPI). We will look at the last 46 years and half of the years are lower than the median and half are higher. The average annual returns were positive except for commodities in low inflation years (the lower 23 years). In higher inflation years commodities increased 22% annually vs. -1.9% in low inflation years. So we might expect higher oil prices and gas prices for 2017 if we assume CPI/Inflation are higher than normal. We expect oil to hover around $62 per barrel in 2017. This level will not be enough to derail the economy, but enough to return profitability to the energy sector which should be another positive for the stock market in 2017.

As we keep discussing sectors such as financials or energy, we think it makes sense to look at how sectors perform annually in different years of an election cycle. We all know Health Care struggled in 2016 and was essentially flat for 2015 and 2016 combined as Washington took their pound of flesh from the industry by claiming they were the cause of high insurance and health care costs. Folks, we are aging as a society and we all want to live longer with new drugs. This costs money! I do think making insurance companies compete across state lines will also drive down costs. This may be a possibility if the new administration finds a way to adjust the Affordable Care Act and make it more Affordable.

Sector Performance in Election Cycle	Election Year	Election Year +1	Election Year +2	Pre-Election Year
Financials	**10.4%**	**15.7%**	**4.5%**	**6.7%**
Utilities	**7.1%**	**3.7%**	**.3%**	**10.3%**
Consumer Staples	**5.6%**	**8.5%**	**8.3%**	**9.7%**
Energy	**7.3%**	**13.9%**	**2.4%**	**14.0%**
Health Care	**3.2%**	**13.1%**	**10.4%**	**13.2%**
Industrials	**5.3%**	**14.9%**	**3.2%**	**15.5%**
Consumer Discretionary	**1.6%**	**19.9%**	**9.4%**	**13.2%**
Materials	**-1.0%**	**14.7%**	**4.7%**	**13.1%**
Information Technology	**-2.0%**	**18.3%**	**15.7%**	**31.8%**
Telecommunications	**-2.6%**	**5.7%**	**7.9%**	**12.1%**
S&P 500 data from 1/1/92 through 12/31/16 Past Performance is not a guarantee of future results.				

Looking Ahead:

We continue to see opportunities for stocks in lieu of bonds in the next year. As we are in Election Year +1, we see good opportunities for the stock market. If earnings hold up as expected this year, the market could move 9-12% higher in 2017. Although we have discussed bonds moving lower (rates higher) it is possible with all the World's Central Banks, interest rates may be range bound as liquidity is extremely high. In addition, money supply in the US and around the world continues to grow even in the face of Federal Reserve Banks around the world raising rates.

Regards,

The Archer Team

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