Capital Market Outlook 2017

PennMutual Asset Management

Capital Market Outlook for 2017

Nearly eight years into one of the most unloved bull markets ever for U.S. equities and credit, the rally now appears ready for "extra innings." Despite increasingly full valuations and an earnings recession for U.S. companies during a recent five-quarter stretch, proposed economic policies under the Trump administration will be supportive of domestic economic growth and corporate profits. The awakening of dormant "animal spirits" should provide a boost to both business and consumer confidence and finally move the economy out of stall speed. Corporate profitability will once again be defined by fundamental yardsticks (i.e. sales growth, margins), as opposed to financial engineering fueled by low borrowing costs.

While supportive of risk markets, Trump's policies will likely spell the end of the 30-year bull market for bonds. Protectionist trade policies, tighter labor market conditions and accommodative monetary policy will push inflation readings above the Federal Reserve (Fed)'s 2% target next year and take interest rates higher alongside. In line with recent Federal Open Market Committee (FOMC) projections (the so-called "dot plots"), we anticipate three quarter-point rate increases this year by the Fed. Long-term Treasury rates will maintain their upward trajectory experienced since Election Day, with the 10-year Treasury projected to finish 2017 near 3%.

We entered 2016 with the view that credit risk premiums were attractive relative to equities. Even our optimistic projections did not foresee high yield bond performance in excess of 17% for the 2016 one-year period. Investment-grade corporate credit also performed well in 2016, outperforming duration-matched Treasury bonds by nearly 5%. Corporate credit spreads overall have now reached fair value territory but pockets of opportunity still exist for active management. Credit selection, yield curve positioning and tactical exposure versus government debt will be necessary to realize significant outperformance in 2017.

This year will be the year equity investors transition back to basics as sales and earnings growth drive performance. Since the financial crisis, the low interest rate environment has incentivized U.S. corporations to borrow and use the proceeds on financial engineering (primarily in the form of share repurchase activity). More than two-thirds of total S&P 500 corporate earnings have been spent on share buybacks during the past year. Incredibly, 119 S&P 500 companies* have spent more on buybacks than they generated in earnings. Proposed Trump policies for fiscal stimulus, a less restrictive regulatory environment and elimination of the tax deduction for interest expense will shift incentives back toward new capital investment. We expect greater dispersion among equity market winners and losers in the new environment, but moderate gains for the U.S. equity markets overall.

*Information from FactSet

Exhibit 1: 2016 Actuals and 2017 and 2018 Forecasts

Baseline Forecasts		Actual 12/31/2015	Actual 12/31/2016	2017 Forecast 12/31/2017	2018 Forecast 12/31/2018
US Economy	GDP	2.0%	1.7% (Q3)	2.6%	3.0%
	Unemployment Rate	5.0%	4.6% (Nov)	4.8%	5.0%
	CPI	0.7%	2.1%	2.2%	2.4%
Stock Market	S&P 500 Index	2,044	2,239	2,300	2,500
	Russell 2000 Index	1,136	1,357	1,450	1,500
Bond Market	Fed Funds Rate	0.25%	0.50%	1.25%	2.00%
	2-year Treasury Yield	1.05%	1.19%	2.00%	2.50%
	10-year Treasury Yield	2.27%	2.45%	3.00%	3.25%
	30-year Treasury Yield	3.02%	3.07%	3.60%	3.75%
Commodities	WTI Crude Oil	$37	$54	$60	$70
	Gold	$1,061	$1,152	$1,050	$1,100
Currencies	Dollar/Euro	1.09	1.05	1.00	0.95
	Yen/Dollar	120	117	125	130

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