January 2018

A frequent and common question investors are asking is how long will this bull market last for stocks? Most are convinced that the run up in U.S. and global equities will, at some point, correct. There are even some that feel equities are in a bubble and will sharply decline, someday. These analysts point to the recent movement of cryptocurrencies and, by analogy, feel this is proof of similar behavior by stocks. However, there is a bullish argument to be made for the rally to continue.

More reasoned commentators would agree it is possible that stock markets could correct some. We are in the midst of the 2nd or 3rd longest expansion without a correction and the U.S. economy has exhibited some late cycle behavior. Still, some of this behavior has been interrupted by changes in the variables used to measure economic potential. The bullish argument is that stock valuation models have been biased by valuation measures from the Great Recession of 2007-10 and the earnings recession in 2015 and 2016. With the snap back in earnings in last year, producing strong year-over-year growth, a higher multiple is in order. Corporate earnings are going to get a boost from the recently enacted tax cuts, warranting higher stock prices, pushing the threat of recession further into the future, and will produce a change in consensus to a higher market valuation.

The enactment of the tax cut law at year end caused analysts to scramble to revise their earnings expectations. Come January, we are in the unusual situation where analysts are revising the yearly earnings estimates higher for 2018. A decline in corporate tax liability can translate directly to earnings. Economic growth has been running above expectations, in excess of 3% GDP growth in 2018 quarter 2 and 3. Deregulatory reforms are reducing costs and confidence has risen to multi-year highs. Stock prices are powered by earnings and if the bulls are right, the market will move higher.

There is also the long term bullish case that the reduction in tax rates will boost after-tax returns on investments. Projects that had been put on hold as uneconomical may be pulled off the shelf, resulting in an increase in corporate investment. This increase in investment may provide some additional economic stimulus later in the year and prolong expansion. Increased investment could increase productivity, without necessarily raising inflation. The argument is that increased investment and productivity will increase corporate profit and then produce better wage and job outcomes. This would also tend to prolong the expansion and rise in market values.

The Federal Reserve most recently projected three rate increases during 2018 and the possibility of a 4th increase late this year, if necessary. The argument is made that quantitative tapering, reduction of the Fed's balance sheet, may move more quickly than currently anticipated. A new chair at the Federal Reserve will take office in February and may move to normalize sooner than later. It has been proposed that once inflation hits the Fed's target rate, they will declare this as normal and pause before any further rate increases. This could imply fewer rate increases than forecast, also supportive of markets. The interest rate yield curve may begin to steepen by mid-year according to this thesis, improving earnings for financial concerns and dampen concerns of any possible recession.

This argument, for a continuation of the bull market for equities, is not without conditions. Prudent asset allocation is never “all in” but the bull case is for investors to lean toward the higher end of their equity exposure. Advocates of this argument see the risk to be to the upside, rather than the downside. Could this be the case? There is another argument that is less optimistic, but we will cover some of these concerns in another article.