# The Weekly

Special Edition: Expectations for 2017

Peapack-Gladstone Bank, Private Wealth Management



| As of 01/06/2017 | | Wk Net Change | Wk % Change | Div Yield | YTD % Change | 12 Mos % Change |
|---|---|---|---|---|---|---|
| **STOCKS** | Close | | | | | |
| DJIA | 19,963.80 | 201.20 | 1.02 | 2.40 | 1.02 | 13.42 |
| S&P 500 | 2,276.98 | 38.15 | 1.75 | 2.05 | 1.75 | 9.56 |
| NASDAQ 100 | 5,007.08 | 143.46 | 2.95 | 1.21 | 2.95 | 5.89 |
| S&P MidCap 400 | 1,682.07 | 21.49 | 1.29 | 1.67 | 1.29 | 18.73 |
| Russell 2000 | 1,367.28 | 10.15 | 0.75 | 1.44 | 0.75 | 19.39 |

| **TREASURIES** | Yield | **FOREX** | Price | Wk %Change |
|---|---|---|---|---|
| 2-Year | 1.21 | Euro/Dollar | 1.05 | 0.08 |
| 5-Year | 1.92 | Dollar/Yen | 116.91 | -0.01 |
| 10-Year | 2.42 | Sterling/Dollar | 1.23 | -0.49 |
| 30-Year | 3.01 | Dollar/Cad | 1.32 | -1.50 |

Source: Thomson Reuters

## Economy

In 2016 the U.S. labor market continued to improve with the unemployment rate declining from 5.0% to 4.6%. The U-6 measure of unemployment also improved, declining from 9.9% to 9.3%. We are expecting similar moves for these gauges in 2017. With respect to U.S. GDP figures, we are anticipating some acceleration with growth coming in between 2.0% - 2.5% for 2017. During the summer recession risks were elevated, but over the last several months these figures have decreased. The chance of recession commencing in one year could move considerably higher as we approach 2018 and 2019. The Federal Reserve will look to continue raising interest rates with most likely a hike in June and one in December. The consumer continues to show strength with personal income increasing 3.5% in the past year, while personal spending advanced by 4.2%. Business sector spending will be a key factor this year, but weak foreign demand and a strong dollar continue to provide significant challenges for corporate America. Fiscal policy has received a fair amount of attention recently, but we see this potential boost only having a modest impact during the first half of 2017. U.S. nonfarm productivity has been dismal the past five years, and if this important metric does not improve the labor market could overheat causing the Fed to move more aggressively. The Consumer Price Index has increased by 1.1% over the past year, but we are anticipating a larger advance this year, possibly an increase between 2.5% to 3.0%. The best news of the quarter was evidence of a corporate earnings rebound after five quarters of negative growth. Very shortly we will be reviewing fourth quarter earnings, and we are expecting to see modest growth once again. Productivity, business spending and fiscal policies will be the wild cards this year. With positive contributions from all three, the U.S. economy could move closer to the elusive three percent GDP level on an annual basis.

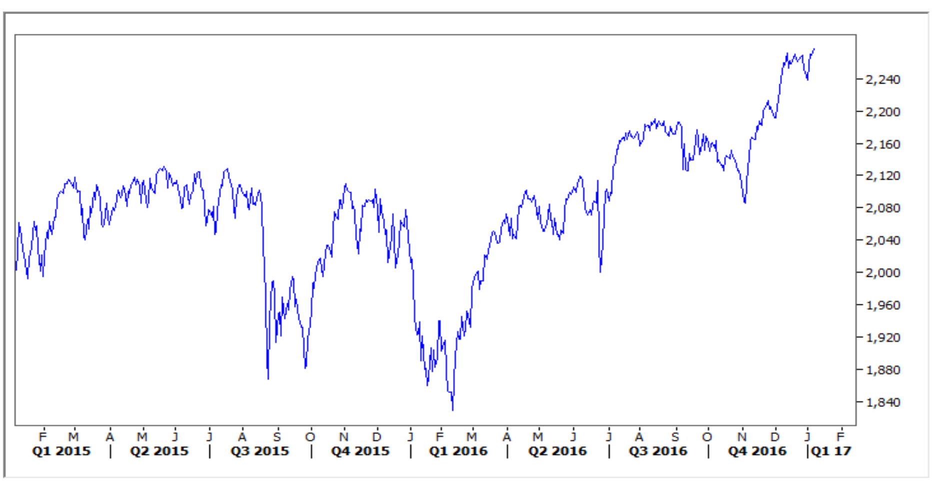
## Equities

Equity markets have begun the new year with stocks mostly holding on to the election inspired run towards the elusive 20,000 mark on the Dow Jones Index. Optimism and generally positive sentiment are keeping traders and investors hopeful that markets can improve on or even repeat the solid performance of 2016 that saw the price weighted Dow 30 sprint ahead by 13.42% and the broad capitalization weighted S&P 500 return just under 9.5%. What is remarkable is that the DJIA has added about 4,400 points from the 15,400 low set barely under twelve months ago and the S&P has increased about 430 points from the 1810 low point. All this transpired despite a host of market headwinds including, deflation concerns, oil crashing, BREXIT, rising interest rates, sluggish growth and a contentious election.

So where do we go from here? Consensus among economists is that recession risk is low now that the trinity of employment, manufacturing and housing appear to be in good shape and should provide a good environment for stocks to remain attractive investments. Perception of a pro-business administration featuring increased infrastructure spending, relaxed regulation and tax relief will also add to the appeal of equities. Investors should keep in mind however, that markets can become volatile and quite risky when expectations are high and valuations are elevated. Success in last year's market was realized by investors who welcomed periods of volatility and took advantage of pullbacks.

We expect increased volatility, sector rotation and usual market surprises to continue. Putting money to work on dips may prove a winning strategy during the coming year. In fact, institutional investors remain quite confident that markets will rebound quickly after any large downdrafts. As always, valuations matter and looking at the eleven market sectors while comparing forward P/E ratios to the various sectors 20-year P/E averages, may be a good starting point to consider adding or overweighting. Based on this viewpoint, technology, healthcare and telecom seem attractive. Each of these sectors have a forward P/E that is below their 20 year averages while also having forward P/E's that are less than the overall forward P/E for the S&P 500. These sectors may also be attractive based on expectations of elevated M&A, less regulation and generally healthy expected dividend payouts that are all above their 20 year averages.

**S&P 500**

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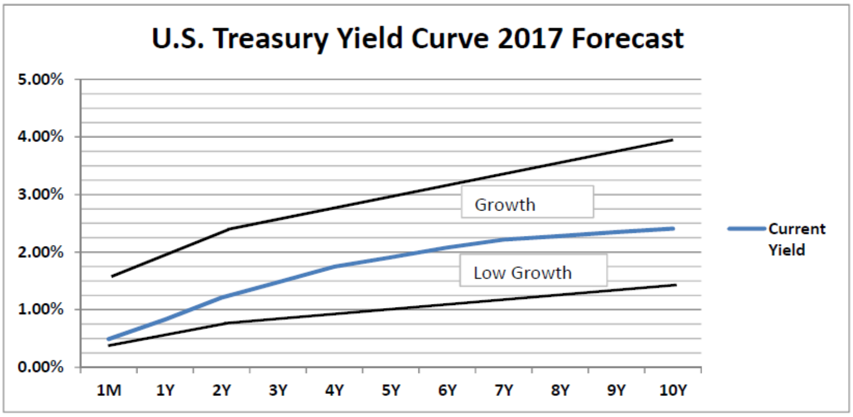


**Fixed Income**

If the economy progresses according to the FOMCs most recent projections, the Fed funds rate should end 2017 at 1.375%, which implies 3 rate hikes over the course of the year. The Fed funds futures market is not quite as optimistic and sees the Fed funds rate ending the year at 1.14%, which implies approximately 2 rate hikes over the next twelve months. The next FOMC decision is scheduled for February 1st and the implied probability of a rate hike currently stands a 12.4%. The second FOMC decision of 2017 occurs on March 15th and right now it looks like there is a 34.8% chance of a 25 basis point rate increase. As of today the first rate hike of 2017 does not have more than a 50% implied probability of occurring until after the May 3rd meeting. If the economic growth that the market is currently anticipating does not come to fruition we would not be surprised if the Fed can only hike rates once in the back half of 2017. However, if wage inflation continues its upward trend and overall inflation rises above the Fed's current forecast moving forward, the Fed may find itself in a difficult position and may have to raise rates faster than what is currently anticipated.

Looking further out on the yield curve, the futures market projects that the 2 and 10-year U.S. Treasury bonds will end 2017 at 1.84% and 2.69%, respectively. Economists, according to the Bloomberg median, are a bit less optimistic and project 12 months from now that the 2-year will yield 1.60% and the 10-year will yield 2.66%. When looking at the 2 to 10-year spread forecasted by the forward market and economists, both project that it will contract from its current level of 120 basis points, which implies 2017 could be another challenging year from a growth perspective. The above listed projections seem reasonable if the U.S. is able to increase GDP growth beyond the low to mid 2% range, and the global economy continues to strengthen. If, however, the previously mentioned goals are not obtained and tax reform, regulatory relief and expanded fiscal policies are not achievable in a 12 month timeframe, U.S. Treasury yields could drop from their current levels.

In 2017 the global chase for yield should continue. Accommodative monetary policies and large scale asset purchases by many major central banks have forced investors into lower quality, higher yielding assets. In 2017, central banks will continue their asset purchases, but the amount of scheduled purchases is expected to be lower than what was experienced in 2016. However, quantitative easing outside of the U.S. will alter the supply and demand landscape and artificially suppress credit spreads to a degree. U.S. debt will remain an attractive alternative for many investors seeking to avoid lower yielding and in some instances negative yielding assets abroad. Furthermore, many central bank buying programs will drive demand for U.S. Treasuries by foreign banks which will ultimately limit the upside potential of interest rates across the U.S. Treasury curve.

The reach for yield extended into the municipal market as well in 2016. Approximately $68B of risky municipal debt entered the market, a 37.5% increase year-over-year. A deluge of municipal issuance is expected in 2017, particularly if President-elect Trump's 5-year $550B infrastructure spending plan begins to take shape. The possibility of increased municipal bond supply and tax reform will be two major headwinds facing the municipal bond market in 2017, as investors will demand higher yields to compensate for the uncertainties that reside within the market.

**Expect Tax Reform in 2017**

Tax reform has been a frequent topic of discussion in Washington over the last decade. Many members of Congress, both Republicans and Democrats, recognize that the U.S. current corporate tax code places domestic corporations at a competitive disadvantage globally. The combined U.S. federal and state corporate tax rate is over 39% versus roughly a 25% average for other developed nations. Both the Bush (Economic Growth and Tax Relief Reconciliation Act of 2001) and Clinton (Taxpayer Relief Act of 1997) tax cuts were proposed, went through Congressional committee, and were signed into law by summer. Both of these laws were also passed by the controversial budget reconciliation that requires only a 50% majority approval. Given the Republican control of both the Senate and the House, we expect to see a sweeping tax law approved by August. We expect a meaningful reduction in the corporate tax rate (very good for earnings) and perhaps a provision allowing for the immediate expensing of capital equipment (very beneficial for technology companies). The Trump Administration may attempt to affect trade policy through the tax code by creating different levels of deductibility depending on the location of production inputs. This would be very contentious and would delay the process.

| COMING UP NEXT WEEK | | Est. |
|---|---|---|
| 01/13 PPI Final Demand YY | (Dec) | 1.6% |
| 01/13 PPI Final Demand MM | (Dec) | 0.3% |
| 01/13 PPI exFood/Energy MM | (Dec) | 0.2% |
| 01/13 Retail Sales MM | (Dec) | 0.7% |
| 01/13 Retail Sales Ex-Autos MM | (Dec) | 0.5% |
| 01/13 U Mich Sentiment Prelim | (Jan) | 98.5 |

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