June Market Outlook

Bullish Case

- Earnings forecasts for 2017 are higher – for now.

- For much of the year, earnings forecasts were constantly being lowered. Now they look like they're stabilizing – for now.

- Interest rates, inflation and oil prices remain low, and are good for the economy and asset prices.

- Oil and many commodity prices have recovered relieving concerns of defaults of energy and commodity related companies.

- Credit spreads are improving, narrowing.

Bearish Case

- China and the global economy are slowing
- Brexit is making the global economic outlook cloudy. The repercussions are being felt in China, Japan, the Middle East, and the Americas.
- Isis and the Middle East create uncertainty, instability and danger
- Earnings continue to be revised downward for 2016.
- Markets are now overvalued (see forecasts below).
- Global central banks, and especially ours, are running out of effective monetary bullets to help our economies, especially if we have a global recession or major financial crisis
- The collapse in oil prices is hurting many energy based economies (Russia, Mexico, Venezuela, Nigeria….). Low oil prices are also hurting the U.S. energy industry and we're seeing more layoffs, bankruptcies, and banks are worried about more energy loan defaults.
- This economic and market cycle is maturing and may enter a decline phase (some indexes have entered decline, bear markets).
- U.S. elections are causing concerns among economists, analysts and investors.

2011 & 2016 Parallels and Divergences

I've read several articles and have seen several "experts" on cable financial news comparing this market to the market of 2011. There are some similarities, but I doubt that this market will follow the same script as 2011.

There are a few similarities:

- International events causing global market disruptions including U.S. markets.

The international events in 2011 included 1. The Arab Spring 2. Grexit and questions about the viability of the Eurozone. 3. The triple tragedies in Japan (earthquake, tsunami, and the nuclear crisis).

In 2016 we do have global concerns 1. China slowing and changing economy 2. Middle East and ISIS (Arab Spring did not have the promise protesters expected and wanted) 3. Brexit.

I believe the mistake a lot of investors are making is paying too much attention to U.S. events and markets, and not enough to international events, as these are where the major risks are for U.S. investors. Brexit is a good example where international events are having major disruptions to markets. Brexit could have long-term consequences for the global economy, especially if other countries follow Brexit.

Just as international events impacted the U.S. economy and markets in 2011, international events are having an impact on our markets, and will probably have an impact on our economy.

- The markets did have major corrections in 2011 and 2016.

Here is a chart of the S & P in 2011:

The markets did fall close to bear market territory in 2011, but recovered and made new highs and almost doubled by 2014. Most U.S. markets and stocks have been moving sideways since 2014 (see chart below).

The markets did recover in 2011, mostly due to comments from the ECB, European Central Bank, President Mario Draghi. Mr. Draghi stated the ECB will do “whatever it takes” to preserve the Euro. Japan addressed its crises, and the ouster of leaders in Arab countries in Egypt, Algeria, and Tunisia. The Arab Spring did not go well in Syria, Yemen and Libya.

The biggest differences between 2011 and 2016 is where we are in the economic and market cycle:

2011 we were early in the economic and market cycle. In 2016 we are very late in the economic and market cycle.

This bull market started in 2009, had a major correction in 2011 early in the cycle, and was able to double from the lows of 2011 in about three years.

I really doubt that the market could double again like the market did from 2011 to 2014.

Most stocks have been trading sideways for about 1 ½ years.

The chart below helps explain the current markets and why prices are stuck in a trading range:

The grey trend line represent earnings. Earnings almost doubled since the bottom of the cycle in 2009. In 2011 earnings did stall, but they resumed their growth. Earnings have essentially stagnated since 2014.

The dark blue trend line represents the S & P 500 prices, following stagnant earnings growth.

After several decades of investing, I've learned to be cautious after a major bull market and when prices form a major topping pattern, a very bearish red flag. Upside is limited, especially with little earnings growth and risks rising. The downside risk is higher than the upside potential.

There are several scenarios the market could take:

1. At best, the market will continue to move sideways with support around 1925 and resistance around 2100.

2. Eventually the markets could look like the Russell 2000 Value ETF (symbol IWN):

The IWN was stuck in trading range for close to two years with support (where prices pull back most of the time) around the 95 to 97.50 level and resistance around 102.50. Prices broke support in July of last year, and are now trading at a new lower trading range with the old support becoming resistance, 97.50, and a new support is being established from around 90 to 82.50.

3. We enter into a bear market with no recession, similar to 2011.

4. We enter into a bear market with a recession. As I mentioned in my June Economic Outlook, the recession and bear market could last longer than most because the Fed has run out of effective monetary tools to stimulate our economy.

Since 1946 there have been 12 bear markets with 8 having recessions. Historically, about 67% of bear markets are associated with a recession.

Price Targets for the Major Markets

Below are the price targets for the major markets based on the current consensus earnings estimates:

2016 FORECAST					
	EARNINGS ESTIMATES	RISK,GRWTH ADJ P/E	FORECAST	CURRENT PX	PTNTL %
DJIA	1073.42	15	16,101.30	17,140.00	-6.45%
SPX	120	16	1,920.00	2,002.00	-4.27%
2017 FORECAST					
	EARNINGS ESTIMATES	RISK,GRWTH ADJ P/E	FORECAST	CURRENT PX	PTNTL %
DJIA	1212.85	15	18,192.75	17,140.00	5.79%
SPX	128	16	2,048.00	2,002.00	2.25%

Source: Consensus Earnings Estimates Thomson Reuters, Barron's

If these forecasts are correct, then the markets are overvalued this year and have some upside for 2017 using a moderate P/E. I use a lower P/E because of the lower growth, higher risks, and the aging of this economic and market cycle.

Consensus earnings estimates have been coming down most of the year, but were starting to stabilize the last few weeks. Let's see what happens to earnings estimates as the dust settles from Brexit, and 2nd quarter earnings reports that should start in about two weeks.

Expected higher earnings later this year, and next year is probably what is keeping markets in its trading range.

Market Winners and Losers

The favorite stocks of last year were FANG (Facebook, Apple, Netflix, Google). Two of these stocks are in bear markets and the other two are down from last year's high and are essentially trading sideways. All of them are overvalued, especially in terms of buyout values, how much the company would be valued at if it were sold in an acquisition. Let's look at Netflix:

Netflix is down over 30%, bear market territory. If prices breach long-term support of around $85, Netflix could have another leg down, and feel the gap made last year in April.

The winners of the market are dividend stocks like utilities and telecommunications. During the market pullback due to Brexit, dividend paying stocks like Clorox, symbol CLX, rallied to new highs.

I recommended and personally invested in CLX, and other similar dividend paying stocks early in the economic and market cycle. Back then the stock was oversold, undervalued and paid a high dividend.

The stock did consolidate during the bull market, but the overall trend is bullish with rising tops and bottom trendlines. The trend has accelerated from the trend line, and is not sustainable. The stock is also overvalued. Would I recommend and personally invest in CLX at today's prices. – NO!!!

Would I sell, no. I doubt prices would fall to the prices I invested at. My current dividend yield at the price I invested at is over 6% with dividend growth over the last 5 years about 7%. I have hedged this and other similar positions. I have also written options against my position when I see prices consolidate, so my adjusted cost is around $50. I will continue to write options against these dividend stocks to continue to lower my cost basis.

IF YOU ARE A RESIDENT OF CALIFORNIA, AND YOU WOULD LIKE HELP WITH YOUR PORTFOLIO, INCLUDING A SECOND OPINION REGARDING YOUR HOLDINGS, CONTACT DAN HASSEY AT dhassey@digeorgia.com.

Dan Hassey's passion for investing began over 30 years ago while getting his MBA from UCLA. Dan has worked for prominent investment firms including Merrill Lynch, Paine Webber, Fidelity Investments, and Charles Schwab. Click here to learn more about Dan Hassey's academic and investment background from his LinkedIn page.