August Market Outlook

I'm finally done with my analysis of Trumponomics. Click here to read my Summary and Conclusion.

I will now be able to get back to issuing my quarterly economic updates and monthly market outlooks. Here is my August Market Outlook.

Although the global and domestic economy are doing well, most assets are very overvalued.

This is a very tricky market because we are in the mature phases of the economic and market cycle, but mostly because equity valuations are expensive.

Be cautious, pay attention to valuation, be diversified and raise cash for the next economic and market cycle. Also, consider some trading.

Bullish Case

- The last two quarters earnings grew double digits (more on this in earnings, valuation section below).
- In 2014, China's change in economic direction caused commodities to collapse and recessions in many resource based economies. Some of us believed these events could have caused a global recession, but most of these resource based economy have recovered, and the global economy is in doing better.
- Consumer and business confidence are high
- Many professional and individual investors and traders are upbeat on the markets. Caveat: Sometimes this is a contrarian indicator, too much bullishness can lead to bearish markets and vice versa.
- Inflation and oil prices are low allowing for low interest rates
- Most assets have limited upside, so investors are buying stocks because of their liquidity and long-term performance.
- High frequency traders, algorithm and financial planners and their asset allocation and rebalancing models provide demand for stocks.

  If prices turn bearish, the momentum could reverse and we could see profit taking and selling.
- Investors and traders have learned to buy market dips, so investors and traders continue to buy on pullbacks.
- For the last 20 years, there has been a significant decline in publicly traded companies. In 1997 there were about 7,000 publicly traded companies, today there are about 3,500. Normally, less supply means higher prices.

- Once prices make a new high, it’s easy to continue to make new highs because there is less supply, resistance.
- The lower dollar is helping international sales and is boosting earnings with better currency conversions.

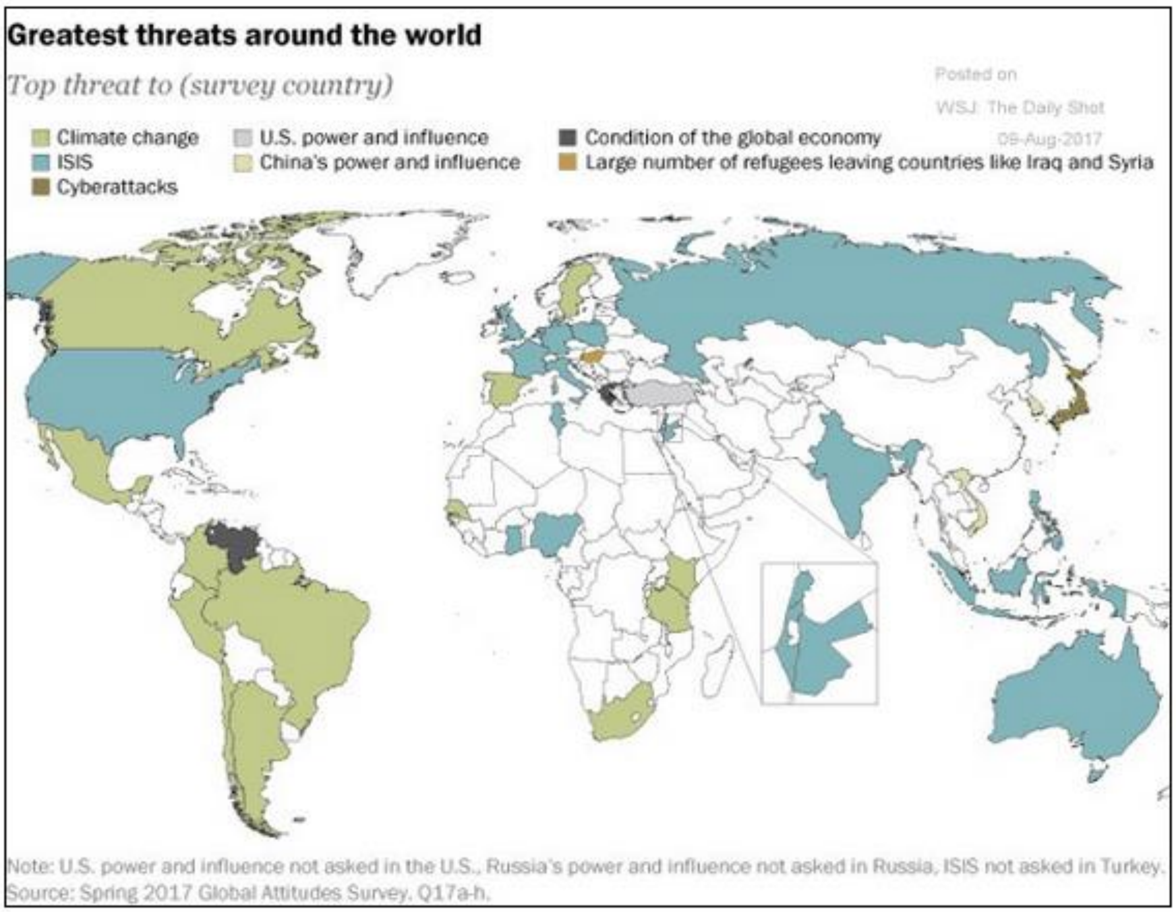
Bearish Case

- Stocks are very expensive (see earnings, valuation section).
- The strength in the markets is due to a handful of stocks in the indexes
- There has been a lot of rotation of money from safety to growth to domestic to international to emerging markets.

  Most market cycles have a strong leadership group, but the constant rotation is sign of speculation versus long-term investing. Guessing the next group to move or fall is more important than valuations.

  The only area that has had some consistency are technology stocks, especially FANG stocks (Facebook, Amazon, Netflex, Google). These stocks are very overvalued, crowded and risky.
- The Fed is starting to raise rates and will start to reduce the size of its $4trillion plus balance sheet. This could be disruptive to the economy and markets.
- If we have a financial crisis or recession, the Federal Reserve will not be able to lower rates enough or use its balance sheet to help our economy.
- There are many geopolitical risks including: Isis, Al Qaeda, Syria, North Korea, Iran, Afghanistan, Venezuela, terrorism, Brexit. The market, traders and investors seem to be overlooking these serious geopolitical risks.
- China’s debt, and slowing economy is a major concern
- Autos and housing sales have been weak
- Loan demand has been weak
- Congress is behind in raising the debt limit and establishing a budget
- The current administration has been plagued by scandals and chaos. The Russian investigation will probably continue to be disruptive. The President is losing credibility at home and internationally because of his tweets, insults, and many comments not based in facts.
- Stock buybacks have been less this year and have been an important market stimulant to this market cycle.
- We are in the late phase of this economic and market cycle
- Trade wars by this administration are still on the table. Trade wars could lead to a global recession.

- Federal Chair Jane Yellen's term is up in February 2018. The uncertainty of who will run the Fed could be disruptive to the economy and markets. I will write more about this toward the end of the year.
- Continued cyberattacks
- Black or grey swan events, low probability and unpredictable events with high impact to the global economy.
- Investors are not pricing in the above risks. The recent sabre rattling by North Korea and the U.S. has barely caused any selling in the markets. Money did move to gold, treasuries, and the selling of the dollar. Below is a map showing where the biggest threats are:

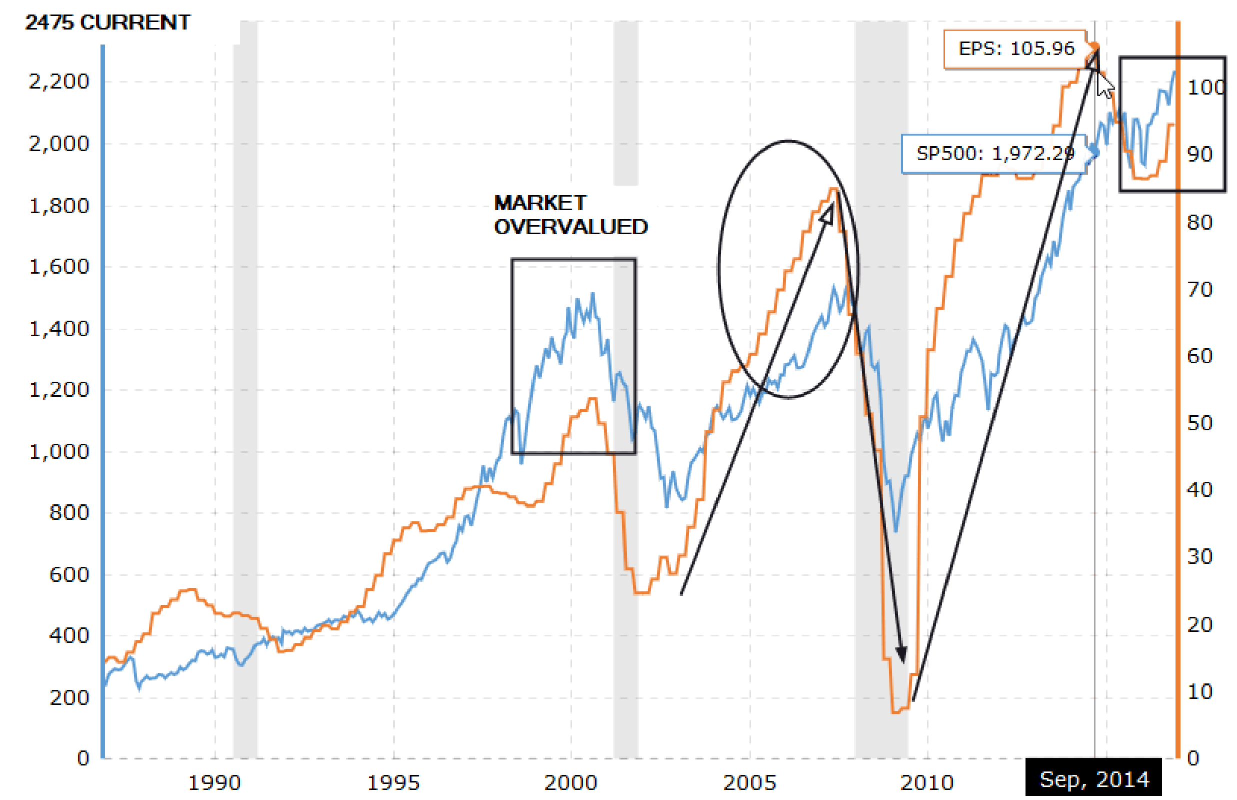


Source: @bruceestokes, @josephncohen

Earnings Growth and Market Returns

Earnings and growth are extremely important to investors. Investors want their investment dollar to grow to protect the value of their investment dollar. Investors invest in companies for their earnings' growth and the growth should be reflected in the companies' stock price Earnings/Income equal revenue minus expenses. Earnings are essentially what creates wealth for an investor.

Below is a 30-year chart of the market and earnings growth:



Source: Quandl

Let's review the chart:

- The chart above shows the strong correlation between earnings growth (orange trendline) and the stock market (S & P 500 blue trendline).
- The major economic, investment trend in the 1990s was the technology, internet revolution. The optimism of the period caused stock prices to become overvalued, stock prices were growing faster than earnings.
- There was value in the markets when earnings were growing faster than equity prices in the early 2000s to 2007.
- Earnings were also growing faster than prices from around 2009 to 2014.
- Currently prices are growing faster than earnings growth, a sign that stocks are overvalued.
- The chart shows the cyclicality of markets and earnings.
- The chart also shows why you want to raise cash before the decline phase of a cycle. Earnings normally crash, and so do stocks. It has always been a great time to load up on high quality companies that are cheap and pay solid dividends when the decline phase is over. The key is to invest in valuations are cheap and dividends are rich, and reduce exposure and raise cash when valuations are expensive.

The table below shows how industry index prices are getting ahead of earnings growth:

INDUSTRIES EPS EST GRWTH		YTD RETURN
Energy: +540%		-10.42%
Tech: +16.3%		21.02%
Financials: +11.8%		7.79%
Industrials: +4.8%		10.80%
Cons Staples: +3.3%		8.38%
Basic Materials: +3.3%		10.91%
Health Care: +3.0%		16.68%
Real estate: +2.8%		6.79%
Cons Disc: +1.0%		12.91%
Telco: +0.9%		-4.81%
Ute's: -3.8%		11.29%
AVERAGE EST ERNGS GRWTH	**52.96%**	
AVERAGE EST EPS GRTH W/O ENERGY	**4.26%**	
S&P YTD RETURN		**11.42%**

Let's review the table:

- The first column shows the earnings estimated growth for most of the different industry groups in the S & P 500 for 2017. The second column shows the returns, how much each industry group is up year-to-date (YTD).

- The bottom rows show that the average estimated earnings per share growth rate for the S & P is about 52.96% for 2017. If we take out energy, the estimated growth rate falls to about 4.26%. The stock market is overvalued because earnings without energy has growth of only 4.26%, but the S & P is up about 11.42%. The market has gotten ahead of itself.

  Earnings growth and price appreciation should be close.

- The above table shows that most industry groups are overvalued as their returns, price appreciation are above their growth rates. The YTD returns that are higher than their EPS growth rates are in red. Industries where their growth rate is higher than their YTD returns are in black, there are only three.

- In normal times, energy should be up more than the market, but the opposite is true. Energy stocks with the highest growth rates are down the most.

- To be more specific about how the markets are overvalued, Apple is up about 35% YTD, but earnings will only be up about 9% in 2017. The stock has gotten way ahead of itself. Also the market capitalization is about $814 billion with revenue of about $220 billion, another metric that shows APPL is very overvalued. Some investors point to the moderate P/E, but it is the only valuation metric that shows AAPL is fairly valued versus overvalued.

Most industry indexes and its stocks are overvalued. Energy, telecommunications, and financials are the only indexes and stocks that are undervalued.

There are also individual stocks that have been hammered and look undervalued. More on this in future outlooks.

Market Price Targets

Below are my market forecasts:

2017 FORECAST					
	EARNINGS ESTIMATES	RISK,GRWTH ADJ P/E	FORECAST	CURRENT PX	PTNTL %
DJIA	1221.08	16	19,537.28	22,002.24	-12.62%
SPX	129	17	2,193.00	2,388.00	-8.89%
HIGHER P/E 2017					
	EARNINGS ESTIMATES	RISK,GRWTH ADJ P/E	FORECAST	CURRENT PX	PTNTL %
DJIA	1221.08	17.5	21,368.90	22,002.24	-2.96%
SPX	129	18.5	2,386.50	2,388.00	-0.06%
2018 FORECAST					
	EARNINGS ESTIMATES	RISK,GRWTH ADJ P/E	FORECAST	CURRENT PX	PTNTL %
DJIA	1334.07	17.5	23,346.23	22,002.24	5.76%
SPX	138	18.5	2,553.00	2,388.00	6.46%

The historical market P/E has averaged about 16.5. It's normal for the P/E to get higher than 16.5 toward the end of a market cycle. I use a 16 P/E for the Dow 30 because the index is filled with large mature companies that have slower growth. The S &P earnings forecast has a higher growth rate and therefore I use a P/E of 17. By using a normal P/E, the markets are overvalued. If we use a higher P/E, the markets are fair to overvalued.

Earnings forecasts are out for 2018 and analysts are forecasting earnings growth. This is one of the reasons why the markets stay bullish, the prospect that we may have earnings growth next year.

If these earnings forecasts are met and the P/E stays elevated, the markets could have some upside. Several caveats with this forecast: 1. Earnings forecasts near the end of a cycle are notoriously wrong and are normally too optimistic 2. If earnings don't grow, the P/E multiple could contract potentially causing big losses in the markets.

Conclusion

- Our economy and companies could continue to grow.
- Unfortunately, the markets more than reflect a growing economy and earnings
- Valuations do not reflect the many risks the global economy and markets face. Most of the risks lie outside our borders.

- The economy and earnings could continue next year, or it could crash tomorrow because of the many risks our economy and markets face. A geopolitical event or black swan event could occur. Our markets doesn't reflect these risks.
- Be cautious, focus on valuations, diversify, raise cash for the next economic and market cycle. Also, I'm a long-term, value investor, but in these type of markets when you should have high cash reserves, to make money it do does make sense to trade stocks, especially those that the market has beat up.

Before the month ends, I will issue another market update that focuses on technical, price analysis. What are stock and market charts suggesting?