Seeking Alpha

2017 Q4 Stock Market Outlook! Is The U.S. Economy Reaching Its Peak?

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SUMMARY:

- Investors are experiencing the second longest economic expansion in U.S. history. If the current economic expansion lasts for another year and a half, it will be the longest on record.
- If tax cut legislation passes and lowers rates from 35% to 20% the S&P 500 forward P/E will drop from the current 17.9 to a forward PE ratio of 15.9.
- If you ignore the “crystal ball gazers” and just look at the current underlying U.S. economic fundamentals, it is unlikely we will see a severe bear market or recession in the next six to twelve months.

Is the U.S. Economy Reaching a Peak?

Investors are experiencing the second longest economic expansion in U.S. history. If the current economic expansion lasts for another year and a half, it will be the longest on record.

Given the global economic expansion and strong underlying U.S. economic fundamentals, I believe it is unlikely we will see another recession or bear market before the Spring or Summer of 2019. If Congress and the President can pass their tax reform legislation, that could postpone the next recession further in the future.

What is Driving Growth in the U.S. Economy?

- Global economies are expanding after years of stagnation. The International Monetary Fund (IMF) forecasts global growth of 3.6% (2017) and 3.7% (2018). Global sales of U.S. companies have been soaring.
- Worldwide low inflation rates are due to low commodity prices for oil, gas and

materials, as well as, an aging worldwide population and a slowdown in population growth.

- A rise in U.S. manufacturing and the use of manufacturing technology has dramatically caused the U.S. to become the second-most-competitive country in the world, moving up to an eight-year high in global rankings according to the World Economic Forum. U.S. manufacturing surged to a 13 ½-year high in September.
- Even with the three major hurricanes, Q4 2017 earnings growth for the S&P 500 Index are expected to be 11.4%.
- The U.S. housing market has recovered from its near-death experience in 2007 and 2008.
- Final GDP growth numbers were revised up to 3.1% in the second quarter of this year.
- U.S. jobless claims are now at a 44 ½-year low. This decline in the number of Americans filing for unemployment benefits points to a strong rebound in job growth.

(source: Reuters)

Is the U.S. Stock Market Overvalued?

If Congress passes their tax reform legislation, it is expected that corporate tax rates will be lowered from a high of 35% to 20%. The savings in corporate taxes will flow directly to corporate earnings.

Here is how the tax reform legislation could affect the average PE ratio of the S&P 500 Index:

- According to FactSet, the current **forward PE ratio of the S&P 500 Index is 17.9**. (source: FactSet 10/20/2017)
- According to Standard & Poors data, S&P 500 earnings for 2018 are estimated to be $144.88 per share. (source: S&P 9/13/2017)
- The average S&P 500 company currently pays 24.17% in taxes. If that rate is lowered to 20%, **the average S&P 500 company will receive a 4.17% reduction in taxes on revenues** of an average of $12.21, that should go directly to increased earnings.
- **The result is a 2018 S&P 500 forward PE ratio of 15.9.** if one adds the $12.21 to estimated 2018 S&P 500 earnings of $144.88 or $157.09.
- **A PE ratio of 15.9 completely changes the valuation of the stock market. It no**

longer looks overpriced! According to FactSet the average forward 12-month PE ratio over 5-years is 15.6.

- While the average S&P 500 company currently pays 24.17% in taxes, many companies in the S&P 500 make most of their revenues primarily in the United States and many of these companies pay the higher 35% tax rate. These companies will benefit the most from this tax reform and some will get a tax break of almost 15% on their revenues and that money will go directly to earnings **and will change many companies price-earnings ratios dramatically.**

Another Way to Determine If the Stock Market is Overvalued

A second way to determine if the stock market is overvalued is to compare stocks to bonds and cash.

To measure this relative value, analysts flip the Price Earnings Ratio (P/E) into an E/P, which is known as the “earnings yield” of a stock.

Today’s trailing 12-month P/E ratio of the S&P 500 Index is 23.04 (10/26/2017), which is an earnings yield of 4.3%. This is the return an investor would receive forever annually if you owned the entire S&P 500 Index and earnings never grew. If you compare that 4.3% return with the 2.3% pre-tax return of a 10-year government treasury bond, one can easily see that stocks are much cheaper and a better investment return than bonds.

What Are the Signs to Look for of a Coming Economic Downturn?

As I have mentioned before, pundits and commentators on financial TV programs and the Internet have been predicting for the last two years that the stock market has peaked and we are entering into a new recession and bear market.

Are these predictions just opinions or "crystal ball—gut feelings?”

Are any of these forecasts backed up by solid economic fundamentals or facts—or are they just “off-the-wall" guesses?

Well Here Are the Facts: The underlying U.S. economic fundamentals always drive the long-term direction of the U.S. economy and stock market. In the history of economics, we have no evidence there has ever been a severe economic downturn when earnings were going up, employment was going up, wages were going up, housing was going up, GDP was expanding and the index of leading economic indicators was going up. It's never happened—I don't believe it ever will!

Don't take the pundits word for it, judge for yourself whether we are entering into a recession!

Recession Analysis Explanation

There is an old adage, that in the short term, any crazy political, natural disaster or global incident can negatively impact the stock market temporarily, but in the long term, the stock market follows the underlying fundamentals of the U.S. economy. If the economy is trending up and expanding, the stock market will follow.

The following "Economic Analysis" is prepared by *Fairfax Global Markets LLC* investment managers each quarter to determine the direction and trend of all the various components that influence the fundamentals of the U.S. economy and the U.S. gross domestic product calculation. Each element is rated "POSITIVE," "NEUTRAL" or "NEGATIVE."

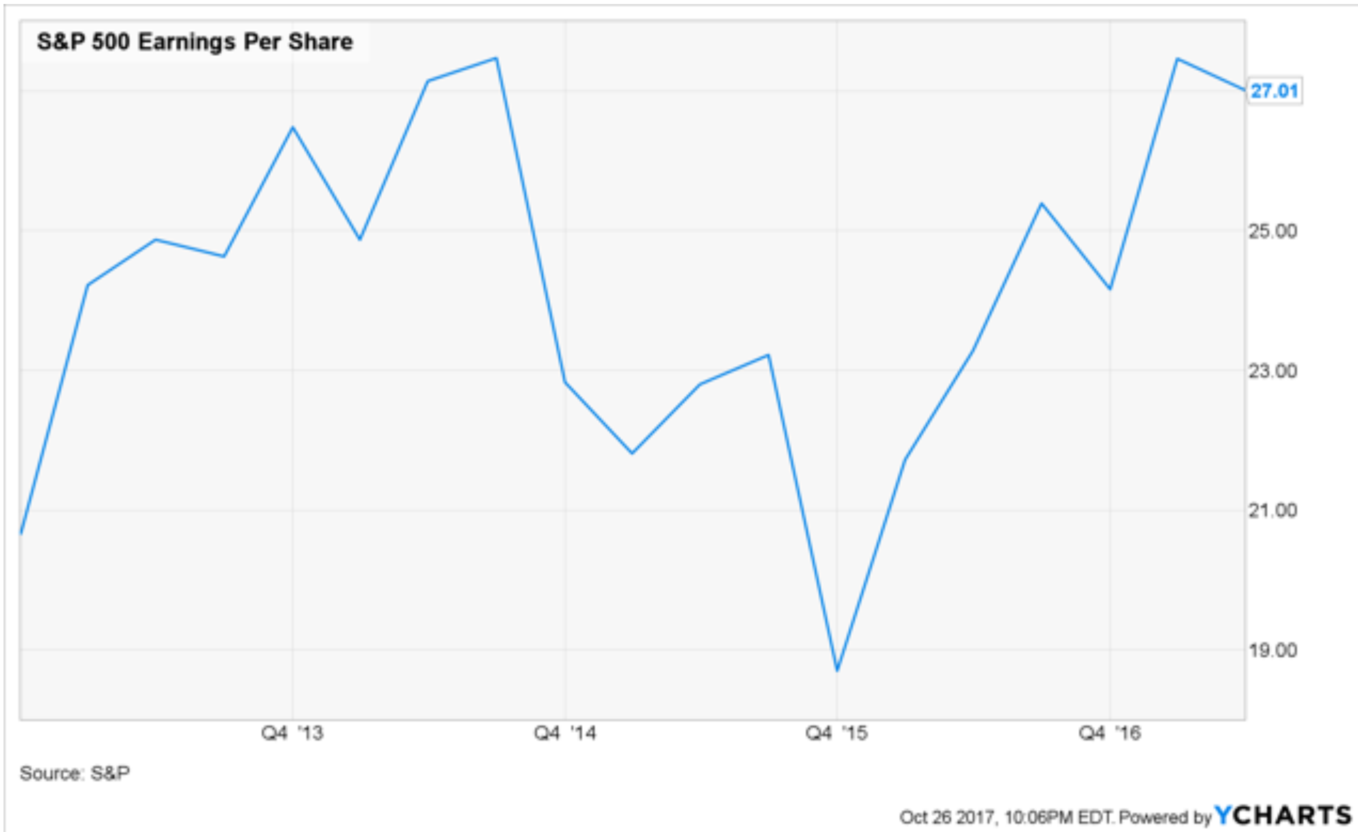
1. When the majority of indicators are POSITIVE or NEUTRAL, a downward trending stock market is most likely a correction.
2. When the majority of indicators are NEGATIVE, a downward trending stock market is most likely entering into a recession/bear market.

Here Are the Fundamental Indicators as of October 2017:

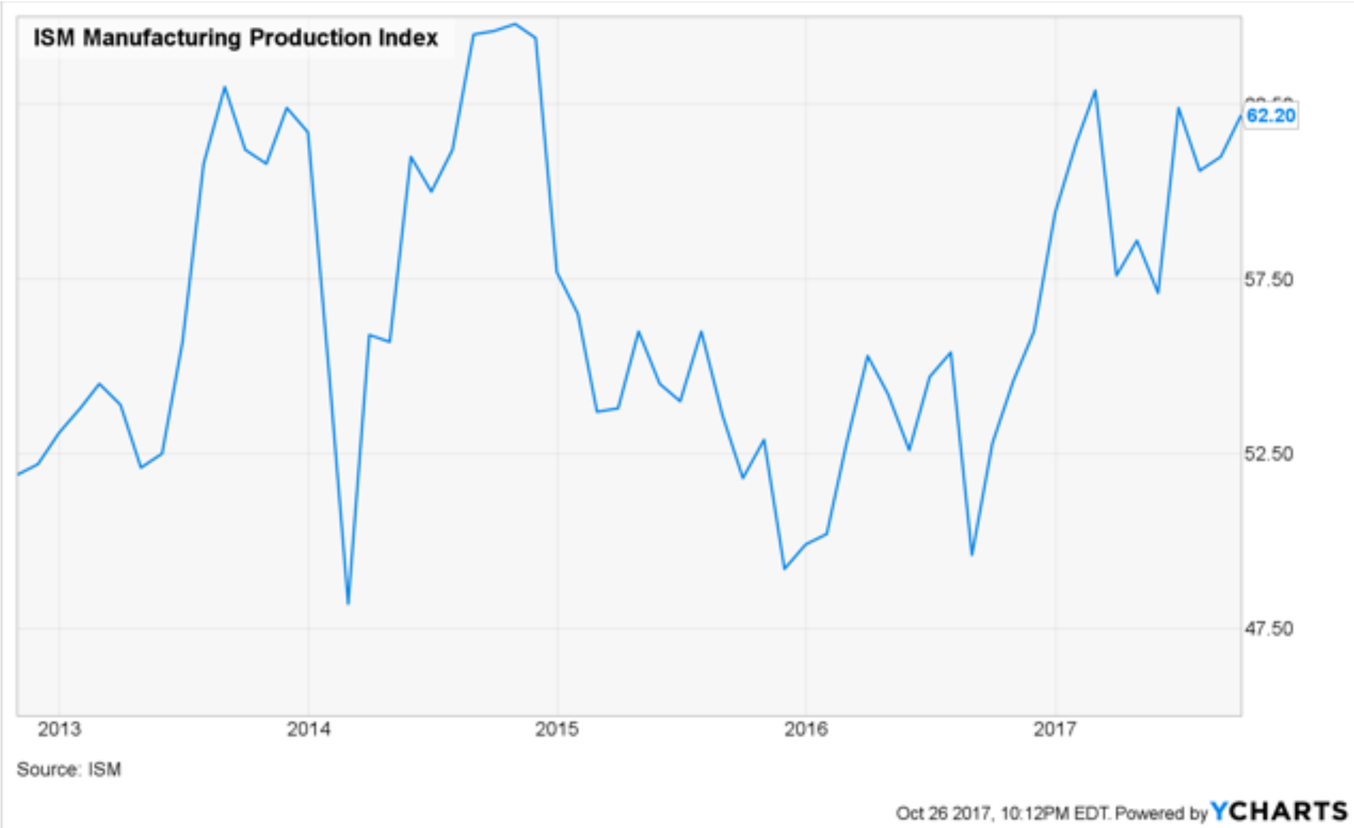
Corporate Earnings-POSITIVE: Corporate earnings are one of the stock market's most important indicators since they show the health of corporate America. If earnings are expanding, the stock market generally will be trending upward over the long-term. If earnings are trending down over the long-term, the stock market usually follows. According to FactSet, for Q4 2017, the estimated earnings growth rate for the S&P 500 is 11.4%.

With Q1 2018 corporate earnings for the S&P 500 expected to grow 10.7% and revenue growth expected to climb 6.3%, “Corporate Earnings” are rated **POSITIVE**.

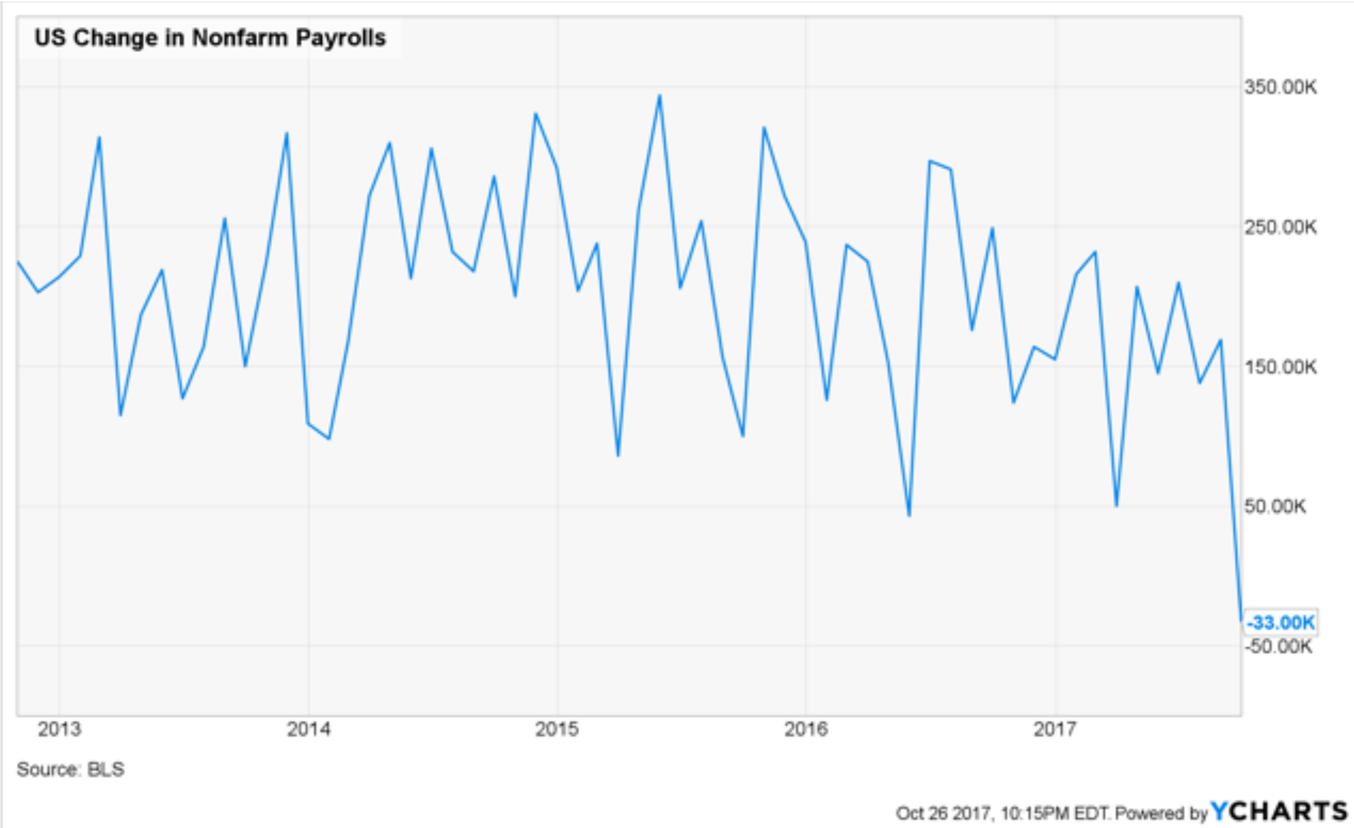
S&P 500 Earnings Per Share is at a current level of 27.01, down from 27.46 last quarter and up from 23.28 one year ago. This is a change of -1.64% from last quarter and 16.02% from one year ago.



Manufacturing-POSITIVE: The **ISM Manufacturing Production Index** is at a current level of 62.20, up from 61.00 last month and up from 52.80 one year ago. This is a change of 1.97% from last month and 17.80% from one year ago. This index is above the average of 50; this means that U.S. manufacturing is expanding.



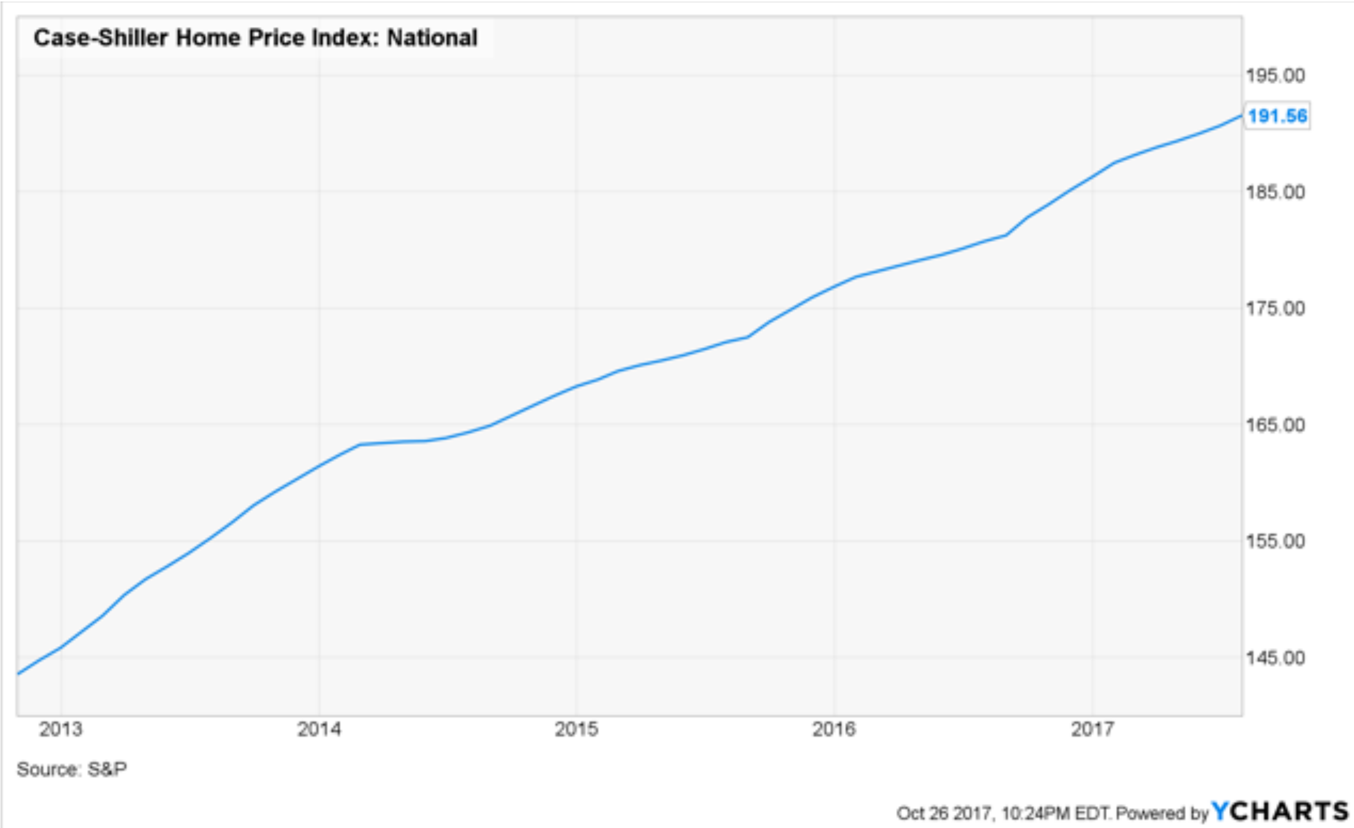
Unemployment-POSITIVE: US Change in Nonfarm Payrolls is at a current level of -33.00K, down from 169.00K last month and down from 249.00K one year ago. This is a change of -119.5% from last month and -113.3% from one year ago. This monthly decline in employment was an anomaly created by the three hurricanes that hit the United States in September. Quarterly growth was still positive.



US Unemployment Rate is at 4.20%, compared to 4.40% last month and 4.90% last year. This is lower than the long-term average of 5.80%.

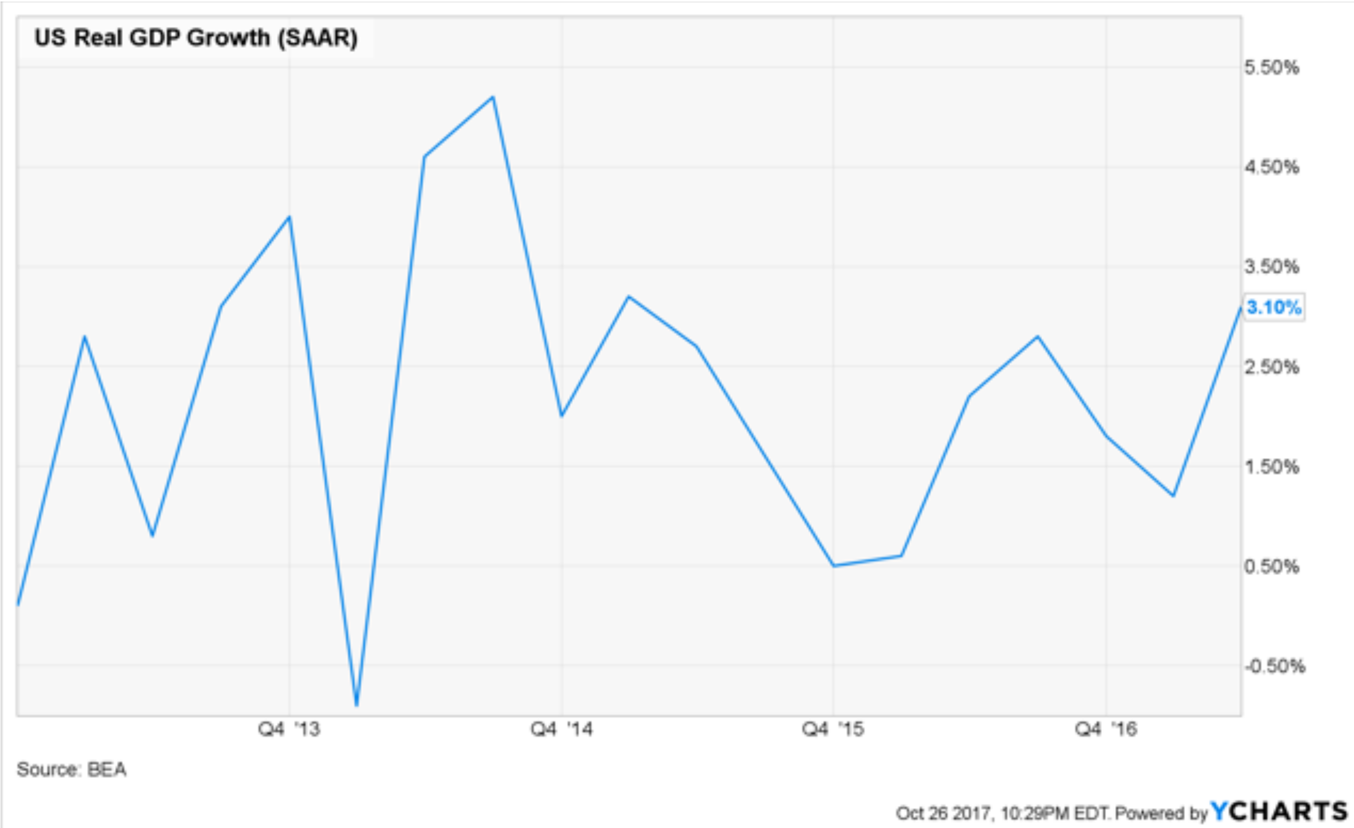
US Average Weekly Earnings is at a current level of 913.32, up from 909.19 last month and up from 887.86 one year ago. This is a change of 0.45% from last month and 2.87% from one year ago.

Housing-POSITIVE: The **Case-Shiller Home Price Index**: National is at a current level of 191.56, up from 190.67 last month and up from 180.74 one year ago. This is a change of 0.47% from last month and 5.99% from one year ago.



U.S. Weekly Leading Index-POSITIVE: The **US Weekly Leading Index** is at a current level of 146.63, up from 145.25 last week and up from 139.17 one year ago. This is a change of 0.95% from last week and 5.36% from one year ago.

GDP Growth-POSITIVE: US Real Gross Domestic Product Growth is at 3.10%, compared to 1.20% last quarter and 2.20% last year. This is lower than the long-term average of 3.22%. This indicator is one of the primary elements the U.S. government uses to determine a recession if GDP declines for two consecutive quarters. **NOTE: Many analysts believe that GDP statistics do not accurately reflect—for technical reasons—the contributions made by the Internet and social media. If so, then the economy's output is undercounted, and growth is stronger than the official figures report.**



US Core Inflation-POSITIVE: US Core Inflation Rate US Core Inflation Rate is at 1.69%, compared to 1.68% last month and 2.21% last year. This is lower than the long-term average of 3.71%.

SUMMARY:

Fairfax Global Economic Analysis 2017 Third Quarter

Corporate Earnings-POSITIVE

Manufacturing-POSITIVE

Unemployment-POSITIVE

Housing-POSITIVE

U.S. Weekly Leading Index-POSITIVE

GDP Growth-POSITIVE

U.S Core Inflation-POSITIVE

FINAL COMMENT: All of the major U.S. economic Indicators are expanding. Any downturn in the stock market is likely to be a normal “correction” that will bounce back within a couple of months. A severe economic downturn or recession is unlikely over the next twelve months.

Disclosure: I am/we are long SPY.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

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