Dow Surpasses 20,000

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The Dow Jones Industrial Average (DJIA) topped 20,000 on Wednesday, January 25, marking a new all-time high and symbolic milestone. U.S. stocks were up about 0.8% on the day, extending the post-election rally that took a bit of a breather in the first couple of weeks of 2017. International stock markets are, in some cases, performing even better so far in the new year.

What is fueling investor sentiment, and what are we expecting from financial markets going forward?

Understanding Investor Optimism

We see three main factors supporting equities. First, corporate earnings (the quarterly reporting season is underway) are coming in relatively strong. In sharp contrast to this time last year, when recession fears were high, oil prices were plunging, and China was seeing rapid capital outflows, the backdrop today is relatively smoother, allowing corporate executives to suggest at least modest optimism looking ahead. Second, economic data — in the U.S., but also overseas — is generally stable or improving. Business confidence surveys are rising, hinting at stronger actual economic activity ahead. Jobless claims reflect a labor market that is continuing to improve. U.S. home prices are rising, boosting overall household wealth.

Third and most in focus, though, is policy. Since the day after this past November's U.S. election, investors started pricing in the pro-growth aspects of President Donald Trump's policy agenda — including tax reform, deregulation, and other forms of fiscal stimulus — sending stocks, inflation expectations, the dollar, and interest rates higher.

It is our base case that equities post positive returns this year, helped in part by passage of some of Trump's growth-supportive agenda, as well as by better economic trends. That said, we would describe ourselves as "constructive but not euphoric," for a few reasons.

First, we believe equity upside from here is likely to be limited by increasingly high valuations (now at the highest levels since the 1990s tech bubble). Second, a tightening labor market in the U.S. suggests higher wages, which will weigh on corporate profit margins, all else equal. But third is — again — policy. A risk we see in today's market can be thought of as selective hearing (something that teenagers are known for). In our view, investors seem to be focusing more on growth-oriented policies and placing a much lower probability on global risks associated with elevated geopolitical tensions, protectionist trade measures, and higher inflation. In reality, while we have gained some more clarity on the priorities of the Trump administration, in part through the Senate hearings for cabinet nominees, we still have very little information on policy specifics.

Take corporate tax reform, one of the policies we believe is underpinning investor optimism. Will the final bill be able to deliver corporate tax rates as low as 15% or 20%? Will border adjustability be included? What about removal of net interest deductions? How quickly can the House of Representatives and Senate get comfortable with deficit and debt projections and bring a bill to the president's desk? Many more questions remain, even before tackling the ramifications for certain asset classes, regions, and sectors. In our view, it is essential to have more information in order to determine whether this latest stock market rally will continue and whether, more importantly, policy change can extend the life of the business cycle.

What Now?

We entered 2017 neutral equities versus our strategic benchmark, and aggressively overweight the U.S. We have increased cyclical exposure through our equity mandates — all this should help us participate if the so-called Trump rally continues. That said, due to factors noted above, we are comfortable holding managed-volatility equity strategies and some non-U.S. exposure. So far this year (while a very short time frame), that diversification has served us well. Despite global economic policy uncertainty being at the highest levels since the mid-1990s (according to policyuncertainty.com), both realized and implied volatility for the S&P 500 Index are hovering near multi-decade lows. We see this as unsustainable, and current volatility levels are, on average, associated with very weak short-term future stock returns. In other words, history suggests a material risk that investors take profits in the next few months and equity markets experience a mild, albeit tactical, correction.

Our reaction to a future market correction, if and when it occurs, will depend on the progress of economic data and policy change (both at home and globally). Regarding policy, should we see continued progress on tax reform, deregulation, and infrastructure spending, we may use a correction to increase risk slightly in portfolios. However, if U.S. relations with China, Mexico, or other important trade partners sour enough to threaten global growth while increasing inflation, we could equally consider lowering portfolio risk, possibly through increased exposure to volatility-minimizing equity strategies.

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