Monthly Market Outlook

2017 is a surprisingly strong year for equity markets around the world, but unfortunately U.S. markets continue to be overvalued, expensive.

2017 is essentially over. I will have my economic and market outlook issued in December and January.

Bullish Case and Why Markets Are Stronger in 2017

- One of the main drivers of this bull market is a technical factor. When prices make new highs, it's easy for prices to continue to make new highs. More on this in the technical analysis section below.

- Investors and businesses continue to be optimistic regarding this pro-business President and his administration. The President has reduced some regulations and has plans to reduce more. Businesses love this. They are also eagerly anticipating tax cuts and reform.

- There was an earnings recession from 2014 to late 2016, but earnings have recovered and forecasters see earnings growth of single digits (excluding energy) for 2018.

- The number of listed companies in U.S. markets was 7,322 in 1995. Currently the number is about half that, a dramatic decline in the supply of listed firms in the U.S. equity markets. Less supply can lead to higher prices.

Where have the companies gone: mergers and acquisitions, buyouts by private equity, bankruptcies (especially during the dot-com bubble), and some have gone private.

- The market has seasonal characteristics during a year that this market is not following:

Below are some of the reasons why this market is so different:

- Earnings forecasts are revised downward toward the end of an economic and market cycle. This year's earnings forecasts have gone up. I don't remember when earnings forecasts are revised upwards this late in an economic cycle.

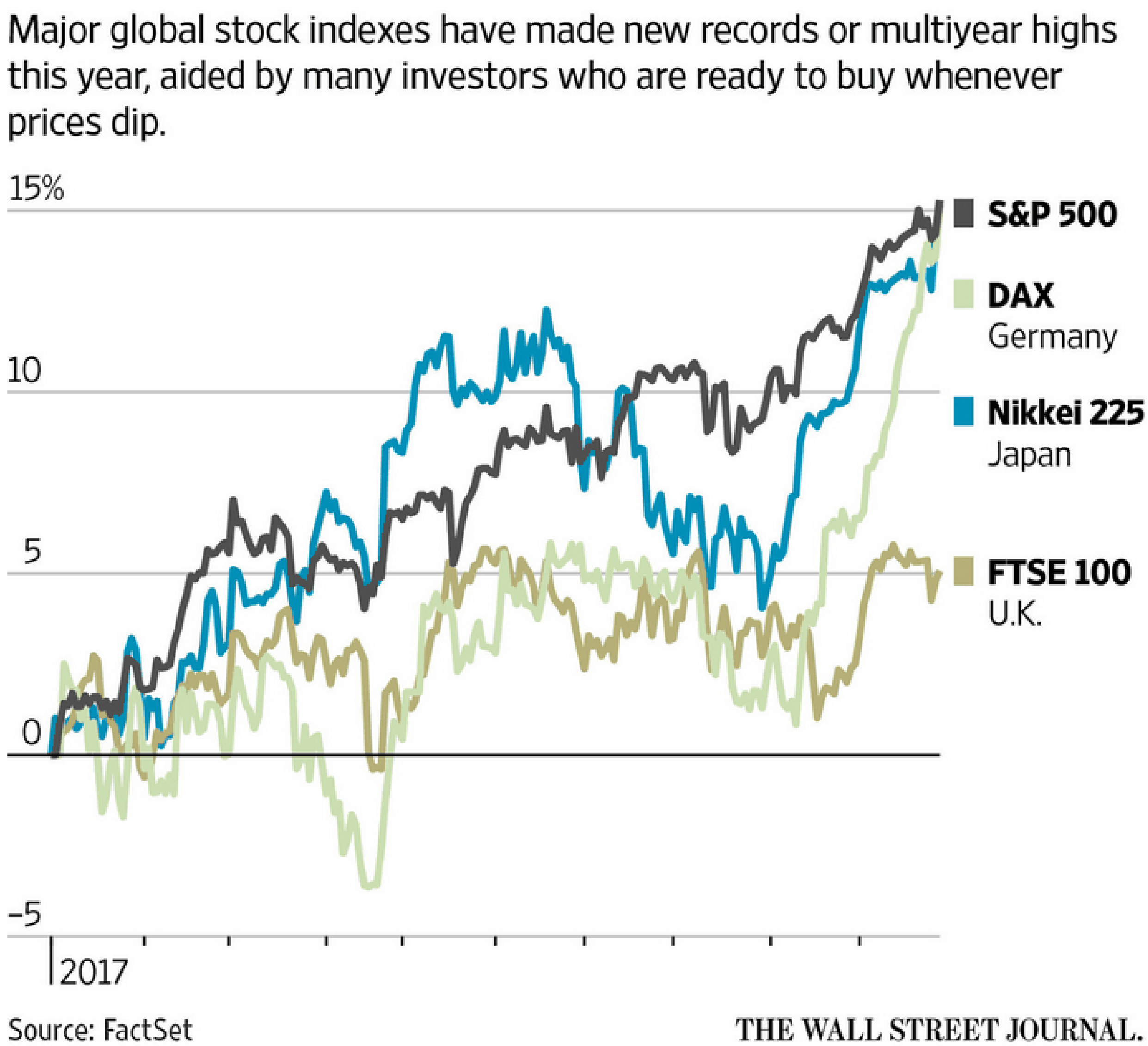
- Investors seem to be paying attention to good news, and ignoring bad news.

- There has not been much selling or profit taking this year. The normal pattern of price action is a move, then some profit taking that establishes a pause or a retracement of the move. Most of the moves that have occurred this year have been met with little profit taking. This year, after the markets move, prices consolidate for a brief period, and then the bullish trend is resumed.

This also means many investors don't want to get out of this market.

- Market participants have been buying the dips on any profit taking. This bull market started in 2009, and many investors and traders have forgotten how big and fast losses can be in a bear market. If an investor, or portfolio manager started in 2009, they have never experienced a bear market, so they've learned to buy the dips. This strategy has worked well since 2009.

Here is chart that shows buying the dips in U.S. and overseas markets for 2017:



The chart also shows the rotation in global markets. More on this in the bearish section, rotation by investors and traders.

Notice that the S & P has not had the pullbacks that other markets have

- The cable financial news guests and commentators often mention that there is global synchronous growth. Japan and Europe have been struggling since the Great Recession, but they seem to be doing better – for now.

IMF WORLD ECONOMIC OUTLOOK- JULY 2017 UPDATE								
GDP Growth Forecast								
	2011	2012	2013	2014	2015	2016	2017	2018
Canada	3.1	1.7	2.5	2.6	0.9	1.5	2.5	1.9
China	9.5	7.9	7.8	7.3	6.9	6.7	6.7	6.4
Eurozone	1.6	(0.9)	(0.2)	1.3	2.0	1.8	1.9	1.7
France	2.1	0.2	0.6	1.0	1.1	1.2	1.5	1.7
Germany	3.7	0.7	0.6	1.6	1.5	1.8	1.8	1.6
Italy	0.7	(2.9)	(1.7)	0.2	1.1	1.0	1.3	0.6
Japan	(0.1)	1.5	2.0	0.2	1.1	1.0	1.3	0.6
United Kingdom	1.5	1.3	1.9	3.1	2.2	1.8	1.7	1.5
United States	1.6	2.2	1.7	2.4	2.6	1.6	2.1	2.1

Source: Factset

Global growth is better in 2017, but not great. According to the IMF's above table, growth will slow down next year.

- The lower dollar is helping our exports making them cheaper in most global markets, and this has been good for our international company's sales and profits. Also, when a currency that is higher and it's converted into a lower dollar, a profit is made in the conversion. This has also helped U.S. international company's profits.

- President Trump and his administration have been promoting its tax cuts and reform all year, especially on cable financial news channels. When there is a big push, lawmakers, the President and his economic advisors go on these channels to explain and promote the cuts and reform, and the market rallies. The cuts and reform, when enacted, will probably help earnings and investors. We don't know what will be enacted or when.

Bearish Case

- Valuations should be a major concern for value, fundamental investors. The markets continue to be overvalued. More on this in the valuation section.

- The debt levels of China, Japan and Venezuela are very high. If we have a global slowdown, these debt levels could make the global economy worse. Venezuela is a concern because of their political dysfunction and they're technically in default (they have not paid interest on some of their debt).

- Military conflicts are always a concern in the Middle East and Africa. Currently, conflicts of concern include: Iran; Iraqis and Turks against the Kurds; Isis; Al-Qaeda; Yemen; parts of Africa.

- A nuclear war with North Korea is hard to imagine, but it's possible.

- We are moving away from monetary stimulus by the Fed. The Fed is expected to raise rates in December and three more times in 2018. The Fed is also reducing its balance sheet, and this has raised long-term interest rates. Most economic and bull markets end when interest rates start to rise. Interest rates normally rise because of rising inflation. Inflation remains low and that makes the rising rates scenario less impactful.

- There are several factors that could change the inflation picture,

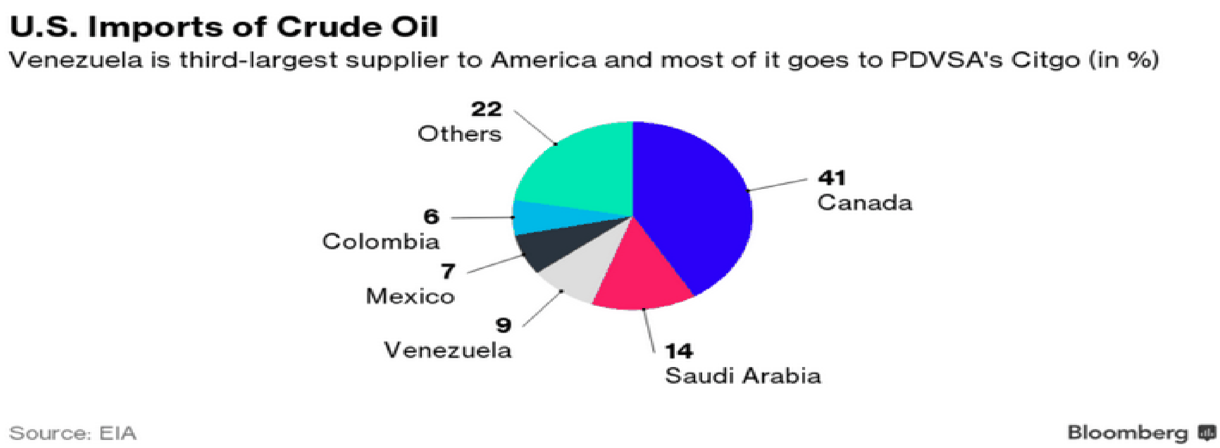
  The U.S. economy is at full employment, if the economy continues to grow, wages will have to rise to attract and retain workers. Higher wages could also increase inflation.

  Oil prices have recovered from the lows of 2016. Higher oil prices could increase inflation.

- Oil crashed in 2014 from a high of about $110, then bottomed in 2016 below $30. Prices are about in the middle of the high and low, around $60. There are potential supply disruptions that could cause oil prices to spike higher. There is a civil war in Iraq between Iraqis and Kurds in northern Iraq. This civil war could disrupt oil supplies from the oil fields in Northern Iraq.

Higher oil prices could lead to higher inflation and interest rates, and both could throw the global economy into a recession. Higher oil prices historically have caused several U.S. and global recessions.

We could see oil supply disruptions from Venezuela because of their political and financial crises.



As the chart above shows, Venezuela provides about 9% of our oil needs. Iraq exports about 7 ½% of our oil demand. Again, if we have supply disruptions globally this could cause the global economy to go into a recession. The biggest threat to global supplies is Venezuela.

- The dollar is starting to rise, and it could hurt sales and earnings of our U.S. international companies.

Source: Barchart.com

Let's review the chart:

The dollar initially fell when President Trump was elected, but his pro-business agenda gained the confidence of the markets and the dollar rallied.

As the market realized the many challenges facing the new president domestically and internationally, the dollar fell.

The dollar is starting to rise due to: the potential stimulus of tax cuts and reform, interest rates will probably continue to rise, the Fed will start reducing its balance sheet as explained above. The higher rates makes the dollar more attractive and the dollar is attracting foreign investors and speculators.

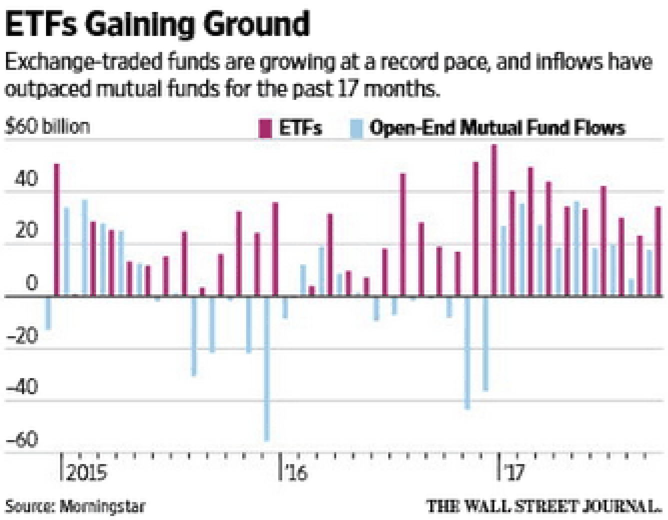
- There are reminders of this market to the late 1990s, early 2000s. The markets in the late 1990s were dominated by technology and momentum investing.

Momentum investing focuses on buying stocks that have price and earnings momentum, especially companies that can beat earnings estimates. If a stock does not have earnings or price momentum, it will probably be left behind. See valuation section.

There also seems to be less of a concern for valuations.

Investors favor technology stocks despite their rich valuations.

- One of the biggest changes over the last few cycles is the emergence of financial planners versus stock brokers. Stock brokers tended to prefer active management. Financial planners prefer passive investing using ETF indexes. The chart below shoes that money is leaving mutual funds and it's flowing into ETFs.



Below is a list of the top 10 asset managers. The top three mostly provide ETFs. 20 years ago the list would have been all mutual fund companies. The ETF industry started around 1993.

Top 400 Asset Managers 2017 (Top 25)

	Company	Country	Total AUM 2017	Total AUM 2016
			31/12/16 (€m)	31/12/15 (€m)
1	BlackRock	US/UK	4,884,550	4,398,439
2	Vanguard Asset Management	US/UK	3,727,455	3,091,979
3	State Street Global Advisors	US/UK	2,340,323	2,066,479
4	Fidelity Investments	US	2,129,650 (1)	1,830,330
5	BNY Mellon Investment Management	US/UK	1,518,420	1,492,895
6	J.P. Morgan Asset Management	US/UK	1,479,125	1,361,178
7	PIMCO	US/Ger/UK	1,406,350 (1)	1,321,158
8	Capital Group	US	1,401,780	1,272,080
9	Prudential Financial	US	1,201,082	1,089,737
10	Goldman Sachs Asset Management Int.	US/UK	1,116,606	996,651

Source: Investment and Pension

The numbers above are trillions of dollar under management. BlackRock has close to $5 trillion assets under management.

BlackRock, Vanguard, and State Street are the largest money managers in the world with trillions under management. Most of their assets are in ETFs. The rest of the list represents traditional active mutual fund and money managers.

In the past, 401K investors had most of their money in money market funds and company stocks. The retirement investment industry and regulators rightly believed that was not good. Target funds (invest in stocks, bonds or cash depending on age and expected retirement year) were developed by the investment industry to help 401k investors. Now most monthly contributions get invested in the markets despite valuations.

- We are seeing rotation in the markets: money flowing from safe to risk assets, from domestic to international, large cap to small cap, value to growth….

  Leadership in a market is important, as it tells where money is flowing in the economy. In the 1970s it was inflation hedges, in the 1980s it was consumer oriented stocks, in the 1990s it was technology, the first decade of the 2000s it was housing and financial stocks. At the start of this cycle is was safer consumer staples and dividend stocks. Last and this year the leaders are FAAMNG. Without leadership and now rotation in the markets, are signs of a cycle in its mature phase.

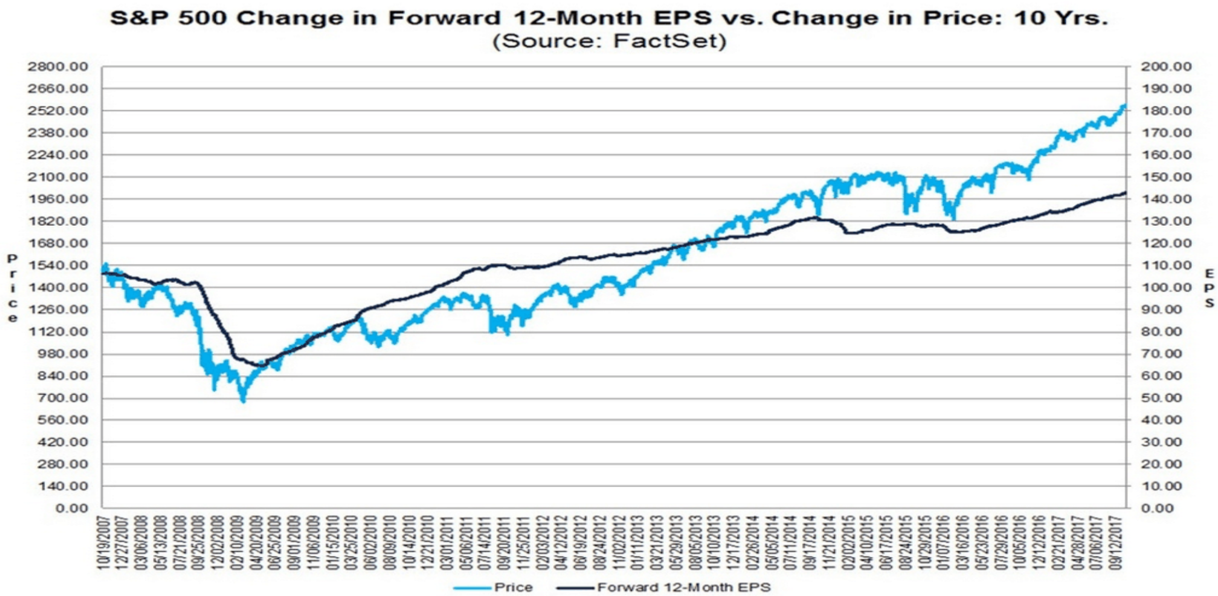
- The number of stocks making new highs is narrow, a sign that this market is getting old.

- Investors and businesses seem to have a blind-spot regarding this President and other risks. Algorithms aren't (they probably don't know how to) factoring in the major risks our and global economy face (nuclear confrontations, terrorist attacks, oil supply disruptions, continued conflicts/wars in the Middle East, too much domestic and global debt, our President and his campaign are under federal investigation and could lead to more arrests).

- Tax cuts and reform may leave our economy with huge deficits and debts constraining our economy and markets.

Valuations

Price appreciation is outpacing growth in earnings, a sign that the market is overvalued as the chart below shows:



At the beginning of the market cycle (from about 2009 to 2013) EPS (earnings per share) were growing faster than prices. This is a time for investors to be fully invested and aggressive.

From around 2014 to 2016 earnings stalled, and so did market prices. By 2014, most markets more than doubled in value, and market returns would have been an average of 20% return per year.

This year market prices are growing much faster than EPS. This is a time to be cautious because earnings are growing faster than prices, not a sustainable trend, especially this late in the market and economic cycle.

If we look under the hood of the markets' EPS, we'll see that earnings aren't growing as fast as they seem:

Company	2017 EPS	2016	EPS GROWTH
Exxon Mobil	3.5	2.37	47.68%
Chevron	4.08	0.94	334.04%
Caterpillar	6.37	3.42	86.26%
Boeing	10.08	7.24	39.23%
Visa	3.6	2.84	26.76%
UnitedHealth	9.99	8.05	24.10%
Goldman Sachs	19.07	16.29	17.07%
McDonalds	6.54	5.71	14.54%
Morgan (J.P)	6.9	6.06	13.86%
Home Depot	7.33	6.45	13.64%
Apple	9.41	8.31	13.24%
3M	9.08	8.16	11.27%
Intel	3.01	2.72	10.66%
Johnson & Johnson	7.28	6.73	8.17%
Pfizer	2.56	2.4	6.67%
Microsoft	3.43	3.31	3.63%
American Express	5.85	5.65	3.54%
Procter & Gamble	4.04	3.92	3.06%
Disney	5.89	5.72	2.97%
Merck	3.87	3.78	2.38%
IBM	13.8	13.59	1.55%
United Technologies	6.61	6.61	0.00%
Coca-Cola	1.89	1.91	-1.05%
Cisco Systems	2.39	2.43	-1.65%
Verizon	3.76	3.87	-2.84%
Wal-Mart Stores	4.37	4.59	-4.79%
Nike	2.25	2.51	-10.36%
General Electric	1.15	1.49	-22.82%
Travelers	7.5	10.12	-25.89%
AVG EPS GROWTH W/O XOM CVX			8.64%
DowDuPont	3.29		

Source: Barron's, Thomas Reuters

Exxon and Chevron, despite having the fastest EPS growth rates, the stocks are down for the year.

If we take out Exxon and Chevron, the average EPS for 2017 is about 8.64%, but the Dow 30 is up about 20%. Again, the trend that price appreciation is outpacing earnings growth is not sustainable.

This market is rewarding momentum investing: a focus on stocks that have a bullish bias, and its EPS reports are beating estimates. Exxon and Chevron, are meeting EPS expectations, but their stock prices have a bearish bias, so investors in this market are basically ignoring stocks like XOM and CVX that don't have price or earnings momentum.

Let's look at Apple that has price and earnings momentum. Apple is up over 50% this year and earnings for the last few years were essentially flat.

Annual EPS Consensus Expectations

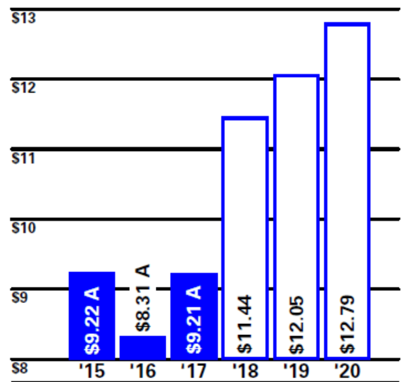
	FY '18	FY '19	FY '20
Mean as of 11/09/17	$11.44	$12.05	$12.79
Previous Mean	$10.78	$11.30	$11.75
# of Brokers	35	28	11
Range (low/high)	$10.39/13.33	$9.70/14.32	$9.90/14.75
Stnd. Deviation	$0.66	$0.89	$1.52
Announce Date			
Year Ago EPS	$9.21 A		

Change Over Previous Year

Calendar Year	'18	'19	'20
Apple Inc	24.2%	5.3%	6.1%
Industry	NA	NA	NA
Sector	NA	NA	NA
Market	11.9%	10.3%	10.1%

Source: Thomson Reuters I/B/E/S

Annual EPS Trend



Apple's year starts in September, so fiscal 2018 earnings are expected to be up about 24% thanks to the new iPhone. Notice that earnings contract dramatically to about 6% in 2019, 2020. What will happen to the P/E and stock price when this happens?

Besides earnings momentum for fiscal 2018, its stock price also has momentum:

Source: erlangerchartroom.com

Apple has a bullish bias with a rising tops and bottoms trendline.

Again, stocks with price and earnings momentum are doing well. Most stocks without momentum are being left behind.

Because of the pervasiveness of ETFs and passive investing, and now the focus on momentum investing, there are questions from the financial media about the relevance of fundamental analysis. If you wanted to sell a company, you would go to a Wall Street banker and they would use fundamental analysis (discounted cash flow models, sum of the parts analysis, industry analysis…) to determine an appropriate value to sell a company. A diversified portfolio of ETFs or a chart, or beating earnings forecasts will not provide a valuation for a company. Fundamental analysis will not go away; it's essential for investors and investing. The goal of fundamental analysis is to determine the valuation of an asset.

Here are my price targets for the markets:

2017 FORECAST					
	EARNINGS ESTIMATES	RISK,GRWTH ADJ P/E	FORECAST	CURRENT PX	PTNTL %
DJIA	1233.21	16	19,731.36	23,558.00	-19.39%
SPX	129	17	2,193.00	2,602.42	-18.67%
2018 FORECAST					
	EARNINGS ESTIMATES	RISK,GRWTH ADJ P/E	FORECAST	CURRENT PX	PTNTL %
DJIA	1359.38	16	21,750.08	23,558.00	-8.31%
SPX	143.67	17	2,442.39	2,602.42	-6.55%

I use reasonable P/Es to value the markets. The markets are overvalued this year and next. The P/E could expand again, but this would continue to make the markets overvalued.

Technicals

One of the main reasons why this market has been strong is because once prices break to new highs, most of the resistance and supply is gone, and it will be easy for prices to continue to make new highs. I rarely hear market analysts on cable financial news talk about this. Below is a long-term chart that shows the breakouts and new highs over the last 18 years:

Source: erlangerchartroom.com

Let’s review the chart and breakouts:

- The Dow 30 was stuck below 11,500 from the late 1990s to 2006. Once prices broke above 11,500 the market was able to make new highs for about another year. Notice that after prices make new highs, many white candles are made. Many large candles show strength. This is true in each breakout, especially the breakout that started late last year.

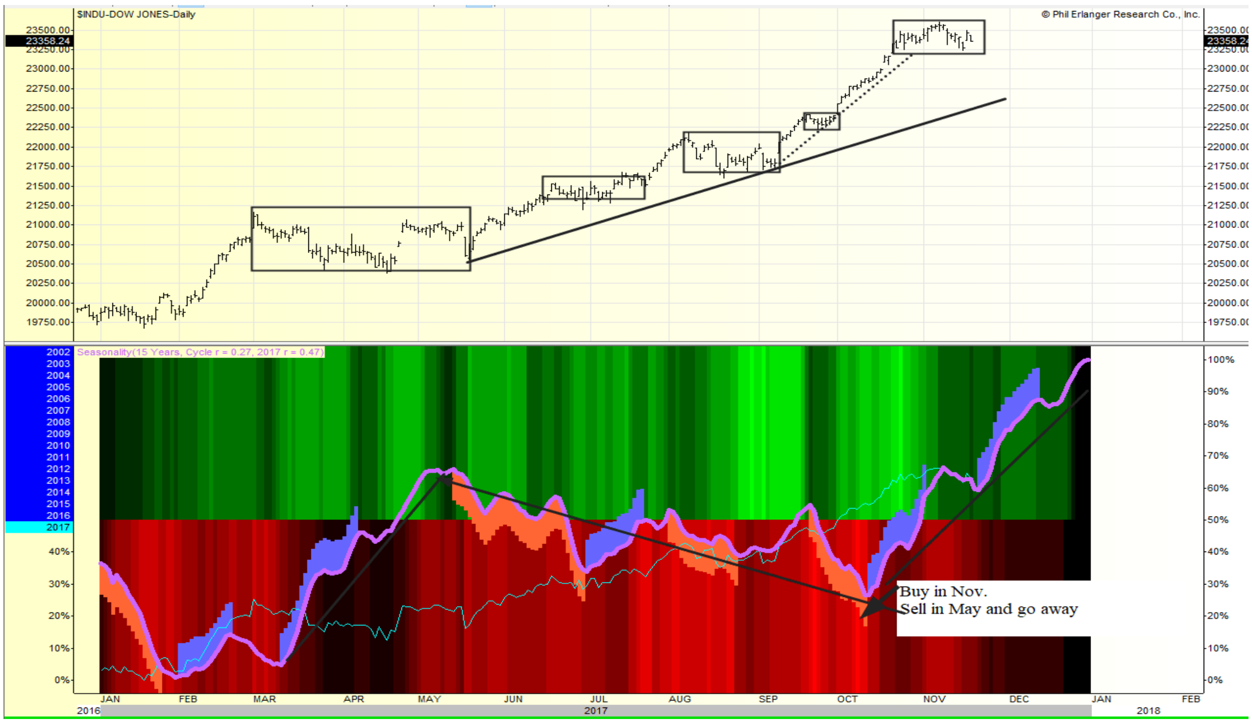
- Prices were stuck below 14,000 from 2007 to 2013, and prices finally broke out to new highs. Prices were able to make new highs until 2015. Prices bottomed in 2009 at around 7000. There was supply resistance at 8000, 9000, 10000 to 14000. Once all the supply and resistance was taken out, prices were able to make new highs for a couple of years. Earnings growth and recovering economy, low interest rates and inflation also helped market performance.

- Prices were stuck below the 18,000 level from 2014 to 2016. Prices broke out to new highs in late 2016. Prices have been making new highs all year. We can expect prices to make new highs in 2018. How much more depends on earnings and if investors will be willing to pay. Also if we don’t have any grey or black swans.

Normally when prices are making new highs, the next resistance level are round numbers. The next resistance levels for the S & P could be 2650, 2700, and for the Dow 30 it may be 23600, 23700, 23800….

- In the bullish section of the update, I brought up the point that the market this year is not following the normal patterns of the markets. One of the main reasons is the market keeps making new highs.

This market is not following the normal seasonality of the markets. Below is a chart that shows the seasonality of the markets:



Source: erlangerchartroom.com

The upper pane shows the price trend of the market year-to-date. The lower pane shows the seasonal composite pattern of the market over a 15-year period.

Normally the market anticipates its prospects for the following year in November and most of the gains for the next year end around May in the new year. This is why some traders and investors "sell in May and go away."

September is a weak month when there is profit taking after a summer rally. We did not have much selling in September.

October is normally weak due to tax selling by mutual funds for reporting reasons. We did not have a weak October. It will be interesting to see if the market will be strong in November and December anticipating a continued expanding economy. This economic and market cycle are lasting longer than most cycles.

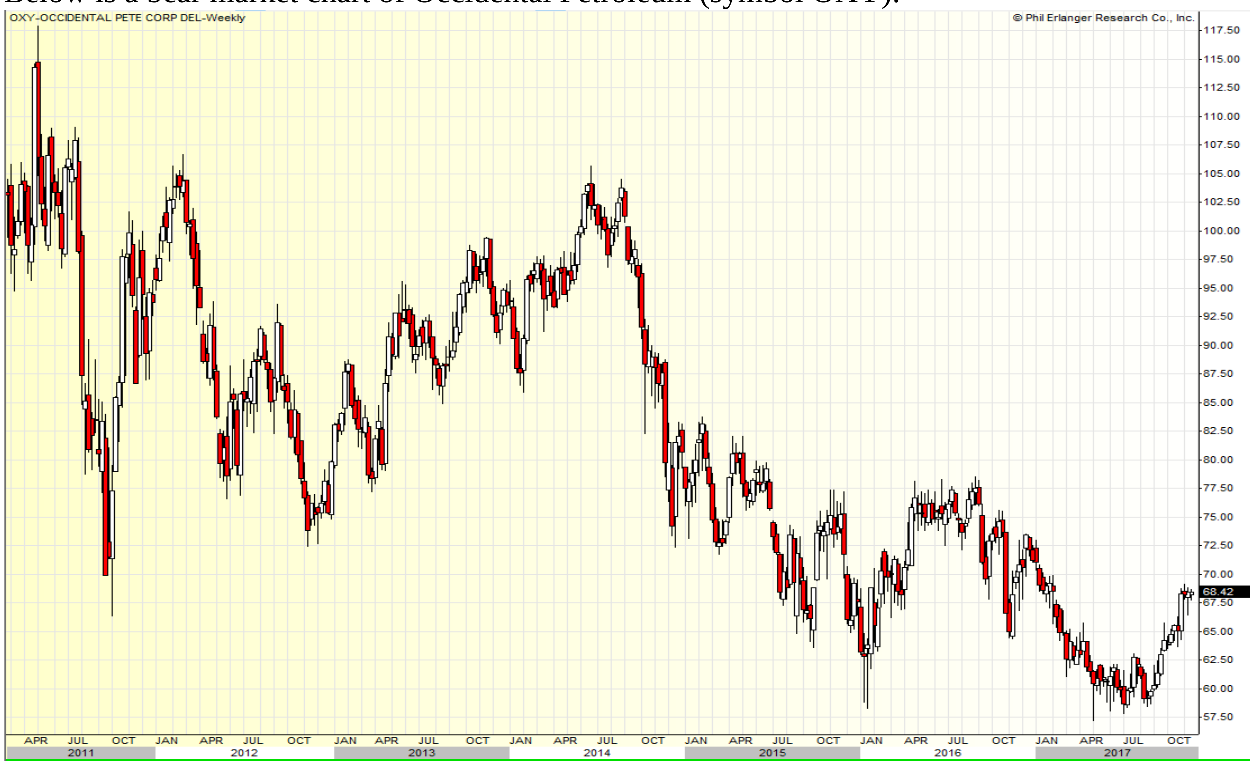
We normally have several 5% declines in a year, and most of the time we have one correction of 10% or more (normally in September or October.) This year we have not had a pullback of 5% or 10%. There have been 5 pauses where investors and traders bought (buying the dips). Many investors and traders are waiting for bigger pullbacks, and many investors are not selling.

I'm waiting for better valuations and stocks that are in bear market territories.

Where to find Value in the Markets

Stocks with momentum are doing well – for now, but many stocks are being left behind. Some of these stocks are creating investment opportunities. Some consumer staples, retailing, energy, and telecommunication stocks are examples.

Below is a bear market chart of Occidental Petroleum (symbol OXY):



Source: erlangerchartroom.com

OXY is in a bear market, and is down about 40% from its high of about $115. When identifying potential investments in bear markets, we need to see prices make a new low for the year, and then prices base, move sideways. OXY probably did see its low in April and has been basing since. The stock has rallied about 15% from its low, thanks to rising oil prices.

OXY currently has proved reserves of about 2.2 billion barrels of oil equivalent. If oil prices continue to move a little higher and stabilize, they could report proved reserves of about 3 billion. This would make their reserves worth about $17 a barrel, cheap. They have other businesses (chemical, marketing and retail, transportation and storage of energy) worth billions that make the stock a bargain.

OXY also pays a high dividend of 4.77% that grows about 5% a year.

When, not if, the economy goes into recession, and the market goes into a bear market, OXY and other stocks in bear markets could have another leg down, but not as much as stocks that are overvalued and are making new highs. Remember, OXY was making new highs in 2011. Bear markets are brutal.

OXY is the type of stocks that I've been accumulating for my clients and myself.

We can also trade the basing pattern, trading range of stocks like OXY.

OXY is not a recommendation, and is for educational purposes only.

Summary

- There are many bullish aspects of this market: continued economic and earnings growth, a global economy that seems to be synchronous – for now, low inflation, a pro-business President and administration, tax reform and tax cuts that could help corporations and stock investors, the technical underpinnings that are bullish, there is little profit taking, participants have learned to buy on dips, most 401k investors buy the markets automatically.

- The markets are overvalued by many metrics: prices are growing much faster than earnings, earnings don't look as good as the markets and analysts suggest, P/Es are too high, the markets are not factoring the many risks markets face.

- This market is not following the normal annual seasonal patterns. Some of the reasons include the automation of many investment decisions, the market continues to make new highs as little resistance occurs when prices are making new highs, investors and traders are ignoring most bad news.

- This market shows many signs of a mature economic and market cycle: expensive valuations and P/E expansion, rotation in the markets and the lack of leadership, the length of this market and economic cycle, the market continues to make new highs after breaking to new highs late last year, smaller list of stocks making new highs, the Fed is raising rates, oil prices are rising, the economy is at full employment.

- There are bargains in this market among stocks and groups that are oversold, and undervalued. Some of these groups include energy, retail, some staples, and telecommunications.

My economic and market outlooks will be out in December and January.