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Bull Market Could Continue for Years Although Political Disruptions, Flattening Yield Curve May Pose Challenges, Analysts Say at CFALA 2018 Forecast Dinner

LOS ANGELES – A strong U.S. economy and rising corporate earnings could propel stock prices higher for several years, but investors should pay attention to potential problems on the political front as well as the possibility of higher interest rates, three top analysts told more than 450 attendees at CFA Society Los Angeles' 16th Annual Economic and Investments Forecast Dinner on Wednesday.

Although stock prices have risen significantly, U.S. equities are not "melting up" but are being carried higher by a bull market that may only have reached its half-way point, Gina Martin Adams, CFA, CMT, Chief U.S. Equity Strategist for Bloomberg Intelligence, said in prepared remarks.

"We really define a 'melt-up' as a period where prices have detached from fundamentals and investors are being driven by the fear of 'missing out' even though economic fundamentals are deteriorating," Ms. Adams said. "If that were the case now, earnings would not be accelerating, and they are accelerating. Economic momentum is accelerating. We are seeing upward revisions to earnings estimates and that is generating optimism. As long as we have upward revisions, you will probably continue to see rising prices."

While market corrections are always possible, stocks may have much further to run, said Ms. Adams, who has been recognized for portfolio strategy, technical strategy and economics in Institutional Investors' All-America Research survey.

"Everything we are seeing – strength in prices, momentum, breadth – is indicative of a bull market and in the last century the average bull market has lasted about 18 years," she said. "We're nine years in, so we may be merely at the half-way point. That doesn't mean we aren't going to see corrections, and if the economic momentum we're seeing doesn't translate into revenue growth in the second half of this year, that becomes a bit of a bind. But you can have significant corrections in a bull market, as we did in the 1990s, and still have the long-term bull trend sustained."

Bloomberg Intelligence, which provides context on markets, industries, companies, and government policy, compiles a "scorecard" that ranks the 11 sectors in the S&P 500 against each other. As of now, cyclical sectors such as tech, materials and financials are ranking at the top of the scorecard, with defensive sectors such as utilities and consumer staples at the bottom, Ms. Adams noted.

After being treated to a steady diet of advancing stock prices in 2017, investors may have to deal with a number of problematic issues on the political and geopolitical fronts this year, Greg Valliere, Chief Strategist at Horizon Investments, said in his prepared remarks.

“We got the dessert first and now we’re getting the broccoli,” he said. “The market went up without a hiccup last year, but I’m not so sure that’s going to happen again. There are a number of things on the horizon that could be difficult for the Trump Administration. At the same time, the economic fundamentals are very positive, both domestically and globally. Investors are going to have to compartmentalize their thinking, separating all the noise coming out of Washington from the strong signals being sent by corporate earnings, expanding GDP, job growth, relatively low interest rates and other fundamentals.”

Gridlock and dysfunction, most recently typified by the government shutdown, remains alive and well in the nation’s capital, said Valliere, who has been interpreting Washington for investors for 40 years.

“Unlike the tax bill, key legislation going forward is going to require 60 votes to break a filibuster and pass in the Senate,” he noted. “Chuck Schumer (D-N.Y. and Senate Minority Leader) has 49 votes, meaning that Democrats are going to have to be included to get anything passed. The Republicans want a huge increase in defense spending, and Democrats are probably going to go along with that if they get an enormous increase in domestic spending. In other words, fiscal discipline is out the window and nobody is taking the deficit seriously.”

The ongoing inquiry into possible collusion between the Trump campaign and Russian operatives in last year’s presidential election is likely to generate more headlines, Valliere said, with congressional midterms also posing a challenge to the administration.

“(Special Prosecutor) Robert Mueller is not going away,” he said. “I think he will bring indictments, probably reaching into Trump’s inner circle, and you have to ask if Trump will fire him, or issue pardons to those indicted – all this in a midterm election year, where the party in power traditionally loses a lot of seats. It’s entirely possible that we could have a ‘wave’ election,’ where both the House and Senate go back to the Democrats. All these things also diminish the chances of getting anything done on issues like entitlement reform or infrastructure.”

Other areas that bear watching include North Korea, Iran and deteriorating U.S.-China trade relations, Valliere said, adding, “My candidate for the most troublesome issue is U.S.-China trade relations, which may be the biggest geopolitical wild card.”

The flattening yield curve, a key metric for investors, is likely to persist in 2018, Ian Lyngen, CFA, a Managing Director and Head of U.S. Rates Strategy in the BMO Capital Markets Fixed Income Strategy team, said in his prepared remarks.

“Our primary focus for the Treasury market in 2018 will be gauging the pace of the flattening of the yield curve. Traditionally, this has been associated with a deteriorating economic outlook. However, we suspect this particular episode is more nuanced and that fact will prove important to investors in the year ahead,” he said.

“While real GDP growth has continued along at a steady pace, the absence of inflation has limited any back-up in longer-dated Treasury yields. We expect this dynamic will persist and are forecasting 10-year yields to end 2018 at 2.40% but not before another attempt to break 2.00%.”

Lyngen, who was recently ranked first in the 2017 Institutional Investor Survey for U.S. Rates Strategy and Technical Analysis, noted that the Federal Reserve’s strategy has changed somewhat.

“Unlike in prior tightening cycles, the Fed has shifted the focus away from the fundamentals of inflation and wage growth, choosing instead to emphasize consistently easy financial conditions. This shift allows the FOMC to push forward with the goal of normalizing monetary policy and leaves us more bearish on the front-end of the yield curve,” he said.

“Supply also matters, and the Treasury Department has indicated a bias toward issuing in the Treasury bill sectors as well as in two- and three-year paper. While auction sizes will surely be increased across the curve, this focus on shorter-dated issuance will only serve to accelerate the flattening of the yield curve.

“All of this leaves us biased to see the curve continue to grind flatter and we view the risk of an inverted yield curve as an important 2018 event with longer-dated yields remaining contained within the prevailing range.”

CFALA’s annual forecast dinner benefits the California Council on Economic Education (CCEE), which provides economic and financial literacy education to K–12 teachers and students to help them make better personal and financial decisions, improving students’ ability to succeed and compete in the global economy. Two teachers received Teacher of the Year awards from CCEE at this year’s dinner: Bonnie Maye, El Segundo High School, El Segundo, CA; and Christy Heaton, Homestead High School, Cupertino, CA.

Founded in 1931, CFA Society Los Angeles is the local member society of CFA Institute, the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behavior in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. For more information, visit www.cfala.org.

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