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RBC WEALTH MANAGEMENT

Global Insight

Focus Article

Three paths for U.S. equities

A look at the U.S. market's reserves of stamina under various scenarios, offering a road map for investors.

Kelly Bogdanov

For important and required non-U.S. analyst disclosures, see page 6

All values in U.S. dollars and priced as of April 28, 2017, market close, unless otherwise noted.

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Focus article

Three paths for U.S. equities

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U.S. equities have been turbocharged for more than a year. But how much staying power does the market have? There are catalysts to drive the economy and the market further, but we also see risks to our forecast. We present three scenarios, and their likelihood of occurring, to help investors navigate the investment environment.

With the U.S. equity market up 11.4% following the election and defying gravity by surging 30% since the February 2016 low, it's useful to assess how much gas is left in the tank.

In our view, there remain catalysts that could push it up further this year, including domestic economic improvement, continued corporate profit growth, and at least *some* pro-growth policies passing in Washington. Presumably all of these are at least partially in the current price.

And we are mindful uncertainties linger and other scenarios could work their way into the narrative.

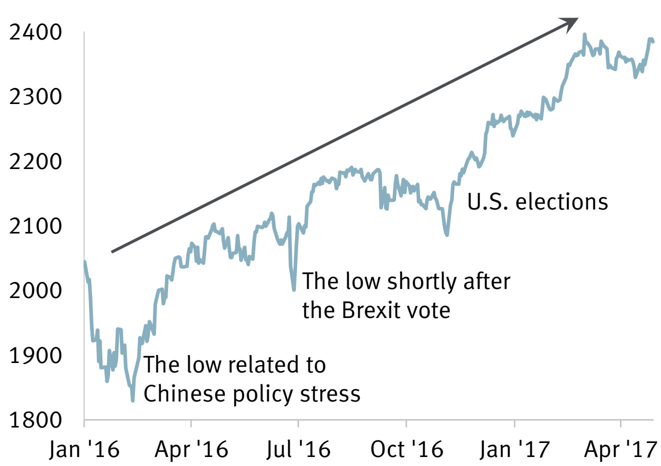
We lay out our forecast for the market and macro events for the balance of 2017, and also weigh pessimistic and optimistic scenarios.

Forecast: 60% likelihood

We continue to anticipate the S&P 500 will deliver low double-digit returns including dividends for the full year, which is an above-average rate. Given the index has already climbed 6.5% year to date, the additional upside would translate into 2.5%–4.5% more in price gains along with almost 2% in dividends. Combined, this would generate an 11%–13% total return. At this stage, we forecast similar low double-digit gains in 2018.

Improved earnings and favorable economic growth should enable the market to climb higher.

S&P 500 performance since 2016



The U.S. market has surged 30% since the February 2016 low.

Source - RBC Wealth Management, Bloomberg; data through 4/30/17

Three paths for U.S. equities

This year, earnings growth seems set to rise at the strongest pace since 2011. It is no longer being held back by massive Energy sector losses and sluggish Financials sector trends, like last year. Strong growth from these two sectors, combined with solid results from others, make it likely the S&P 500 can earn $128–$131 per share this year, up 8%–11% from 2016.

Better economic trends could also materialize. The initial Q1 GDP reading was weak at 0.7% mainly because consumer spending grew only 0.3%, the most lethargic pace since late 2009, and inventory accumulation slowed. Seasonal distortions also occurred, similar to previous years. However, we believe growth will rebound in Q2, as the consumer spending and inventory headwinds should reverse. If this occurs, full-year GDP could grow faster than the subpar 2% trend rate.

Earnings growth seems set to rise at the strongest pace since 2011. Better economic trends could also materialize.

Our forecast also anticipates at least *some* pro-growth legislation will be passed in 2017, such as corporate tax cuts and deregulation, but this may not impact the economy until next year.

Pessimistic scenario: 20% likelihood

A more pessimistic scenario for the market would likely be caused by weaker-than-expected domestic and/or global economic growth.

Considering U.S. GDP has been lackluster and inconsistent throughout the expansion cycle, it wouldn't take much to push it below the 2% trend rate—all the more so given the weak Q1 already in the books. This has happened in three of the past seven years, including in 2016 when GDP grew by only 1.6% partly because crude oil briefly plunged to $26 per barrel.

Weak commodity prices could constrain economic growth again this year and reawaken disinflation risks. We doubt this will occur as OPEC and non-OPEC producers seem willing to restrain crude oil supplies.

RBC Wealth Management's 2017 forecasts and scenarios

	Pessimistic scenario: 20% likelihood	RBC's forecast: 60% likelihood	Optimistic scenario: 20% likelihood
U.S. GDP growth	less than 2%	2%–3%	3%+
U.S. inflation rate*	3%+	2%–3%	2%–3%
Fed rate hikes*	2–3 amid weak GDP	2–3 amid good GDP	3–4 amid stronger GDP
10-year yield*	2.00%	2.55%	2.85%
U.S. Dollar Index*	$98	$101	$103+
Crude oil price (WTI)*	$50 or less	$55.50	$58+
Tax cuts	No tax cuts	Corporate, middle-income	Robust tax package
Deregulation	Little deregulation	Moderate deregulation	Aggressive deregulation
Infrastructure spend	No spending	Little spending	Tax credit-based package
Trade policy	Protectionist measures	All bark, little bite	Orderly renegotiations
S&P 500 earnings	$127 or less	$128–$131 (up 8%–11%)	$132+
S&P 500 total return	8% or less	11%–13%	13%+

* U.S. inflation rate, 10-year yield, U.S. Dollar Index, and crude oil forecasts are for year-end; # of Fed rate hikes are for full year
Source - RBC Wealth Management, RBC Capital Markets, RBC Global Asset Management

Sluggish economic conditions could also develop if tit-for-tat protectionist trade policies are implemented, although we believe trade risks have diminished since the election given the president's less-strident rhetoric and his appointment of "free trade" advocates.

Of course a geopolitical event related to North Korea or the Middle East could have negative domestic economic implications, particularly if consumer confidence is impacted.

We believe trade risks have diminished since the election given the president's less-strident rhetoric and his appointment of "free trade" advocates.

Apart from the geopolitical and trade risks, slower economic growth could also unfold if the Federal Reserve increases interest rates too far, too fast. We expect this will pose a bigger risk for 2018 and 2019 than for the current year.

We are not overly concerned about these risks and place a low 20% probability on them occurring.

Optimistic scenario: 20% likelihood

An optimistic scenario for the market would probably hinge on a number of pro-growth legislative measures passing in Washington, including aggressive corporate and individual tax cuts and a robust infrastructure spending plan. These are not factored into our baseline earnings estimates.

While we think tax cuts on corporations and middle-income Americans can pass by year-end, we believe Republican debt hawks and most Democratic members will oppose an aggressive, sizeable tax overhaul and infrastructure package.

Another unrelated, but positive scenario could see growth in China and Europe pick up more than expected, pulling the U.S. economy higher.

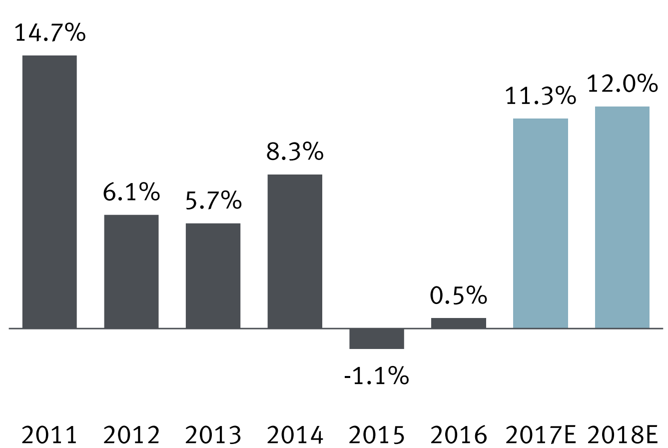
Stock market stamina

We remain constructive on U.S. equities and would maintain a moderate Overweight position based on a 12-month time horizon. The economy is on solid footing, recession risks are rather low, and corporate earnings seem set to deliver the strongest growth since 2011.

These factors, combined with the possibility at least *some* pro-growth legislation may pass in Washington, give us confidence that our forecast for low double-digit total returns this year and next year has a reasonable likelihood of unfolding.

S&P 500 y/y earnings growth

Actual: gray; consensus estimate: blue



This year, earnings could increase the most since 2011.

Source - RBC Wealth Management, Thomson Reuters I/B/E/S; bottom-up consensus data through 4/28/17

Research resources

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