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**Dow 20,000 or Bust?**
By Scott P. Noyes, CFA CFP®

The Dow Jones Index has been trading in the 17,300 to 18,350 range for almost two years. During this period, the economy continued to grow, unemployment declined, consumer spending expanded and homebuilding improved. Monthly panics have come and gone such as the Greek debt crisis, the Middle East, an oil and commodity glut, the Brexit vote, the China banking bubble, etc. Global central banks have partially offset these concerns with easy monetary policy worldwide, resulting in unusually low interest rates and support for higher stock prices.

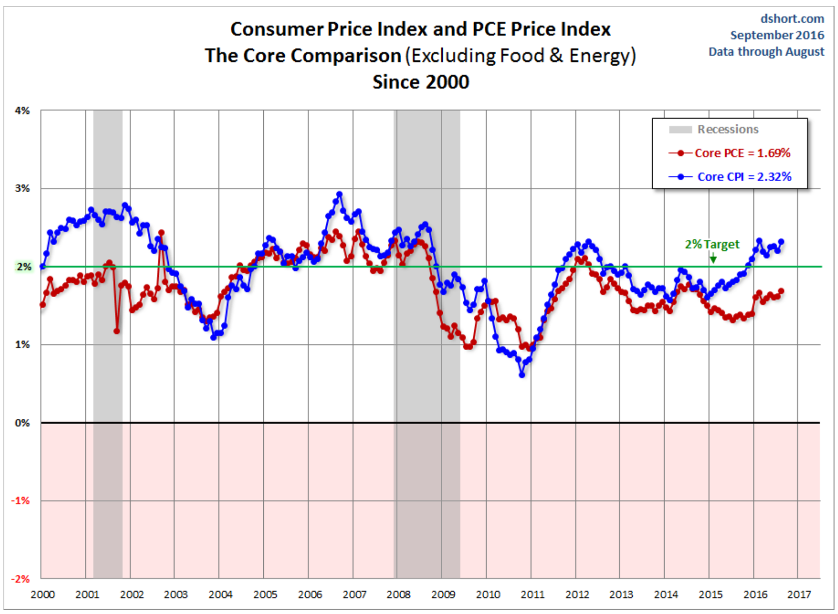
The U.S. economy continues to grow, albeit not as fast as many would like. After the election, consumer and investor confidence is likely to improve and the market focus will shift to increasing infrastructure spending, higher commodity prices and rate increases from the Federal Reserve. In my opinion, increased investor confidence could unleash a test of 20,000 for the Dow Jones Index, a rally of 9.6% from current levels. We remain patient and fully invested.

**Chart 1: Dow Jones Index Broke Out to New Highs in 3Q – Patience Required**

## Prepare for 2.5% Inflation

To the surprise of many, the U.S. is undergoing a modest reflation in price levels with Core CPI running at 2.3% and expected to increase by year-end. With unemployment at or below 5%, labor market conditions are poised for wage increases down the road. Unemployment rates for those with college degrees remains well under 2.2%. In addition, the rate of change of oil prices has moved from negative to positive and should contribute to future inflation. If core CPI exceeds 2.5%, I suspect the Federal Reserve would be forced to restart the discussion about raising interest rates.

## Chart 2: Inflation is Approaching Levels that Will Worry the Federal Reserve




## The Federal Reserve is Likely to Raise Rates in December and Twice in 2017

After the September FOMC meeting, Fed officials announced that three members were in favor of a rate hike, and they anticipated a decline in the 2016 median year-end fed funds rate projection from 7/8% to 5/8%, implying that one 2016 rate hike is still on the table. They also anticipate a decline in the 2017 median fed funds rate projection from 1-5/8% to 1-1/8%, implying that the FOMC foresees just two rate hikes in 2017.

The fact that three FOMC members dissented in favor of higher rates immediately—a rare occurrence—suggests that most participants still expect one rate hike this year which clearly enhances the chance for one at December's policy meeting. However, with the FOMC consensus steadily reducing its rate projections for 2017 and 2018, it is believed that Fed policy will not become overly restrictive anytime soon.

## Prepare to Shift from Monetary Expansion to Fiscal Expansion

Monetary policy has been helpful in the recovery after the 2008–2009 recession, but its effectiveness as an economic stimulus has diminished. Monetary policy was the principal tool used across the world. The United States and others used selected fiscal measures as well, particularly at the beginning, but monetary policy, which requires no legislative approval, was the instrument used most extensively. In 2007 the balance sheets of the central banks of the United States, England, the European Union and Japan had total assets of $3.5 trillion. Today, according to Bianco Research, the aggregate is more than $12 trillion. The slow pace of world growth is troubling when monetary policy has been so expansive. But central banks have had no incentive to stop printing money, because inflation has not kept pace with the growth in the money supply.

Almost everyone agrees that the time has come for more fiscal spending on infrastructure, education, job training, research and development and other programs to improve growth and increase competitiveness. The companies that are doing well are the "disrupters" like Amazon, Google, Apple, Airbnb, Uber and Netflix. The "old economy" companies will continue to face challenges from margin pressure and foreign competition. Many believe that the world is condemned to a prolonged period of slow growth unless vigorous fiscal spending takes place in the major industrialized economies. We believe that some of these fiscal spending policies will be adopted after the election.

## Negative Real Interest Rates

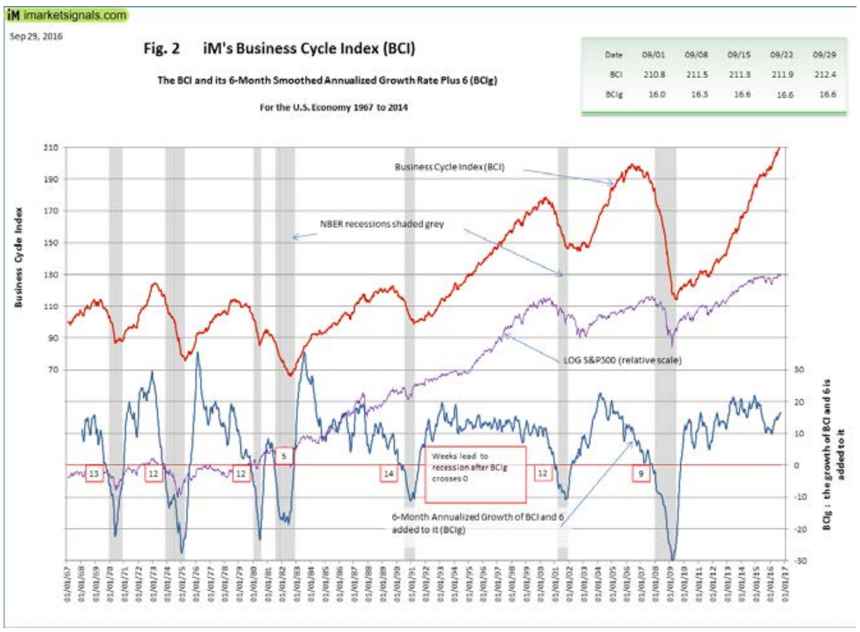
U.S. Treasury 10-year bonds currently yield 1.72%, up from a low of 1.51% in July. This is still lower than the current and projected rate of inflation, resulting in a negative real interest rate. With interest rates extraordinarily low and inflation on the uptick, there is nowhere to hide in the bond market. We have chosen to maintain our credit risk at normal levels, reduce our maturity risk and increase our exposure to emerging market bonds. If people start to believe the Fed's projected rate increases, interest rates are likely to go higher. As seen in Chart 3 below, the upside target for the 10-year Treasury is 2.25% to 2.4%.

## Chart 3 – Interest Rates May Have Put in a Double Bottom

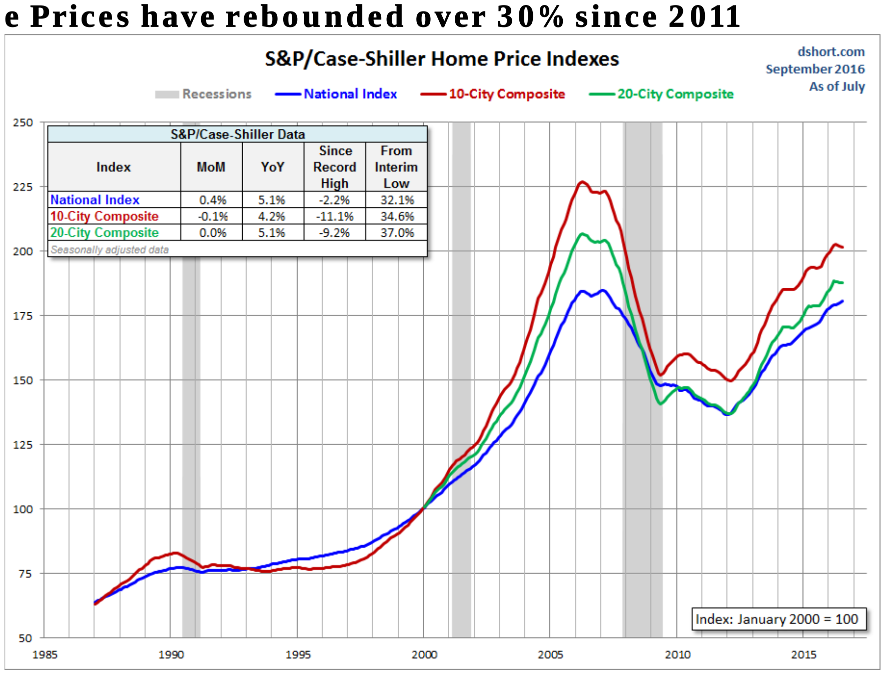
## Prospects for the U.S. Economy

The odds of a recession occurring remain low. My best leading indicator of the economy is the Business Cycle Index developed by iMarketsignals.com. It has tended to lead economic downturns by 40-50 weeks, almost a full year. It continues to gain strength on a weekly basis and does not signal future economic weakness. Leading economic indicators such as employment, business confidence, retail sales and new home sales all suggest the U.S. economy is on a positive growth track. The October monthly jobs report is expected show improving employment and year-end holiday sales are expected to be solid.

## Chart 4 – The Business Cycle Index Continues to Expand




## Chart 5 – Home Prices have rebounded over 30% since 2011

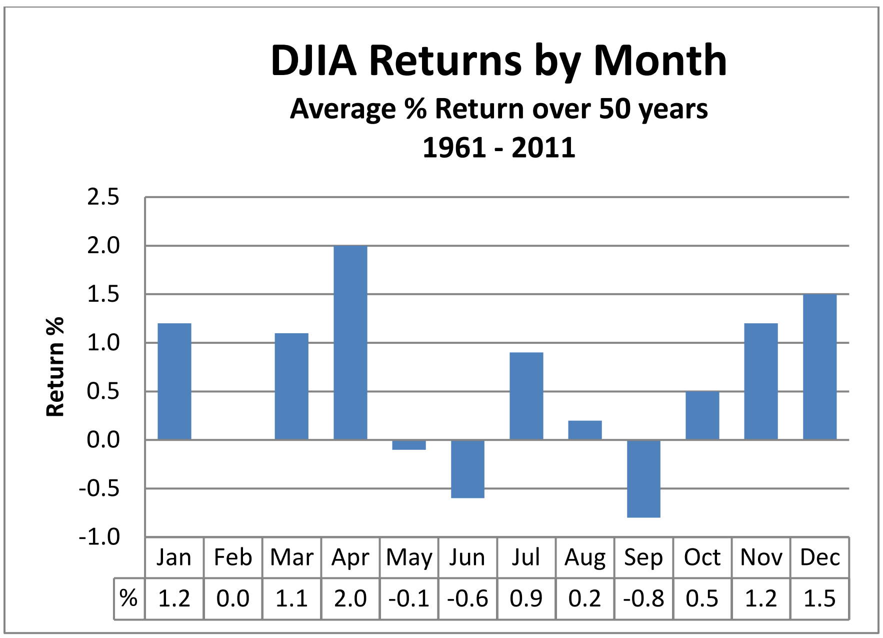


**Seasonal Return Trends are starting to Provide Support for the Market**

Historically, you will receive far better returns during the winter months (+7.0%) than the summer months (+0.1%), excluding dividends. The chart below lists the returns of the Dow Jones Industrial Average (DJIA) over the last 50 years sorted by month.

The strongest months of the year are April (+2.0%), December (+1.5%) and November (+1.2%). The cumulative return of investing from November 1st to April 30th is 7.0%, the return for summer months is +0.1%. This indicator suggests that it is best to remain invested in the market when seasonal trends are in your favor.

**Chart 6 – Seasonal Patterns Suggest to Buy from October to April**




## **Problems That Remain a Concern**

There is a long list of issues that may cause the market concern:

- The S&P 500 remains in an earnings funk. For the sixth quarter in a row, analysts projected that estimated earnings for the S&P 500 would decline by 2.1% in the third-quarter of 2016. Energy stocks remain the chief culprit. Margin compression and limited revenue growth are a concern for all companies. However, the rate of change for energy sector earnings is bottoming and should result in stronger earnings comparisons in 2017.

- In June, the British voted to pull out of the Eurozone. The major issues were immigration and sovereignty from Brussels and the European Parliament. However, the cost of leaving could be quite high. Many companies will cap hiring in the U.K. until the smoke clears. London's continued success as a financial center will be questioned. The future for the U.K. and the British Pound is likely to be fairly difficult.

- In Germany, Angela Merkel's fortunes have faded with her open access refugee policy. In mid-2017, German voters will decide if her party returns to power.

- Europe's persistent economic stagnation is becoming quite troubling. The Continent has made slow progress in solving its longstanding economic, political and social problems. The relative prosperity of Germany and Austria diverges vastly from that of southern Europe, so much so that it calls into question the European Union's viability.

- Islamic terrorism is occurring randomly throughout the developed world. The recent attacks in Brussels and Pakistan are examples of the ongoing discord in the Middle East.

All of these issues create ongoing uncertainty which usually translates into negative moves for the financial markets. In spite of the problems in the U.S., we remain the most stable, growing force in the world economy.

**Market Outlook**

The U.S. has become the safe haven for all global investors. With interest rates at exceptionally low levels, capital is forced back into all forms of equities—there is no other alternative. While valuations remain rich relative to earnings, the path of least resistance is to be invested.

In terms of sector rotation, we are probably seeing the end of commodity deflation. I suspect that owning hard asset providers such as energy and material stocks may be a constructive strategy as we move into 2017 and beyond. Emerging markets are starting to benefit from stronger commodity markets and both stocks and bonds are now attractive relative to Europe.

I remain concerned about investments in Europe due to major elections in Germany and France in 2017. I prefer to redirect some international exposure to Asia and commodity-rich nations such as Canada and Australia.

I am optimistic that investor psychology will improve after the U.S. election, leading to a test of the Dow at 20,000 in the medium term.

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