



2017 - THE YEAR AHEAD

Expectations for the year ahead are all over the map. Generally it is good to hear so many divergent economic and investment opinions to help build a wall of worry among investment managers. The old adage on Wall Street says “the market loves to climb a wall of worry”. A growing wall of worry creates one of the best investment environments for equity investors. With that said, the best standard measure by which all markets are gauged is total return. So our expectations will be based on a total market return basis and the underlying fundamentals and valuation of each security we own.

Large Capitalization, Small Capitalization or International stocks are always questions asked by investors to determine the better investment theme. In our opinion the most important aspect of a good investment is not the theme, sector or country of origin but the individual investment and its valuation. Valuation is the most important aspect of making the proper investment and is the main determinant in our investment thesis. With that said we also look to the markets solely as a valuation device that helps us in determining the markets valuation and our investments valuation. The markets valuation not direction is most important in determining potential for total return.

Simply put, there are three components to total stock market return - earnings growth, dividend yield, and changes in valuation. Earnings are the underlying determinant of value for a stock or stock market. Thus as earnings grow, so too does value. Historically, corporate earnings have grown in line with nominal GDP, or about 7% per year. But over the next few years, we are looking for a somewhat lower-than-average 5 to 6% earnings growth due to the top-line pricing pressures of a low inflation, increasingly competitive global- business environment. As for dividends, the current yield of the Standard & Poor's 500 Stock Market Average is slightly less than 2%. So excluding changes in valuation and ignoring the interim fluctuations, we can look forward to 7 or 8% stock market returns, longer term.

And what about valuation? The long-term average price/earnings ratio of the S&P 500 is 15.4 on trailing earnings. Currently, P/Es are somewhat higher with the S&P valued at 16.8 times this year's forecast earnings and 15.8 times next year's expected earnings. But stock market valuations have usually been higher during periods of low interest rates and mild inflation, such as we are currently experiencing.

flation	Average Trailing P/E	Peak Trailing P/E	Minimum Trailing P/E
<2 %	19.0	27.8	13.7
2 - 3 %	19.9	28.4	14.5
3 - 4 %	16.2	23.5	11.8
4 - 5 %	15.6	21.6	10.1
5 - 6 %	14.8	18.0	10.8
6 - 7 %	10.6	12.0	8.7
>7 %	8.5	11.3	7.3

Source: Morgan Stanley Research, S&P - 1956 to present

In fact, according to Morgan Stanley Research, over the last fifty years the average trailing price/earnings ratio was 19.9 during periods when the inflation rate was in the 2 to 3% range. And even with a somewhat higher rate of inflation, 3 to 4%, the average P/E was still an above average 16.2. So from an interest rate/inflation standpoint, the current stock market valuation is actually lower than would seem justified historically.

Our bottom line expectation is 6 to 8% stock market returns over the next five years or so. And we think those returns will compare quite favorably to the rate of inflation as well as to the returns produced by most stock market alternatives. The returns available on cash and cash equivalents, for instance, remain below the rate of inflation.

Regarding bonds, we have been expecting interest rates to rise. While the process is taking longer than we had originally anticipated, partially due to high oil prices, we believe the current economic soft patch will soon pass. So rising interest rates are highly likely over the next year or two. The probable result, in our opinion, will be falling bond-market valuations and near-zero fixed income returns. Following the projected bond-market weakness, we would expect two or three years of relatively steady interest rates. There will be a time to invest in fixed income, but that time is not yet at hand.

Closing Statement:

We remain optimistic about the long-term opportunities in the equity market and continue to feel more comfortable stating that the bull market is still intact. Although our market return expectations may seem modest, we think the coming environment will be one which rewards savvy investors with better-than-average investment returns. Thus, we believe that a disciplined, value oriented, long-term, total-return approach to stock market investing makes great sense at this point in time. Our strategy continues to perform well and we will continue to focus on companies with strong earnings and growing revenues as we select new names for the SWCM composite.

As always, SWCM values each client and continues to focus on your investment objectives. If you have any questions or concerns please do not hesitate to call.