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INSIDE THIS ISSUE

If the current bull market lasts until mid-March, it'll be the longest bull market ever for US stocks.

Perspectives

2016 was a year of emotional trading for the markets. The major indexes gained more than 10% without the help of earnings growth. Stock and bond prices fluctuated based on fears and hopes rather than earnings. 2017 could be very different. Of course, emotions will always help drive prices, but after the price/earnings multiple expansion that we saw in 2016, companies need to show their earnings will grow to make these prices hold, much less improve.

After the election, investors who had remained on the sideline until the uncertainty was over decided to come back into the market with the hopes that the talk of a massive spending plan will be approved and implemented sooner than later. Increases in government spending coupled with tax cuts and decreased regulation could come to fruition and create a set-up where company earnings can grow at a quicker pace than we've seen in years. On top of these potential stimulating factors, the economy is already doing well with low unemployment, rising home prices, and expanding manufacturing and services sectors.

As with any positive news investors hear, it's important to know what negative changes could affect stock prices. Oil prices have risen substantially since the beginning of last year. So far, this has been great for stocks because oil companies are making more money and bond investors no longer have to fret about the risks of a contagion effect from failing oil companies. At a point that is drawing nearer, the price of oil will impact the price of gasoline enough that drivers notice again. Such a tipping point will eat into consumers' free cash flow and will hurt the food and services industry first followed by most other consumer focused industries. For now, domestic oil producers and OPEC countries have found a happy middle ground that allows both to profit without tipping the cart. This Goldilocks scenario rarely lasts long, so keep an eye out for which direction it begins to trend.

Inflation is a positive for the economy, when kept moderate, because it produces higher nominal profits. Even if not "real" profits when inflation adjusted, the rise in nominal earnings allows stock prices to move higher. Home owners can pay down debt easier when inflation helps increase wages. Inflation expectations with Trump stimulus plan and rising oil prices will be stymied by rising interest rates. While some investors expect the Fed and the incoming administration to balance each other as the US finally moves away from historically low interest rates, the risk of a misstep from either side is worth our attention.

Ideally, as parts of the proposed stimulus plans are enacted and the pace of US Gross Domestic Product (GDP) growth quickens, the Fed will be able to increase interest rates substantially. In 2016, the Fed predicted four interest rate increases, while they only came through with one increase and lost a lot of credibility. For 2017, the Fed is predicting three increases, which should be taken with a grain of salt. If GDP is expanding above 3%, as it was in the third quarter, the economy should be able to handle rising interest rates. The importance of coupling higher interest rates with the spending of a large stimulus plan is to prepare for the next bubble bursting. The economy will suffer when the infusion of spending from stimulus is over and the Fed will need to have the flexibility to lower rates as the usual recessionary cycle repeats. Bubbles within an economy form easily during periods of fiscal stimulation and lowered regulation. The question is not if we will have another bubble, but how big will it get before it bursts again.

The S&P 500's trailing P/E ratio moved from 19.21 at the end of 2015 to 24.82 at the end of 2016. Earnings estimates for 2017 put the forward P/E ratio at 18.92, but forecasts rarely meet reality and at current levels, the large cap index has little room to push higher until the forecasts prove to be accurate or at least improving.

If the current bull market lasts until mid-March, it'll be the longest bull market ever for US stocks. Investors should expect a long run of gains after the second worst recession ever in the US. Investors need to remain focused on fundamental data more than worry about the bull's age. As I've said before, bear markets begin because of recessions, not because of old age. While stocks may not have much upside available in the near-term after the post-election rally, they don't have a lot of reasons to fall hard either without a recession expected to hit soon. 2017 is setting up to be a good year to buy on the dips, but don't buy blindly. Each move lower in stock prices should be viewed through unemotional lenses to decide if the price drop is warranted and could turn into something bigger.

Summary of Indexes

Courtesy of Morningstar.com

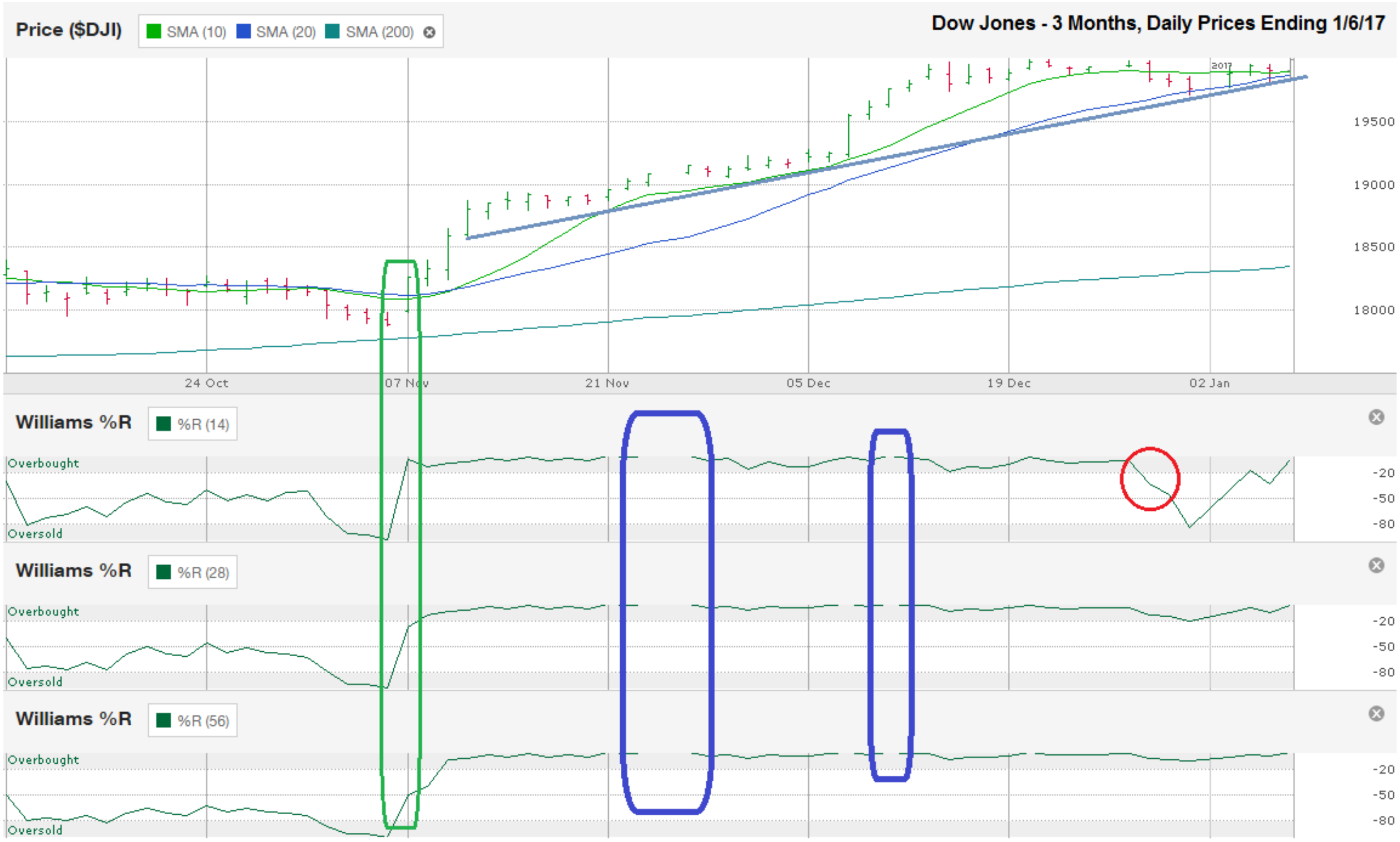
Name	As of Date	YTD	1-Year	3-Year	5-Year
US Stock Indexes					
DJ Industrial Average	1/6/2017	1.07	21.29	9.42	12.88
NASDAQ Composite	1/6/2017	2.56	14.17	10.31	15.60
Russell 2000	1/6/2017	0.76	26.86	7.52	14.36
S&P 500	1/6/2017	1.76	16.94	9.93	14.68
S&P MidCap 400	1/6/2017	1.30	25.69	9.99	15.30
Global Stock Indexes					
MSCI Emerging Markets	1/6/2017	2.18	15.96	-3.23	-1.01
MSCI World, Excluding US	1/6/2017	1.88	8.88	-0.57	6.52
Bond Indexes					
Core Bond	1/6/2017	0.20	2.38	3.18	2.47
Intermediate Core Bond	1/6/2017	0.05	1.87	3.18	2.56
Long-Term Core Bond	1/6/2017	0.72	4.88	5.98	4.04
Short-Term Core Bond	1/6/2017	-0.01	1.30	1.08	1.11

Fundamentals & Indicators

- The Empire Manufacturing Survey began the last quarter on a sour note with an October reading of -6.8, but improved over the next two months to 1.5 in November and 9.0 in December.
- The Philadelphia Fed's Business Outlook Survey remained strong throughout the past quarter with an October report of 9.7, followed by 7.6 in November, and 21.5 in December. The December report was the highest since November 2014 and marked the fifth consecutive month of positive readings.
- Retail sales remained tame in the three reports with declining momentum. September showed 1.0% growth, while October slipped to 0.6% and November's growth was only 0.1%.
- Producer prices index (PPI) wavered as inflation remained in check from September through November with readings of 0.3%, 0.0%, and 0.4% respectively. The index was up 1.3% year-over-year, which was the biggest 12-month increase since November 2014.
- The Consumer Price Index (CPI) indicated prices are rising due to stronger economic activity. September showed a 0.3% increase, followed by October with a 0.4% gain, while November rose 0.2%. CPI is up 1.7% year-over-year. The improvements over the past few months helped give the Federal Reserve backing for the small interest rate increase in December.
- The Case-Shiller 20-city Home Price Index maintained a steady rise of 5.1% in each of the past three reports from August through October.
- Housing starts declined in September to 1,052,000, rose in October to 1,340,000, and declined again in November to 1,090,000. The slowdown from the past four months has created more of a sideways chart than a declining trend. Housing starts more than doubled the rate seen at the depths of the recession. Further declines are expected if interest rise through 2017.

- Existing home sales fared better than housing starts recently. The pace of existing home sales improved to 5,490,000 in September, 5,570,000 in October, and 5,610,000 in November. The November sales pace improved 15.4% over a year earlier and is the highest level reached since February 2007.
- New home sales in September hit an annualized rate of 593,000, which was below the revised August rate of 575,000 (from 609,000), and less than the 610,000 that was expected by the consensus.
- Pending home sales rose 1.5% in September, but began to decline in October with a reading of only 0.1% growth. November turned negative with a 2.5% decline in pending home sales.
- Factory orders have been far from robust, but have improved over the past quarter's reports. New orders grew 0.4% in August, 0.3% in September, and 2.7% in October. Even with the recent growth, factory orders are still down 2.0% year-over-year.
- Durable goods orders rose 0.3% in September and 4.8% in October, but fell 4.6% in November due to a large decline in nondefense aircraft orders. Year-over-year, durable orders are down 0.3%.
- The ISM Manufacturing Index continues to expand at an improving pace. October's reading moved up to 51.9 (above 50.0 indicates an expansion). November improved to 53.2. December extended the expansion to 54.7 to reach the highest level of 2016.
- The ISM Services Index also continued to show expansion each month. In October, the index read 54.8, while November and December both had readings of 57.2.
- Construction spending slipped 0.4% in September and recovered quickly in October with a 0.6% increase and in November with a 0.9% increase. On a year-over-year basis, construction spending has increased at an annual rate of 4.1%.
- The third estimate of the third quarter Gross Domestic Product (GDP) rose to an expansion of 3.5%, up from an initial estimate of 2.9% and a second estimate of 3.2%. The US economy is finally beginning to pick up its pace as 2017 begins, but uncertainty with a new administration and rising interest rates could cause some bumps to the progress while the broad trend of growth continues.
- Weekly unemployment claims remained below 300,000 for the 96th consecutive week, with the latest weekly data showing only 235,000 new claims. 96 consecutive weeks is the longest streak below 300,000 since 1970.
- Total nonfarm payrolls (including revisions to the first two months) came in at 135,000 in October before recovering to a healthier 204,000 in November, but declined to 156,000 in December, below the 6-month moving average.
- The unemployment rate waivered from 4.8% in October to 4.6% in November, and then up to 4.7% in December. The slight increase in December is partly due to the rise in the labor force participation rate from 62.6% in November to 62.7% in in December. An increasing labor force is a bullish indicator, but the percentage is still historically low at levels not seen since the 1970s.
- The U-6 unemployment rate (includes the total number of unemployed and those employed part-time, but seeking full-time employment, is viewed as a more realistic picture of total unemployment) maintained its trend lower. October's U-6 rate dropped to 9.5% followed by 9.3% and 9.2% in November and December respectively.
- The average workweek was reported at 34.4 hours per week in October and November, but dropped to 34.3 in December.
- Average hourly earnings began the past quarter with an increase of 0.4% in October, but decreased in November by 0.1%. December's report showed increase of 0.4% and pulled the year-over-year increase in hourly earnings to 2.9%, making it the best year-over-year gain since the recovery began in 2009.

Index Chart & Analysis



The chart above shows the daily prices for the past three months on the Dow Jones Industrial Average after the index closed for the week at 19,963.80 on Friday, January 6, 2017. The Dow has gained almost 9% since the election as animal spirits took over trader sentiment for a month and a half. However, the large cap index has failed to push above the round 20,000 barrier that has no significance other than it has four zeros and the press likes round numbers as targets. These large round numbers always draw a lot attention on the news, perhaps because it's a way to draw in viewers and readers, but their efforts end up making the number matter, if only until the trading algorithms can work past it and a more worthwhile headline can take its place.

The normal trading pattern that occurs when nearing a round number is for the first one or two attempts to fail before the bulls can finally push above the otherwise meaningless barrier. The current pattern has played out according to that script so far. After coming within 13 points on December 20, the Dow moved sideways for a few days before dropping as low as 19,718 on December 30. The small late December dip was enough for a reset and on Friday, the Dow reached a new all-time high of 19,999.63 before losing steam. We'll know soon if the second attempt to break above 20,000 results in failure and if traders need one more reset before they can push through into the 20,000s.

Technical indicators can help foreshadow the future prices of individual stocks and indexes. The Dow stayed above its 10-day moving averages from the election until December 28 when it fell below its 10-day moving average and closed below it for four consecutive days. On December 30, it dipped below its 20-day moving average, but has not closed below this longer-term moving average since the Friday before the election. Intraday crossings of a moving average can raise warning signals, but it is the closes below the moving averages that holds more significance. For the past three days, the Dow has closed above both moving averages as it has held in a consolidation pattern, refusing to rollover or break higher.

The single trend line I drew in this chart shows the line of higher lows that began on November 10. This trend line has been the guide for bulls to follow when the bears try to push prices lower. They've used the guiding line as reentry points on every hint of weakness. Eventually the line will break and that's when bears will be able to have a longer run, especially since a break in this trend line will also coincide with a break in the moving averages covered above. The combination of the multiple technical indicators signaling at once increases the probability they will be accurate predictors of future prices.

Technical indicators work until they don't. None is infallible. The Williams %R indicator proved this point in November and December. The two areas I circled in blue include periods when Williams %R was literally off the chart for being overbought. Typically, the index will falter two days after such a rare event. Neither occurrence produced any weakness on these days. Williams %R was accurate the day before the election when it moved above its oversold region (circled in green) on its 14, 28, and 56-day indicators. Moves out of either oversold or overbought on all three periods indicate a change in momentum and are usually accurate. In late January, the 14-day indicator fell below its overbought range (circled in red), but the 28 and 56-day indicators didn't echo the sell signal and the Dow stayed elevated.

Traders can use these three technical indicators as a guide to when the bulls will step out of the way and yield to the bears temporarily. When this happens, the Dow could retreat as low as 18,345, where the 200-day moving average is ascending slowly. Before falling that far, it will have to get through its 50 and 100-day moving averages (not shown), currently at 19,180 and 18,738 respectively. Each moving average is likely to give reason for pause, but until support is clear, don't bank on it being more than a speed bump during a deeper slump.

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