Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

4 Reasons to be Bullish in 2018

By Mitch Zacks
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At the end of 2016 and the outset of this year, I wrote about my bullish outlook for stocks in 2017. I believed a corporate earnings recovery was in order largely because of the fading drag from the Energy sector. Our portfolio managers here at Zacks Investment Management agreed and were confident that the U.S. and global economy would continue to grow modestly in a favorable interest rate environment.

We were pleased to see many of those forecasts play out. My call was for high single-digit returns for the S&P 500, which the index looks easily poised to clear.

In 2018, I see more positive returns ahead for U.S. and global equities. Here are four reasons why you should too:

Reason 1: Tax Cut = Earnings Boost

The tax reform bill is currently in conference committee, which almost always results in compromise and a bill reaching the President's desk. There are many aspects of the bill that may result in contentious debate, but the sizable corporate tax cut does not appear to be one of them. Both the House and the Senate proposed lowering it to 20%.

Here's why I think this proposed cut is bullish: the average S&P 500 company currently pays a corporate tax rate of 24.17%. So, if that rate is lowered to 20%, then the average S&P 500 company would receive a 4.17% reduction in taxes on revenues, which should ultimately end up on the balance sheet as gains to the top and bottom lines. And there is a decent chance those gains get distributed to shareholders in some way (dividends, share buybacks).

S&P earnings expectations for 2018 are $136.98, *without factoring a tax break.* A generous estimate might have the tax cut adding somewhere around $12 to aggregate earnings. Let's be more conservative and call it ~$6. If that's the case, the higher earnings could cut the current 12-month forward P/E of the S&P 500 from 20x down to a forward P/E of 17.9x. Stocks all of a sudden do not look so expensive.

Reason 2: Global Economic Growth Continues Apace

Our analysts believe it's possible that the world economy could notch ~4% growth in 2018, a solid pace relative to growth rates throughout this nine-year expansion. It is also significant that virtually all of the developed world and even Emerging Markets should be participating in this growth, and there are few worrisome signs that global inflation pressures pose a risk. The euro region in particular should retain solid growth momentum as Brexit discussions inch forward. Here in the U.S., "muddle through" GDP growth of +2.4% US is our call for 2017 and +2.3% is where 2018 stands. If U.S. stocks could perform well with muddle-through growth in 2017, we do not see a strong case for why they can't do the same in 2018, especially if the tax cut provides a sentiment and earnings boost.

Reason 3: Inflation Remains at Bay (i.e., Central Banks Won't Ruin the Party)

As expected, the Federal Reserve raised rates at their last meeting (to the 1.25% - 1.50% range), and the European Central Bank hinting at plans to start curbing QE bond buying next year, investors are starting to get jittery that coordinated tightening at the world's biggest central banks could tighten credit conditions and choke off the expansion – or at least moderate it. While this outcome is possible, a few improbable events probably have to trigger it: an inflation surprise, a closing of the global output gap, and bigger than expected wage pressures. None of those outcomes seems likely at least in the first half of the year, but probably not in the second half of 2018 either. If they tighten at all, most major central banks are likely to withdraw stimulus very gradually.

Reason 4: Equity Yields Look Much Better than Bond Yields

In many cases, investors face a fairly straightforward choice when making an investment decision, and it's based on this question: Is the yield on equities materially higher than the yield on bonds? In the current environment, the answer is a simple: yes.

In order to calculate the equity yield, just turn the P/E ratio of a stock or an index on its head. For the S&P 500, to calculate the earnings yield we divide $131 in projected earnings for 2017 by an S&P 500 trading at 2575. That begets a 5.1% earnings yield. Now, compare that 5.1% earnings yield to the current 2.79% yield on the 30-year U.S. Treasury, and it is easy to see which option looks better (hint: it's stocks).

Bottom Line for Investors

Investors should always balance their outlooks for stocks with risks, and there are several at the margin that we need to keep close eyes on. I will cover those risks in my piece next week. But I can

tell you this now: in my view, the positives far outweigh the negatives, and I'm as optimistic for 2018 as I was for 2017 at the outset of the year.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

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