First Trust
Monday Morning OUTLOOK

630-517-7756 • www.ftportfolios.com December 27, 2016

2017: Dow 23,750, S&P 2700

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We have used the metaphor of the "Plow Horse" to define the US economy since 2009 – an economy driven by new technology and entrepreneurship (fracking, the cloud, smartphones, big data…), but held back by the friction of a growing and burdensome government.

Since mid-2009, real (inflation-adjusted) economic growth averaged a Plow Horse-like 2.1% per year. With the current forecast for Q4 real GDP at 2.5%, 2016 will finish right on that average.

The great news is that we finally have more than just hope to believe that this year, 2017, is the year the Plow Horse Economy finally gets a spring in its step.

We're looking for **real growth of about 2.6%**, led by faster growth in home building, a return to more normal growth in inventories, and, most importantly, more business investment.

That last part is key. Other than investment in technology, which has helped boost productivity, business investment has been weaker than normal. It looks very likely that President-Elect Trump and Congress are going to push for supply-side cuts in the corporate tax rate. In addition, cuts in regulation and less emphasis on government subsidies which direct resources toward politically-favored, and non-efficient industries will reduce economic friction. As a result, look for firms to both raise investment and use their pre-existing assets more efficiently.

In spite of these gains in efficiency, there is a massive amount of excess monetary liquidity in the system and inflation looks likely to pick up. In 2015, the consumer price index was up only 0.7%, held down by another year of falling energy prices. For 2016, it looks like the CPI will be up 2%. For 2017, look for an **increase in the CPI in the 2.5% to 3.0% range**.

Meanwhile, the unemployment rate will keep falling. Next year should end with the **jobless rate at 4.4%** (versus 4.6% in November), with risks more toward a lower rate than a higher one. Healthy job growth will continue, but companies will get more output growth from productivity.

On monetary policy, the Federal Reserve has consistently talked a more hawkish game then they have accomplished. This year, the Fed will deliver. **We're looking for three or four rate hikes on the table.** A March rate hike is possible, but we think the Fed will wait until after tax cuts become law before it pulls the trigger.

Longer-term interest rates are heading up as well. Look for the **10-year Treasury yield to finish next year at 3.25%**.

For the stock market, get ready for a strong bull market in 2017. We use a Capitalized Profits Model (the government's measure of profits from the GDP reports divided by interest rates) to measure fair value for stocks. Our traditional measure, using a current 10-year Treasury yield of about 2.5% suggests the S&P 500 is massively undervalued.

Using a 10-year yield of 3.5% suggests fair value for the S&P 500 is 2757, which is 22% higher than Friday's close. The model needs a 10-year yield of 4¼% to conclude that the S&P 500 is already at fair value, with current profits.

But profits have been held artificially low since mid-2014 due to the energy industry absorbing lower oil prices. Now that oil prices have rebounded, the energy sector should be a tailwind for economy-wide profits, not a headwind.

As a result, we're calling for the **S&P 500 to finish at 2700 next year**, up almost 20% from Friday's close and slightly more than 20% including dividends. **The Dow Jones Industrial Average should finish 2017 at 23,750.**

It's important to recognize, though, we are not market timers and are not saying a correction won't happen. Corrections come and go, like early in 2016, when the stock market recorded its worst two-week start to a year in history. Some investors were freaking out, while pessimistic forecasters were popping champagne and predicting a bear market.

For the past several years, we have been telling many investors that even though public policy isn't great, there are reasons for optimism, including the entrepreneurial spirit, which remains alive and well. Now we can look forward to tax cuts, a freer market in health care, less regulation, and more energy production than ever before. As we've been saying since 2009, and say even more emphatically now, those who stay optimistic will be richly rewarded. Stay optimistic and stay invested.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-27 / 9:00 am	Consumer Confidence – Dec	109.0	**109.3**	113.7	109.4
12-29 / 7:30 am	Initial Claims – Dec 24	264K	**264K**		275K
12-30 / 8:45 am	Chicago PMI – Dec	57.0	**56.4**		57.6