WHAT WALL STREET AND CAPITOL HILL COULD HAVE IN STORE FOR 2017

Jeremy Siegel — WisdomTree Senior Economist
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The final two months of 2016 have delivered plenty of excitement for investors. First, there was Donald Trump's surprising victory in the November presidential election. Then the Federal Reserve (Fed) finally got around to raising [inter est rates](), as was widely expected, last month.

As 2016 drew to a close, U.S. equities resided near record highs with investors eyeing the next significant round-number conquests for major U.S. indexes, such as the [S&P 500]()and the [Dow Jones Industrial Average](). Although the market didn't break 20,000 last year, 2016 has been quite a ride.

Heading into 2017, claims that stocks are pricey may be exaggerated. The S&P 500 trades at 20 times operating earnings, which is not inexpensive, but not unreasonable considering interest rates remain low. While there are plenty of unknown factors impacting stocks heading into 2017, earnings growth should be healthy. Although I view S&P's estimate for operating earnings of $131 per share as overly optimistic, I hope we can see earnings of $120 per share, which would put the current [price-to-earnings (P/E) ratio]() between 18 and 19 (based on December 22 prices).[1]

President Trump: The Wildcard That Wasn't

The results of the 2016 presidential election are among the most stunning in modern U.S. political history, but that shock was limited to a matter of hours in U.S. equity markets as stocks have clearly come to grips with President Trump. With U.S. election uncertainty in the rearview mirror, investors can begin focusing on Trump's policies and the potential impact on various asset classes.

For example, Trump pledged to lower corporate taxes within his first 100 days in office, a move that the equity markets would widely embrace. Since Election Day, mid- and small-cap stocks have been thumping large caps because smaller companies typically generate the bulk of their revenue within the U.S. and would be most influenced by a lower tax rate, and they do not have the strong headwinds of a rising dollar.[2]

Another tax reform effort to monitor is rolling back [dividend]() taxes, which rose under the outgoing administration. S&P 500 dividend growth has been slowing over the past several years, and at the end of the third quarter, the payout ratio on the benchmark equity index was nearly 40%,[3] toward the lower end of the averages seen over the past several decades. A drop in the dividend tax rate could give dividend-paying stocks a nice boost.

Can Trump and the Fed Play Nice?

Following the Fed's interest rate hike earlier this month, its first and only such move last year, Chair Janet Yellen signaled she expects the U.S. central bank to increase rates as many as three times in 2017.

But raising three times is in no way a slam dunk. As we saw coming into 2016, what the Fed says it wants to do and what it ultimately does can be two very different things. A year ago, investors were expecting the Fed to raise rates as many as four times in 2016, but that number turned out to be just one.

There are several issues to consider regarding the new president's relationship with the Fed, including Trump's ambitious infrastructure plans, which would obviously be hampered by higher borrowing costs. The new president also has the opportunity to shape the Fed more in his view. As I've previously noted, there are two openings for governors that the Fed would like to see filled, and Trump can make those appointments immediately after confirmation.

Looking Overseas

Post-election dollar strength has been a boon for Japanese stocks as the yen has tumbled. Notably, Prime Minister Shinzo Abe was the first global leader to meet with Trump, potentially giving Japan added gravitas with the new U.S. president. As the U.S. economy gains steam, Japan has a tendency to follow.[4]

On the heels of the recent Italian referendum that added momentum to the global populist swell, the eurozone is another region to watch in 2017 as Germany, France and the Netherlands all will hold elections during the year.

Emerging market equities performed well in most of 2016 as the dollar slumped and the Fed remained in the "lower for longer" camp, but Trump's victory has been a near-term drag on emerging stocks and debt. Additionally, there is political risk in Brazil and Turkey, to name a couple of places, heading into 2017. Still, P/E ratios on emerging market stocks remain low compared to developed market counterparts, while earnings and economic growth are turning for the better.[5]

[1]Source: Robert Huebscher, "Jeremy Siegel – Why Long-Term Investors Should Own Stocks: Bonds Are 'Dangerous,'" Advisor Perspectives, 11/28/16.

[2]Source: Jeremy Schwartz and Josh Russell, "Impact of Potential Tax Reform: Size and Sector Analysis," WisdomTree, 12/13/16.

[3]Source: FactSet Dividend Quarterly, 9/22/16.

[4]Source: Quentin Webb, "Pacific Partnership," Reuters, 12/19/16.

[5]Source: "Outlook on Emerging Markets," Lazard Asset Management, 10/16.

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Interest rates : The rate at which interest is paid by a borrower for the use of money.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Dow Jones Industrial Average : The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq.

Price-to-earnings (P/E) ratio : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Dividend : A portion of corporate profits paid out to shareholders.