Some High-Conviction Themes for 2017

By David Rosenberg and Peter Mann

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The financial markets are dynamic, but even in the most volatile environments there is opportunity for money to be made so long as you are on the right side of the trade.

This is especially likely to be the case in the coming year. While we can expect more turbulence from a new and untested government in the United States and several elections in Europe, from an investing standpoint 2017 will definitely not be about sitting on our hands.

It will be more of a selective, ideas-based market than is normally the case, especially considering how much good news has already been discounted since the Trump victory.

In that light, we want to share our equity investment outlook that transcends hope and faith, and has some real substance behind it no matter who occupies the Oval Office.

With regards to valuations, although the market as a whole is trading expensively, one must keep in mind the disparities that lie beneath the surface.

There are 70 companies in the S&P 500 trading at a forward price-to-earnings multiple of 20x or greater; but there are 160 companies in the S&P 500 trading at a forward multiple of 12x or less.

So we do see quite a bit of opportunity, especially in a year where we strongly believe that "value" will outperform "growth".

We believe that the economic and market cycle is mature as it's about to enter its eighth anniversary, and that this would have been the case no matter who won the election.

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One classic characteristic of a late-cycle market and economic cycle is a ramp up in merger and acquisition activity. There is a long list of companies looking very attractively priced from an asset value perspective and there are industries that will continue to roll-up (Media Content & Distribution being one area of focus for us).

Capital spending also tends to be a late-cycle performer, looking at historical patterns, and the move by the Trump team to ease regulatory burdens and boost profits via tax reform should help accentuate this pattern in 2017.

We are of the view that there is a shift afoot that will persist through the year whereby companies that previously were rewarded for devoting their cash flows to dividend payouts and stock buyback programs will now confront a shareholder base applying more of a premium on businesses that divert more of their earnings towards capital spending. In contrast to the past few years where buybacks reigned supreme, capex will imply a better business outlook for companies, and any hit to margins will be seen as temporary.

While the Financials have emerged as market leaders in recent months, we think there still exist opportunities in this space as the U.S. banks get further re-rated for looser regulation and capital-return characteristics. They will also benefit from higher short-term interest rates as the Fed tightens policy further.

There are a variety of Homebuilding and Automaker stocks that should perform well, given their low valuations, even if the pundits are right that we are already at "peak" autos and housing for the cycle.

Energy is a growing area of focus because if the WTI oil price of $50 per barrel holds, and we think it can in view of the quicker-than-expected shift to a balanced global market for crude, it means tremendous profit margin growth given the substantial amount of costs that have been removed in these recent turbulent years in the industry.

This recovery in Energy will also benefit the Canadian banks from a loan-loss provisioning standpoint, and the U.S. hedge funds are providing added thrust to these stocks as they begin to cover their unprecedented multi-year short position.

The monetary policy divergence between the Fed raising interest rates and other central banks sitting on their hands or possibly easing further, not to mention the election uncertainties in France, Germany and the Netherlands, will ensure that the U.S. dollar remains strong.

This may be a crowded trade, but the balance of probabilities suggest it will be the correct trade. That means attention paid to domestic plays stateside and exporters in other countries, including Canada, that will benefit from even more "competitive" currencies.

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Consumer Staples and Technology are sectors we think will lag through much of the year, as the rotation out of multinational yield and growth and into domestic value plays continues for the next several quarters.

Internationally, we see a growing list of opportunities in Japan, which is benefitting from signs of a pulse finally emerging in domestic demand growth and, of course, the benefits of the ever-weaker yen.

Even with recurring political turmoil in Europe, there are a number of mispriced assets, especially in Financials, that are presenting some interesting arbitrage opportunities both on the equity and debt sides of the capital structure.

We may have more of a preference for "value" over "growth" investing right now, but we are mindful of how the backdrop could change, and we have put U.S. Health Care on our list for a second-half surprise outperformer. The sector has been crushed, is under-owned, and right now expectations are very low. For a contrarian, these are very appealing attributes, but right now we feel it is a bit too early to stake a claim.

Once the attempt to repeal and/or change Obamacare is made, we anticipate there to be several winners — likely in the very places that investors currently see no hope.

2017 will be a challenging year, but heightened volatility will breed opportunity.

In addition to heightened volatility, this will be a year where we have to be cognizant of the Fed and a flatter yield curve; focus on sectors that work well late in the market/economic/credit cycle; maintain a keen sense that value will surpass growth strategies and have a heavier focus on balance sheet quality and valuations that are compelling (as in, buying stocks that have recession probabilities priced in already). We will have an additional tailwind knowing that active investment management will "trump" passive styles in what promises to be a roller-coaster year of quickly taking profits and quickly stepping into underpriced opportunities when they present themselves.

In other words, 2017 will be about special situations beneath the veneer of the major averages, but the major point is that the real money will be made based on classic value-investing that focuses more on company fundamentals than on Trump-onomics.

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