

Financial Markets 2015: Earnings, Government and the World

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Last year, we predicted that the 2014 financial markets would be driven more by earnings than by concerns about whether the politicians could agree with each other. We guaranteed that 2014 would not be as good as 2013.

We were right. From November 20, 2013, to the same date this year, the S&P500 rose 13.7 percent from 1,805 to 2,053. This contrasts with the twelve months ending on November 1, 2013, where the S&P 500 rose a spectacular 25.5 percent. The rise in the S&P 500 was mimicked by similar increases in the Dow and the broad-based Russell 3000. All show that the stock market performed well, just not as well as the previous year. Still, the most recent year is well above the 7.5 percent average return over the past half century. We think average to below-average returns are the most likely scenario for 2015.

What factors are likely to drive the stock market over the next twelve months? We think it will be a combination of earnings and government. With valuation ratios near historic highs, the market appears to have little potential for increasing the valuation of companies other than what they produce by earnings. If anything, interest rates may drive valuations lower, but we forecast interest rates to be flat over 2015. As usual, government is likely to either hurt the market or be neutral.

The Washington dysfunction may prove neutral for investors. With Republicans now controlling both the House and Senate, an increase in taxes or spending is unlikely. With the economy growing, federal taxes are roughly 17.5 percent of GDP. As a result, the budget deficit fell from \$608 billion in fiscal year (FY) 2013

to a projected \$506 billion in FY 2014 (which ended in September). If we combine this fiscal policy with our forecasted 3 percent real GDP growth and 1-2 percent inflation, this is a relatively favorable environment for investors.

While the Obama administration has taken actions that undermine investor confidence in the past, such as tougher climate-change regulations, its attention appears to be focused on foreign policy (e.g., ISIS) and health policy (Ebola). It is unlikely that it will undertake major economic initiatives over the next year.

The Federal Reserve has backed off of quantitative easing (QE), but the policy is likely to be “dovish” in targeting interest rates rather than inflation. Bond buying is now an established part of the Fed’s toolkit, especially with inflation forecasts being in the 1-2 percent range.

It appears that the eurozone will be one of the major risks to U.S. stock market performance. October was a brutal month for hedge funds that made concentrated bets in favor of eurozone growth. With this area accounting for 17 percent of world GDP, it may be a source of negative earnings surprises for U.S. companies during the year. A recent Fed survey of top money managers had them far more worried about weakness in Europe than the threat of Ebola.

With this as a background, we turn to fundamentals.

Economic Fundamentals

Stock prices are a very good indicator of future economic activity: Investors buy stocks anticipating the real economy will pick up in the near future. There are many positive reasons to believe this reasoning:

- **Earnings:** Of the 495 companies that have reported earnings to date for third quarter 2014, 77 percent have reported earnings above the mean estimate and 59 percent have reported revenues above the mean estimate.
- **Earnings Growth:** Analysts are forecasting earnings will increase about 9.4 percent in 2015 for the S&P 500. Consumer discretionary has the highest earnings growth at 18.2 percent, while energy has the lowest at -4.2 percent.
- **Valuation:** Price-earnings (PE) ratios are above their long-run averages, but only by modest amounts. The S&P 500 PE ratio is 18—above its long-term average of 16. The “forward” PE (price today divided by expected earnings) is 15.5, which is above its long-term average of 14.0. All of this suggests that valuation ratios are not about to fall off a cliff.
- **IPOs are strong.** As of October 2014, there were 231 initial public offerings (IPOs) raising \$73.4 billion, which is the highest in 10 years. The largest sectors were technology (\$30.6 billion, led by Alibaba’s \$25 billion), financial (\$15.2 billion), and energy (\$10.3 billion).
- **Companies are starting to reduce their large cash positions.** Some of this reduction is being used for share buy backs, which will be immediately helpful, and some is for expanding investment.
- **Revenue** growth for publicly traded firms for 2015 is projected at 3.1 percent, which is close to 2014 levels.
- **The Federal Reserve** is continuing to phase out the bond-purchasing program, but we believe that

even if the Fed refocuses their attention on tying the rate outlook more closely to inflation (rather than employment), the pace and timing of interest rate hikes should be pushed further into 2015 as inflation remains very low. This is a different scenario than just a few months ago when some Federal Open Market Committee members were talking about increasing short-term rates given improvement in the labor market.

- We think **inflation will remain subdued**. Our forecast of 1.1 percent is in-line with most forecasts (the Fed's inflation forecast is 1.5 percent, the Office of Management and Budget's is 2.2 percent, and the Organization for Economic Cooperation and Development's is 1.9 percent).

Threats

However, there are negative factors that could make the market recovery short-lived:

- **The cyclically adjusted PE ratio for U.S. stocks** is at 25.7, which is the highest since January 2008 (but lower than May 2007, which was 27.5). This suggests that stocks have more room to fall than rise from factors driving basic valuation but not earnings.
- **The eurozone is more a source of risk than return:**
 - **Banks have not passed stress tests:** The European Central Bank concluded that 25 banks (nine Italian) need to add €13 billion in capital. The need to increase capital will limit their ability to make loans to businesses.
 - **Supply side barriers** such as labor market constraints may have created a "secular stagnation" that will impede an economic recovery.
- **China's growth** is clearly slowing.
- **Profit margins are unlikely to expand:** Firms must increase

earnings by revenue growth, which is problematic given the weakness in Europe and China.

- **Strong U.S. Dollar:** The dollar has appreciated about 8 percent against the euro and 10 percent against the yen over the past year, despite continuing QE. This will make U.S. exports more expensive in global markets, while imports into the U.S. will become cheaper.
- **U.S. Debt:** The expansion of the national debt since the end of 2008 is unprecedented since World War II. The debt to GDP ratio will have increased from 40 percent to almost 74 percent by next year. The massive government deficits may lead to inflation and much slower growth. This may have an adverse effect on business investment even though we forecast business investment to increase.
- **Budget Deficits:** The projected budget deficit for 2014 is about 3 percent of GDP. This is not expected to change in 2015—or in the next five years. If interest rates return to their historical average levels, the budgetary impact will be dramatic. The average interest rate on debt held by the public is 1.8 percent and interest payments are forecast to be \$251 billion for 2015. Increasing the average rate by 1 percent will trigger an additional \$140 billion in federal spending. This will require reduced spending, increased taxes or both.
- In spite of the recent upturn, **industrial output is still only at 79 percent of capacity**, which is below the long-run average (including previous recessions) of 81 percent.
- **The U.S. still faces a huge funding deficit** in Social Security and Medicare payments. The present value shortfall is about \$62 trillion. This is equivalent to

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\$206,000 per person or \$825,000 per U.S. household. These problems are not insurmountable, but they do require common sense and bipartisan leadership—something that appears to be in short supply in Washington, D.C.

Forecast

Looking forward to 2015, the positives outweigh the negatives for the economy—but just barely. We expect the recovery to continue, GDP growth in the 2-3 percent range, and inflation in the 1-2 percent range. The combination of low inflation, a Fed that is on hold and good prospects for earnings growth suggests a favorable year for stocks. The primary risks are growth reductions in the eurozone and China.

In this environment, we expect that the return to equities will be positive, but below the long-run average return of 9 percent—perhaps at the half-century rate of 7.5 percent. With Treasury bonds already at extremely low yields, there is little potential for gains with these investments. In addition, we think there are material long-term inflation risks that could make long-term bonds unattractive. In contrast, the low Treasury rates make mortgage rates still attractive, with 30-year fixed rates forecasted at 4.4 percent. ■