Financial Outlook for 2014

Dubos J. Masson, Ph.D.: Clinical Associate Professor of Finance, Kelley School of Business, Indiana University Bloomington
Robert S. Neal, Ph.D.: Associate Professor of Finance, Kelley School of Business, Indiana University Indianapolis
Charles Trzcinka, Ph.D.: James and Virginia Cozad Professor of Finance, Kelley School of Business, Indiana University Bloomington

Last year we wrote about the roller coaster ride caused by the fiscal cliff and the resulting debt problems. While this "beast" is still in the picture, we predict that the 2014 financial markets will be driven more by earnings than by concerns about whether the politicians can agree with each other. However, we can guarantee that 2014 will not be as good as 2013.

In the twelve months ending November 1, 2013 the Standard and Poor's 500 index (S&P 500) rose a spectacular 25.5 percent (S&P 500 was 1,416.18 on November 1, 2012 and was 1,771.95 on October 29, 2013 including dividends). This return was dramatically higher than for the same period last year (12 percent) and is the highest since the late 1990s. The S&P 500 and the Dow are now at all-time highs and the stock market has easily recovered from the Great Recession. About half the increase over the past year was due to an increase in earnings and the other half was due to price-earnings (PE) ratios increasing. The five year return from the low point in February 2009 is a stunning 16.7 percent per year. This remarkable return occurred in spite of policy uncertainty in Washington.

The Washington dysfunction may prove beneficial for investors. With Republicans controlling the House, it is unlikely that there will be an increase in taxes or spending. Simultaneously, the "sequester" is mechanically lowering federal spending, which is now about 20.8 percent of gross domestic product (GDP) versus 22 percent in FY 2012. With the economy growing, federal taxes are roughly 18 percent of GDP. As a result, the budget deficit fell from $1.1 trillion in FY 2012 to $680 billion in FY 2013 (which ended in September). If we combine this fiscal policy with our forecasted 2 percent to 3 percent real GDP growth and 1 percent to 2 percent inflation, it results in a relatively favorable environment for investors.

With this as a background we turn to fundamentals.

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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 story now:

- Earnings Scorecard: Of the 374 companies that had reported earnings-to-date for the third quarter of 2013, 74 percent reported earnings above the mean estimate and 53 percent reported revenues above the mean estimate.
- Earnings Growth: Analysts are forecasting earnings will increase by about 10.9 percent in 2014. Consumer discretionary has the highest earnings growth at 15.7 percent and utilities the lowest at 4.4 percent.
- Valuation: PE ratios are above their long run averages, but by modest amounts. The S&P 500 PE ratio is 19, more than its long-term average of 16. The forward PE is 14.8, which is above its long-term average of 14.0.[1] This suggests that earnings are not yet overvalued. One note of caution: the widespread use of share buyback programs may be artificially pushing earnings per share (EPS), and thus PE ratios upwards.
- IPOs are booming: By the fall of 2013, there were 191 initial public offerings (IPOs) in social media, biotech, cloud, internet security and energy. The week we kicked off the Outlook panel, November 4–8, was the biggest week for IPOs since 2006, with $4.8 billion being raised. Twitter jumped from its IPO price of $26 to $45 on the first day of trading.
- Revenue growth for publicly traded firms in the third quarter was 2.9 percent, higher than the expected 2.2 percent.
- The Federal Reserve is continuing to keep interest rates low to fuel the economy. The Fed Funds target rate of 0 percent to 0.25 percent will likely be maintained throughout 2014, and the 10-year bond rate is expected to maintain its current rate of 2.6 percent.
- Housing is the biggest potential upside as the market appears to have hit bottom and the housing "bubble" is working off its excess inventory.
- We think inflation will remain subdued. Our forecast of 1 percent for 2014 is in line with most forecasts.[2]
- The Conference Board's Leading Economic Indicator is rising,

suggesting an increase in domestic growth.
- The Eurozone economy is improving. Growth is expected to rise to 1 percent in 2014, much better than the 0.3 percent decline in 2013. Interest rates on sovereign debt have risen slightly since the start of the year, but are materially lower than 2012 levels.

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

- The cyclically adjusted PE ratio for U.S. stocks is at 24.7, the highest since January 2008 but lower than May 2007 (27.5). This suggests stocks have more room to fall than rise.
- Earnings as a percent of GDP are at a 50-year high (about 11 percent of GDP). Hourly pay is stuck at 2008 levels in real terms. If hourly pay had kept up, earnings would be at the historic average, not the all-time high.
- "Taper Talk" will cause the market to fall for at least the short term. There is considerable debate as to why: the common answer is the Fed's quantitative easing (buying $85 billion per month of long term bonds and mortgage-backed securities) is keeping bond prices high, which diverts money into the stock market and increases stock values. When the Fed talked about tapering in June, the market fell 4 percent through much of June, recovering only when the Fed started to buy long term securities. During this same period, the 10-year bond yield rose from 1.6 percent to 2.9 percent before settling down to about 2.6 percent.
- Washington: The immediate risk is the potential shutdown in January and the debt ceiling battle in February. As we suggested in the introduction, the lack of agreement over the budget may have a benefit but the disagreement over the deficit is clearly a risk. However, the lack of consensus in Washington may shake the investors' confidence in the political system's response to the problem of the deficit and the need for substantial infrastructure spending in the United States.
- 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 nearly doubled by 2014, from 40.5 percent to almost 70 percent. The massive government deficit may lead to fears of higher interest rates, accelerating inflation and much slower growth. These will have an adverse effect on business investment. The projected budget for 2013 is somewhat lower, about 4 percent of GDP. If the 2014 deficit is financed by tax increases, the tax bill will average about $2,050 per person.
- Companies have very large cash positions on their balance sheets, possibly related to policy uncertainty in Washington. The election may not resolve this uncertainty.
- Industrial Output: In spite of the recent upturn, industrial output remains at only 78 percent of capacity, well below the long run average of 81 percent (including previous recessions).
- Funding Deficit: The United States still faces a huge funding deficit in Social Security and Medicare payments. The present value shortfall is about $62 trillion, equivalent to $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 to 2014, the positives outweigh the negatives for the economy, but just barely. We expect the recovery to continue, but at a much slower rate than is typical for recovery: GDP growth will be in the 2 percent to 3 percent range, and inflation will be in the 1 percent to 2 percent range. Earnings will likely rise, but we suspect the rise will be weaker than Wall Street forecasts. Both Obamacare and the Dodd Frank bill are wild cards that could cause poor economic performance.

In this environment, we expect the return to equities to be positive but below the long-run average return of 9 percent. Treasury bonds are already at extremely low yields, and 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. However, the low Treasury rates make mortgage rates extremely attractive, with 30-year fixed rates at 4.125 percent and 15-year fixed rates at 3.25 percent.

Summary

The U.S. economy appears to be heading to smoother waters but unemployment remains a stubborn reminder of the recession. Partisan politics may continue to disrupt economic relationships, especially in January. The adjustment process to full recovery and full employment will likely continue to take time. Until a complete recovery is in sight, we expect market returns to be positive, but below their long-run average.

Notes:

1. Forward PE for the S&P 500 is 14.8 based on an S&P 500 value of 1,756.54 and projected earnings of 119.05 in 2014.
2. Wells Fargo Securities predicts 1.4 percent, the Fed Forecast personal consumption expenditure (PCE) is 1.7 percent, the Congressional Budget Office (CBO) PCE is 1.6 percent, the Office of Management and Budget (OMB) and the Organization for Economic Cooperation and Development (OECD) each forecast 1.9 percent.