Financial Markets 2016: The Groundhog Forecast

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

Retro movies have been in the news recently. The Star Wars film has generated a lot of publicity. Considerable attention has been given to the 30th anniversary of Back to the Future. From an economic perspective, our touchstone is the Bill Murray classic, Groundhog Day. In the movie, Murray’s character (Phil Connors) is forced to relive the same day—over and over and over. He tries to break the spell, but he’s always stuck.

This is an apt description of our economic situation. Every six weeks, the Federal Reserve has their own Groundhog Day. Like Bill Murray, they’ve been stuck in the same situation—a low growth economy—over and over. Like Murray, their efforts to break the spell have been unsuccessful and elicited increasingly aggressive monetary policy.

While we were supportive of the Fed’s liquidity policies during the financial crisis, we are concerned that the aggressive monetary policies in the following years have become counterproductive and pose a material risk to our investment portfolios.

When the Fed started quantitative easing (QE), it was argued that the lower interest rates would jump-start business investment, encourage economic growth, and the wealth effect from higher asset prices would increase household consumption. What we have seen is the weakest postrecession recovery of the modern era. From the perspective of finance, this outcome isn’t surprising. When stock and bond prices get bid up higher than they would without QE, their expected returns will be lower. With lower expected returns, businesses conserve cash and scale back investments; consumers save more and reduce spending. The net result is lower growth.

The risk to our portfolios rises in this environment because of a growing disconnect between investment returns and the real economy. For example, it is common for companies to borrow at these low rates, use the funds to buy back their own stock, and thereby increase their stock prices. The cash dividend rate on stocks is 3 percent but the cash plus buyback rate is 6 percent.

In addition, a number of countries now have negative interest rates on their sovereign bonds. This is an unambiguous market distortion. In a world of integrated capital markets, QE from Europe, Japan and China will impact U.S. asset prices, even as the Fed scales back its own QE.

As investors, we face a serious challenge: How do we manage our portfolios in a QE world? One thing we have learned is that buy and hold is actually a pretty good QE strategy. Over the past five years of QE, the average return to the S&P 500 is about 14 percent per year. This is well above the historical average of about 10 percent. Our guess is that global QE will be a force at least through 2016. However, we need to be diligent in looking for signals suggesting the phase-out of QE strategies. Robust earnings and a rise in global bond rates are indicators that QE will be phased out.

In many respects, our forecast for 2016 is similar to our forecast from last year. Following our opening theme, we call it the “Groundhog Forecast.” Last year, we predicted that the 2015 financial markets would be driven more by earnings than by concerns about whether politicians can agree with each other. We forecast that the stock market would have a below-average but still positive return. We were right, but just barely. The S&P 500 rose about 3 percent since last November. It hit this level by late spring, and over the summer looked like we might get an average year. August was a bad month, however, and we have been recovering slowly. The economic forecast, international problems in China and the ever-present Washington dysfunction gave us a bumpy ride. We can certainly expect more of the same.

What are the factors that are likely to drive the stock market over the next 12 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 or slightly increasing over 2016. As usual, government is likely to either hurt the market or be neutral.

With the Republicans controlling the House and Senate, it is unlikely that there will be an increase in taxes or much of an increase in spending. With the economy slowly growing,
federal revenue is projected to be $3.51 trillion in 2016, which is about 19 percent of GDP. Federal expenditures are projected to be $3.93 trillion, giving us a deficit of $420 billion or 2.2 percent of GDP. The deficit is down from 2015 ($426 billion) and 2014 ($485 billion). 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 is taking actions that undermine investor confidence, such as tougher climate change-motivated regulations (including the recent cancelling of the Keystone pipeline) and the problems with “Obamacare,” its attention appears to be focused on foreign policy (e.g., ISIS). It is unlikely that it will undertake major economic initiatives over the next year.

The Federal Reserve will back off of QE, but the policy is likely to be “dovish” in targeting interest rates rather than inflation in the near term. We expect an increase in the Federal Funds rate sometime in 2016 (a “hawkish” policy). 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. 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.

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 story now:

- **Earnings:** More companies beat earnings per share (EPS) estimates, but fewer are beating sales estimates. Of the 444 companies in the S&P 500 that have reported earnings for third quarter 2015, 74 percent have reported earnings above the mean estimate and 46 percent have reported revenues above the mean estimate.

- **Earnings Growth:** Analysts are forecasting earnings will increase about 8.3 percent in 2016 for the S&P 500. Consumer discretionary has the highest earnings growth at 15.3 percent, while energy has the lowest at 1.7 percent.

- **Revenue Growth:** Among S&P 500 firms, revenues are expected to rise 4.6 percent in 2016.

- **Valuation:** Price-earnings (PE) ratios are above their long-run averages, but only by modest amounts. The S&P 500 PE ratio is 17, which is higher than its long-term average of 16. The “forward” PE (price today divided by expected earnings) is 16.5, above its long-term average of 14.0. All of this suggests that valuation ratios are not about to fall off a cliff.

  - **The market is rewarding beating estimates more and punishing misses less.** The average price increase for those beating estimates is 2 percent (vs. a five-year average of 1.1 percent). Meanwhile the average price decrease for those missing is -1.6 percent (vs. a five-year average of -2.2 percent).

- **IPOs are mixed.** As of November 10, there were 156 IPOs raising $28 billion. Both numbers are down from last year (356 and $85 billion, respectively). The average first-day return was 14 percent, which is also down. The top IPOs were Spark Therapeutics (premium 160 percent), Shake Shack (123 percent), Global Blood Therapeutics (119 percent), Inotek (102 percent) and Fitbit (79 percent).

**The eurozone will be one of the major risks to U.S. stock market performance.**

- **The Federal Reserve** is continuing to phase out its 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 2016 as inflation remains very low.

- **We think inflation will remain subdued.** Our forecast of 1.1 percent is in-line with most forecasts (the Fed’s 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.** 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, and analysts are increasingly skeptical about official numbers.
• **Profit margins are unlikely to expand:** Firms must increase earnings by revenue growth, which is problematic given the weakness in Europe and China.

• **The strong U.S. dollar is a headwind:** 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 total debt (held by the public) to GDP ratio has increased from 64 percent to 102 percent in 2015. The massive government deficits may lead to fears of higher interest rates, accelerating inflation and 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 2016 is about 2.2 percent of GDP, and this is not expected to change 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 2.43 percent and interest payments are forecast to be $261 billion for 2016. 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 77.5 percent** of capacity, which is below the long-run average (including previous recessions) of 80.5 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 $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 2016, 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 suggest 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 about 3.9 percent and 15-year rates at 3.0 percent.

We expect that the return to equities will be positive, but below the long-run average return of 9 percent.