Outlook for 2015

In our "Outlook" newsletter for 2014, we bullishly opined that S&P 500 earnings estimates could be met in a year where the U.S. economy seemed likely to strengthen. We predicted that the market would maintain its PE multiple at 17 and that the S&P 500 would trade up to 2053, implying an 11% return for the year.

As it turns out, the S&P 500 finished the year at 2058, only 5 S&P points higher than our prediction. As far as prognostications go, it doesn't get much closer than that! The S&P 500, Dow Jones Industrial Average and NASDAQ Composite rose 11.39%, 7.52% and 13.40% respectively in 2014.

So, what does our crystal ball tell us about the coming year? Let's frame today's economic underpinnings and compare against potential hurdles in order to assess this year's prospects.

The U.S. economy has picked up steam in the last two quarters and a recent poll of economists by the Wall Street Journal pins consensus for 2015 GDP growth at 2.9%. With the price of oil having plunged from over $107 per barrel in June to current levels near $50 per barrel, consumer spending should get a nice boost in 2015. There are over 130 million motorists in the U.S. who are expected to save an average of $600 per month on fuel costs. Since consumer spending accounts for roughly two-thirds of the U.S. economy, it is estimated that the recent collapse in energy prices will add approximately 0.4% to 2015 GDP growth. Consumer balance sheets are in the best shape in over three decades. Corporate profits are at all-time highs and Corporate America is awash in cash – merger and acquisition activity, buybacks and dividend increases ought to remain strong in the coming year. 2014 marked the best year for job growth in 15 years and the unemployment rate fell to 5.6% from 6.7% at the end of 2013. Interest rates remain historically low and the Federal Reserve is expected to remain patient in the wake of persistently benign inflation. In turn, low interest rates will continue to boost automobile sales and the housing market. The Republican majority in the House and Senate will give at least a glimmer of hope for much-needed fiscal policy reform. Meanwhile, all coincident and leading economic indicators point to a continued pace of steady growth in manufacturing and services.

As much as the economic fundamentals here in the U.S. are favorable and point to sustainable, moderate growth, there are a number of potential hurdles that must be considered. The first potential hurdle revolves around monetary policy and the Federal Reserve. With QE now in the rearview mirror, the Fed has promised to remain patient before finally hiking interest rates. Recent minutes reveal a Fed growing more concerned about overseas weakness and the potential spillover risk posed to the U.S. economy. Presently, the fed funds futures market assigns a 53% chance for a Fed rate hike by July and a 68% chance by September. The first risk here is that the global economy remains too fragile and the Fed begins to raise rates at a time when many of the world's other developed economies are struggling with deflationary pressures. Higher rates in the U.S. will spur higher demand for an already strengthening dollar, potentially leading to further commodity price weakness and heightened concerns for deflation.

With interest rates in Europe and Japan well below that of the United States, higher interest rates would certainly be met with enormous demand by foreign buyers. So, even if the Fed does hike rates later this year as the market expects, long-term rates are unlikely to rise, resulting in a flattening of the yield curve. We would be more concerned if the yield curve were to become inverted due to a change in monetary policy.

While it does not appear to be a major risk today, especially with the price of oil having fallen so precipitously, it cannot be totally disregarded that the Fed ends up waiting too long before hiking rates, mainly due to global weakness, and inflation pressures unexpectedly build up here in the U.S. Fed Chair Yellen has already telegraphed that the Fed could hold rates steady should inflation continue to run below 2.0%. Should global weakness prevail even as inflation moves closer to the 2.0% threshold, the Fed's resolve will be tested. To be sure, the Fed is in a tough position. They will be damned if they do hike rates and damned if they don't.

The added layer of risk with regards to interest rates and monetary policy is that stock market valuations leave much less wiggle room for error. Once rates begin to rise, cash and other short-term fixed income instruments will begin to look at least marginally more attractive. If rates remain constant or go down, present valuations may prove to be reasonable. The argument for reasonable valuations will become more difficult to make in a higher interest rate environment, That said, even if the Federal Reserve does hike rates this year, we do not believe that interest rates would rise sufficiently to make bonds an attractive alternative to stocks.

Another hurdle to consider is the increasingly strong dollar. Currency headwinds will undoubtedly spark a wave of reduced earnings guidance from global companies that garner a large portion of their earnings overseas. Currency swings tend to have a short-term impact on stock price as investors look through to revenue growth and unadjusted numbers. This hurdle is likely to become a source of volatility in the months ahead.

In a world where 10-year German bund yields are 44 basis points away from zero and the 10-year Japanese government bond yields are 30 basis points away from zero, it is difficult to envision U.S. interest rates rising from current levels. There is simply too much institutional and foreign demand to buy our debt, even as the Federal Reserve has stepped away from its QE campaign.

While current economic conditions in the United States look very healthy, especially relative to the rest of the world, there is an underlying sense of foreboding that comes with such low levels of global interest rates and plunging commodity prices. We believe that the sharp decline in energy prices has more to do with increasing supply and a reversion to the mean. It had become vogue for hedge funds and other financial speculators to treat oil and other commodities as an asset class. Fueled by excessive leverage, commodity prices entered a mania phase and the bubble has clearly burst. We will remain vigilant for any signs of softening economic data that might lead investors to question earnings estimates and the sustainability of the current economic and bull market cycle. Ironically, softening economic data would inevitably lead to a further reduction in interest rates and make stocks even more attractive relative to bonds.

Today, consensus for S&P 500 earnings estimates stand at $117.02 for full-year 2014, $126.49 for 2015 and $141.50 for 2016. At 2014 year-end levels, the S&P 500 traded at 17.5x trailing earnings, 16x this year's earnings and 14.5x next year's estimates. We think interest rates will remain historically low and that the bias for stocks will be to the upside again in 2015. We see the S&P 500 trading at 2200 by year end for an approximate 7% annual gain, though we would not be surprised to see a much wider trading range in 2015. Interesting to note, the S&P 500 has been positive in every year ending in '5' since its 1957 inception while the Dow has been negative in only one year ending in '5' since 1885. Meanwhile, the Chinese zodiac year of the goat has historically been the best performing year of all years.