ADVISOR PERSPECTIVES

Levitate: More Market Mood Swings in 2015?

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Key Points

- Secular bull market is likely intact, but 2015 could bring more volatility associated with Fed policy and/or global events.
- Longer-term sentiment suggests the “wall of worry” is intact; but shorter-term sentiment is more troubling.
- Falling oil and rising dollar have generated loads of questions from clients … history tells a generally positive story.

In December, I and several of my “SME” (subject matter experts) colleagues gathered in New York City for a 2015 outlook event we hosted for the financial press. In a variety of forms, this information has been disseminated throughout the Schwab channels; but I wanted to take the opportunity of my first report in the New Year to share it with clients and readers with a few updates sprinkled in. We structured the event and its collateral material in Q&A form—which is always a popular form—and we started with our 2015 outlooks. Read on.

Give us your high level thoughts on the US equity market and economic outlook for 2015.

Let me start by reiterating the view I’ve held since the market bottomed in 2009, which is that the bull market underway is secular, not cyclical. This of course, does not mean it’s immune to corrective phases, just that it shares many of the characteristics of past secular bull markets. For one, the first four years of this bull market—with an annualized return for the S&P 500 of 22%—have mirrored the first four years of prior secular bull markets—which had annualized returns ranging from 22% to 24%. Of course, the current bull tacked on another strong year to that string with 2014’s 11.4% price return for the S&P 500. The current bull run is the second-longest annual winning streak on record —and the longest since the nine-year stretch from 1991-1999.

The economic characteristics which secular bull markets shared at their outset include secular valuation lows, secular unemployment rate highs, and negative real interest rates. All three characteristics were also in place at the beginning of the current bull market.

Since I put the bull market in the context of the economy, let me share a high-level outlook for the US economy. The current recovery/expansion will likely soon become the fifth longest in the past 100 years; while four of the past five quarters have had above-normal growth. In addition, we are in the midst of a 50-month uninterrupted stretch of job creation—the longest in history.

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Unique in this expansion though is the large spread between the average quarterly real growth of overall gross domestic product (GDP), which has been a relatively paltry 2.4%, and that for private sector growth, which has been a healthier 3.2%. This spread has already narrowed from a full 1.0% and I believe it will continue to narrow, with the overall growth rate catching up to the private sector's growth rate—due to waning fiscal drag—while both move higher.

Private sector deleveraging has also largely wound down; which is why consumer spending has been recovering. It is not likely to reach prior lofty levels due to the muscle memory of the debt crisis and a general increase in "frugality." But with consumer free cash flow on the upswing, largely courtesy of falling energy prices, consumer spending (~68% of US GDP) should remain relatively healthy, and could even accelerate more than income growth.

In addition, we appear to be in a more capital spending (capex)-driven phase of the economic expansion, which tend to be longer-lasting than those that are consumer spending-led. Since the mid-2000s, corporate cash has been biased toward financial engineering—via stock buybacks—and dividends. But the tide appears to be turning toward a greater focus on capex. Capacity utilization, a capex leading indicator, just surpassed the critical 80% level (see first chart below); while prior underinvestment in (and "old age" of) fixed assets (see second chart below); suggests a sustained expansion in capex.

Capacity Utilization >80% Key for Capex

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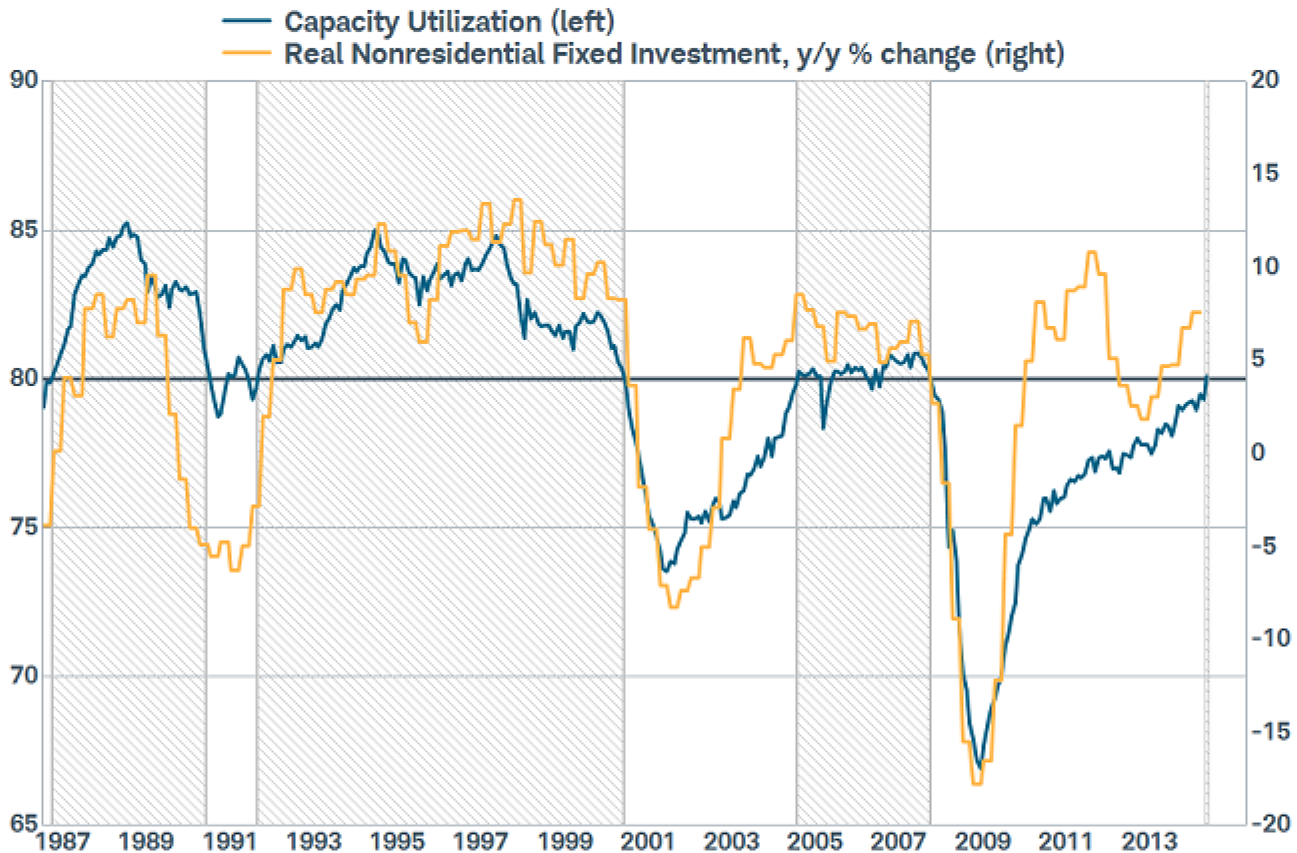

Capacity Utilization as of 11/14. Non-residential fixed investment as of 3Q14. Gray shaded-areas indicate periods when capacity utilization is above 80. Source: FactSet, Ned Davis Research (NDR), Inc. (Further distribution prohibited without prior permission. Copyright 2015 © Ned Davis Research, Inc. All rights reserved.), Strategas Research Partners LLC.

Old Age of "Stuff" Key for Capex

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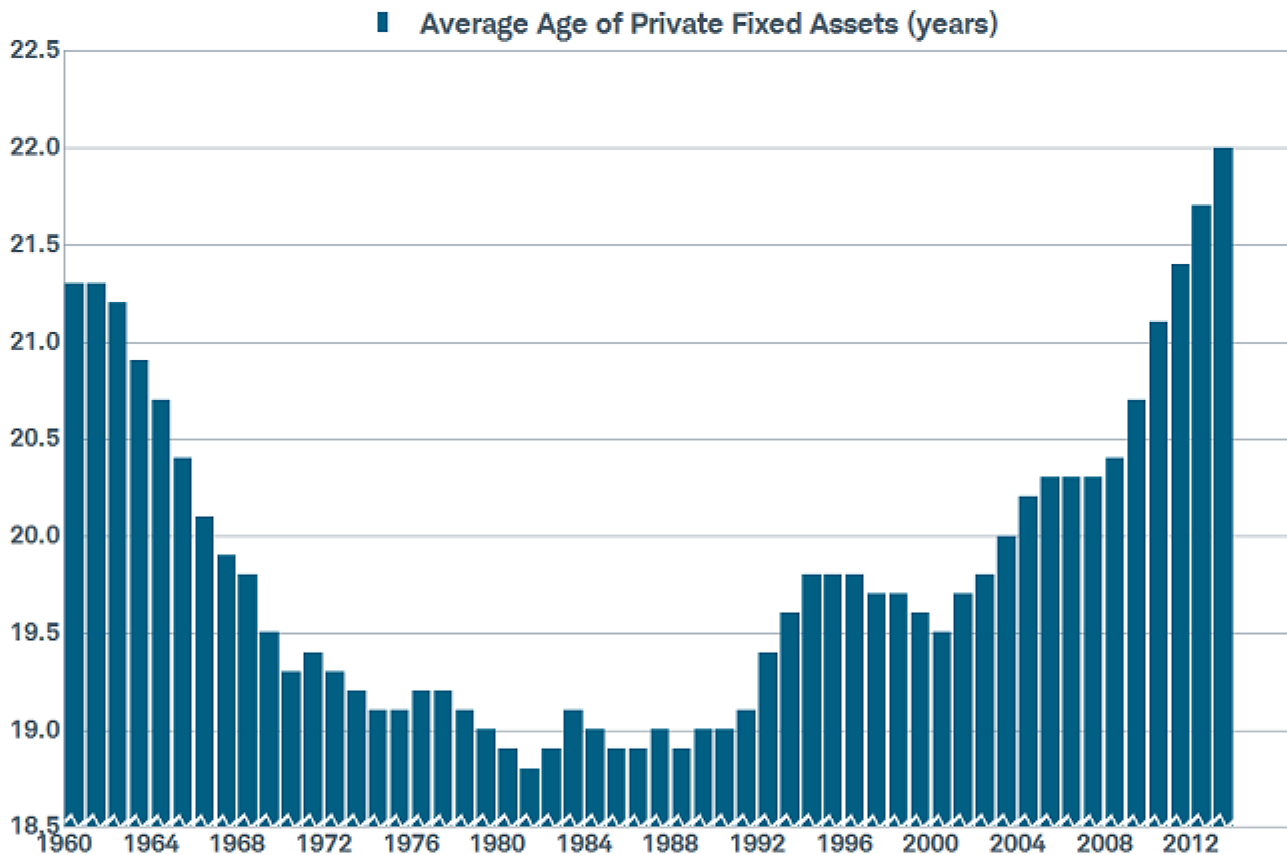

Source: Bureau of Economic Analysis, FactSet, as of December 31, 2013.

But every bull market—secular or cyclical—has stages, and we are likely in a more mature phase of this one. Using Sir John Templeton's famous phrase—"bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria"—I would argue we are in the third, mature phase. What may be unique in 2015 relative to every year since the 2009 bottom is that Main Street may finally share (and even exceed) the joy that Wall Street's brought over the past six years.

That said, what's remarkable about this bull market is that sentiment has not been more ebullient. There is really none of the euphoria that one might expect given the near-245% appreciation in the S&P 500 on a total return basis since the March 2009 bottom. Investors remain skeptical of this bull market, meaning the "wall of worry" stock prices like to climb remains intact. Take a look at the Yale one-year confidence chart below; showing that individual investors have a very low confidence level about the near-term future of the stock market.

Low Longer-Term Investor Confidence

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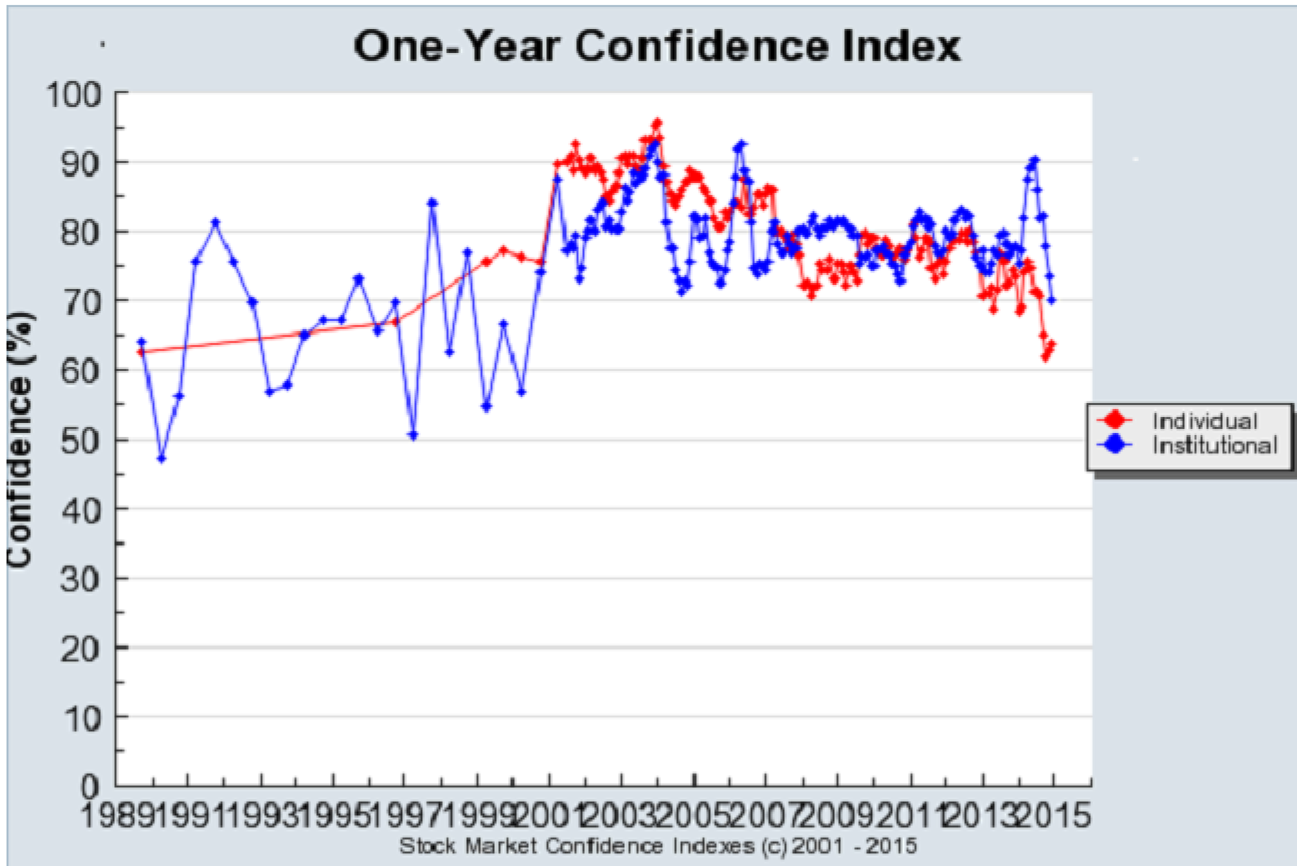

Source: Yale School of Management, International Center for Finance, as of December 31, 2014.

Sentiment is always crucial, but we also need to look at the market's fundamental underpinnings. My friend Larry Kudlow often refers to earnings as the "mother's milk of stock prices." Quarterly operating earnings for the S&P 500 actually dipped into slight negative territory during the worst phase of the financial crisis, which means doing a percentage improvement from that trough is mathematically impossible. However, for an apples-to-apples comparison in terms of timing, S&P earnings have tripled since March of 2009, while the stock market is "only" up ~245%. In other words, the E in the market's P/E has appreciated more than the P, which is why valuation is no worse than about neutral now. In fact, both on a trailing and forward basis, the market is about at historic median P/Es; while most of the macro conditions supporting higher valuations remain in place. These include a "Goldilocks" economic environment of healthy growth and subdued inflation and the stronger dollar. And speaking of a not-too-hot, not-too-cold environment; it's also the case historically that the market's best performance comes when earnings growth is positive, but not too hot.

Many have argued that multiples have risen "artificially;" pushed up by risk-seeking investors and record-low interest rates (the "QE is propping up asset values" argument). Interestingly though, the multiple expansion in this bull market has been about average for bull markets since 1957. So if valuation expansion has been average, why have stock market returns been so high? Earnings!

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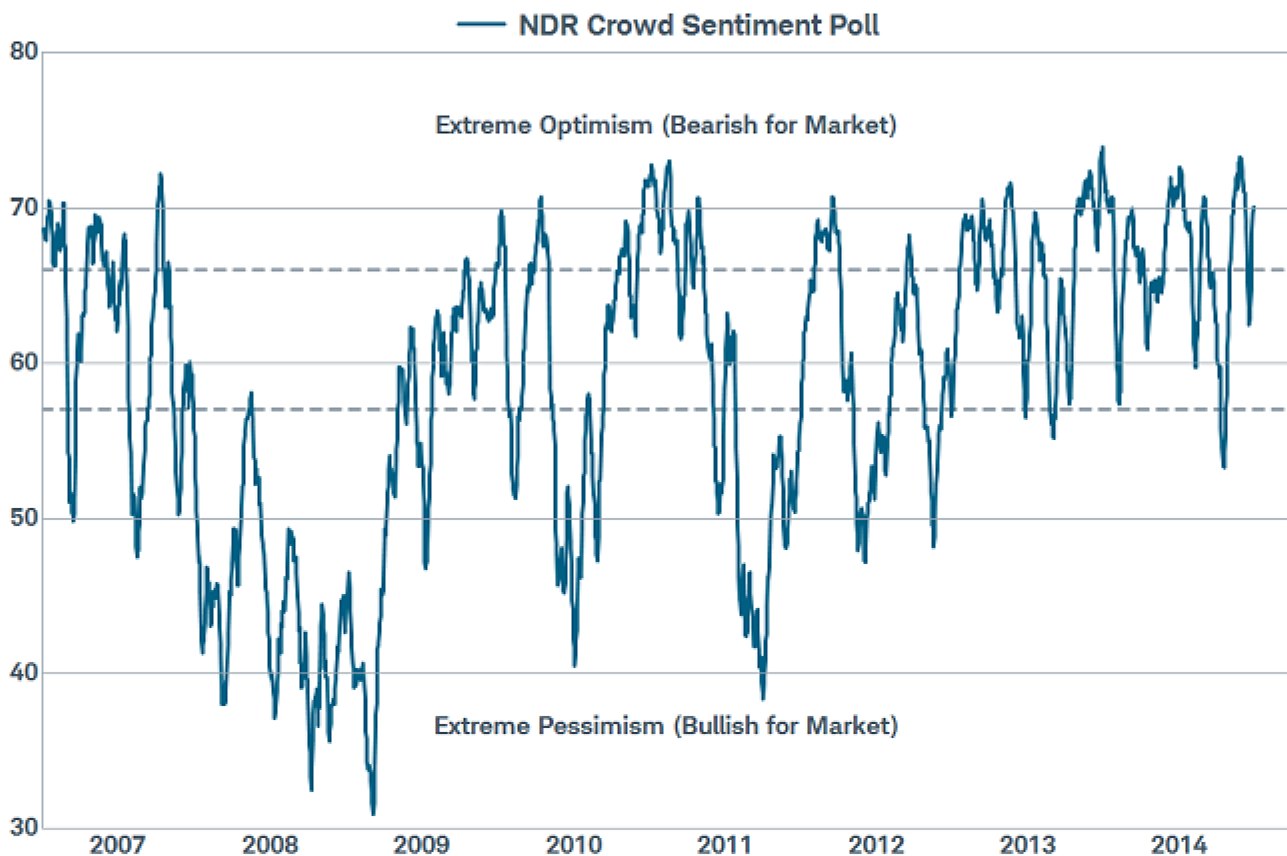
Earnings growth in the current bull market has been 20% above the average level of growth for all bull markets since 1957.

That said, a factor that will likely drive the market's ups and downs in 2015 is shorter-term investor sentiment; which as of this writing, has moved back up the optimism spectrum courtesy of the market's swift rally off the October lows (see chart below). Much like when attitudinal measures of investor sentiment became too optimistic/complacent in September, the market can become vulnerable to negative catalysts.

High Shorter-Term Investor Confidence



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One of those catalysts in 2015 could be interest rate uncertainty as the Fed moves toward an initial rate hike. The onset of Fed tightening cycles has not upended bull markets historically—quite the contrary—but they do often usher in bouts of volatility and pullbacks. Case in point would be the most recent two tightening cycles (during the mid-1990s and mid-2000s); during which periods the

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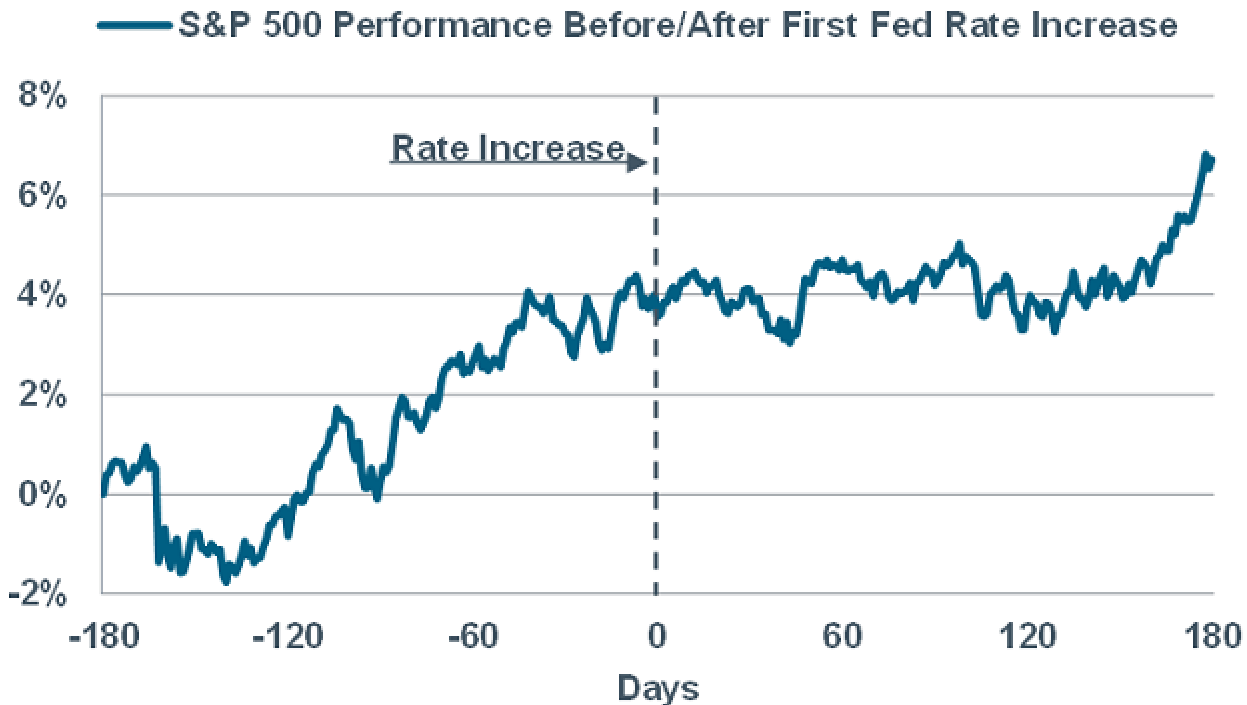
stock market performed admirably, but with five corrections (or pullbacks) during each cycle. The corrections averaged -12% in the mid-1990s cycle, while the average pullback was a lesser -7% in the mid-2000s cycle.

Looking at every initial rate hike since the early 1960s, and analyzing the stock market's behavior in the six months before and after that initial hike, we find that the market's weakest period tends to occur several months in advance of the initial hike; but that the trajectory of the market's performance is largely higher over the full year.

Market's Done Well Around Initial Rate Hikes



Based on Fed tightening cycles since 1962. Discount rate used prior to 1984; fed funds rate used since 1984. S&P 500 price only performance. Source: Birinyi Associates, Inc.

Other supports for the market in 2015 surround the election cycle. The market has a strong historic tendency to pull back in advance of midterm elections (as was the case in 2014), yet rally quite sharply for the year or so thereafter. In fact, the third year of the presidential cycle is by far the strongest historically, with average returns of over 13% annually, and an 86% track record of success. That compares to about 5% average returns for the other three years in the presidential cycle, with lower track records of success.

And here's a fun fact: 2015 of course is a year that ends in a 5. For what it's worth, going back to

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1905, the stock market (as measured by the Dow until 1925, and then the S&P 500 thereafter) has never been down in a year ending in 5; with the average return a whopping 32% (and only two years without double-digit returns).

Finally, the renewed strength in the US dollar is a support for the stock market; as it was in the 1990s. We will have more on that topic later in this discussion.

When you're out talking with individual investors, what questions and concerns are coming up the most as we begin 2015 and what are we advising them to do?

What is perhaps most remarkable about the frequently asked questions I've been getting is the negative tone around them. Only recently have individual investors been asking questions that has an optimistic tone; whereas most of the questions revolve around broad macro concerns and typically have a "what's the next shoe to drop" theme to them.

However, one theme of questions I've been getting recently—and it's a bit troubling—is about diversification. In particular, many of our Windhaven investors are questioning the merits of global tactical asset allocation vs. a pure-S&P 500 approach given the steady gains in the US stock market. A desire to "index" to the hottest market is often a sign that discipline is beginning to take a back seat to performance-chasing.

I've received a lot questions about the US dollar and its strength's impact on the economy and market, which I will address in a later answer herein. But I still receive a lot of questions about the dollar's status as the world's reserve currency—it's a staple of the doomsday crowd. The answer to the question is pretty straight-forward. The US dollar is unlikely to lose its reserve status any time soon, not least because there's no viable alternative. The US dollar share of foreign central bank reserves has indeed gradually dropped since the late-1990s, but that follows a prior spike in the 1990s. In fact, the dollar's share of reserves is higher than it was in 1995. In the end, what matters is what foreigners want and need to own, and that remains US dollars.

Another common theme of questions relates to the impact of geopolitical events on the market; and why the market's been so resilient. I've pointed out that most geopolitical events historically have had only a short-term impact on the stock market and/or economy; unless they are protracted and affect the economy via channels like oil prices; which in turn can drive an economy into recession. Geopolitical events can drive up investor pessimism; which at extremes is a contrarian indicator; which is partly why we've seen such quick rebounds by the market after recent geopolitical "shocks."

A final common theme of questions is around demographics—specifically concern around retiring baby boomers and the impact on the stock market. This is has a fairly straight-forward response as well. First, the baby boom generation is over 18 years wide in terms of its age span; as such, it makes no sense to generalize in terms of things like retirement, asset drawdown, moves from capital appreciation focus to income generation focus, time horizons, past investment experiences, etc. In addition, the so-called "echo boomers" (the kids of the boomers) outnumber the baby boomers by about 10 million, so there's a whole new generation of investors and consumers behind them.

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Oil prices have been plunging. On the one hand that's a positive for consumers. On the other hand that's a negative for the capex spending that has been occurring in the energy sector. What's the net impact on the economy and what does that mean for stocks?

Here are the key statistics that get directly to the question. The US economy is 68% driven by consumer spending; while oil/gas capex represents about 1% of US gross domestic product (GDP) and less than 10% of US total capex (which in turn represents about 12% of US GDP). The benefit of lower energy prices to the consumer, and many businesses, greatly outweighs the hit to energy companies and/or energy-oriented capex; even if the hit is not inconsequential, especially to energy-oriented states. This establishes the case for consumer spending outpacing income growth, given that consumer free cash flow is rising rapidly.

US domestic capex has grown by over $600 billion over the past four years; with $100 billion of that being energy-oriented. In addition, one can argue that much of non-energy capex would benefit from reduced operating costs courtesy of lower energy prices.

Lower energy prices also put downward pressure on overall inflation; a plus for both the US economy and stock market. It reinforces the "Goldilocks" economic environment which is a plus for stocks; and notably, lower inflation has historically meant higher equity valuations. In fact, there is a direct inverse correlation between the energy sector's weight in the S&P 500: a lower weight, typically courtesy of lower energy prices, has led to higher overall S&P 500 P/E ratios, and vice versa.

If lower energy prices were being driven by dramatically weaker global growth, the US economy and stock market would likely be less buoyant. But given that prices of industrial metals—which are more responsive to changes in global demand—have held up better than oil prices, it's likely increased supply (courtesy of US production) that's the primary driver.

What is driving the current strength in the US dollar, and is a strong dollar good for the US stock mrket and economy?

The conditions supporting the US dollar ascent are very similar to those that drove the 1990s' dollar bull market; most of which were also positive supports for the stock market. During this period, the dollar and stocks were positively correlated. Very recently, the correlation between the dollar and stocks moved back into positive territory; and we think it will remain there (see chart below).

Correlation Between Dollar and Stocks Surging

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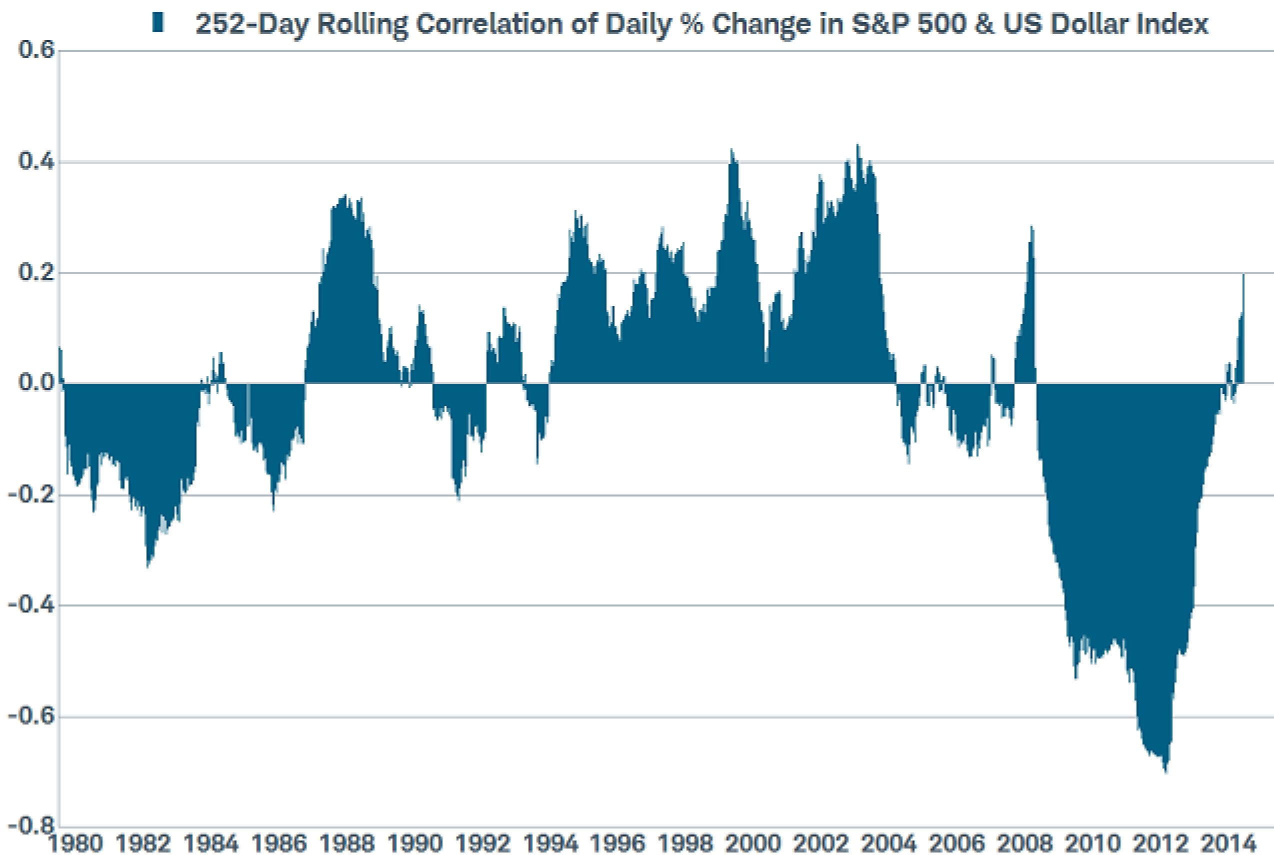

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This is in contrast to the dollar bull markets in the early 1980s, or during the financial crisis. In the case of the former, it was runaway inflation and double-digit interest rates that drove the dollar higher—not positive conditions for the stock market. In the case of the latter, it was purely the dollar's safe-haven status amid a crumbling global financial system—also not a positive condition for the stock market. During these phases of dollar strength, the stock market was inversely correlated to the moves in the dollar.

As far as economic impact, although a stronger dollar makes exported goods more expensive, exports represent only 13% of US GDP, while consumer spending makes up 68%. Since many commodity prices—notably oil—are priced in dollars, a stronger dollar means lower commodity prices; which is good for consumption-oriented economies like ours.

A common question is around whether too much dollar strength would be a bad thing. The answer probably rests with the bond market. The negative implications—the tightening effect—of a stronger dollar can be offset by a decline in longer-term interest rates. In 2014, the dollar index (DXY)

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appreciated by nearly 13%, while the 10-year Treasury yield fell by 86 basis points. As such, the bond market is at least partly doing its job as an offset to the negative implications of a stronger dollar.

As noted by Bespoke Investment Group (BIG), there have been seven prior years (since 1968) when the US Dollar Index rallied more than 10% in a given year; and in the year that followed those rallies, the S&P 500 was up every time for a median gain of 14%.

In sum

I believe the secular bull market is intact; but that 2015 could bring more mood swings than investors have come to expect. Primary triggers for some market unrest could be Fed policy and/or geopolitical events. It's also likely that 2015 could be a year when Main Street's optimism catches up to (and possibly exceeds) Wall Street's optimism.

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