Outlook for 2016

More of the Same

As the title of this commentary suggests, I don't see significant return differentials for 2016 versus 2015. US returns will likely improve modestly, but where we see the opportunities in US equities should change as well. Other developed markets should once again perform decently. But when the dust settles on December 30th, 2016 (the 31st is a Saturday) and I'm finished staring at my terminal for a few days, I believe returns for equities should be positive but modest. It will likely come, however, with a lot of gut-wrenching volatility once again, courtesy of multiple geopolitical events, as we had in 2015. Inevitably these are expected to cause over extrapolations of the economic impact on equities, causing unnecessary volatility and emotional trading reactions.

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US Economy

To be clear, I am a devotee of the Carmen Reinhart/Kenneth Rogoff thesis about the trajectory of economic cycles following a financial crisis driven recession. Based on their studies of past banking crises, the relative amount of deleveraging was so unprecedented that the trajectory of the recovery is expected to be muted for about 10 years.

There are two stages of this 10 year cycle. In the first five years, the economy barely gets off the ground given the fragility of the recovery (+0.5% annual GDP growth) During the second 5 year stage, we should expect to see better, but below par, growth. (-2.5% annual GDP growth)

While 10 years would suggest we will not recover to a median 4% annual GDP growth until 2017-2018, I believe the salient point is that we remain in this improved but still below par growth. And that should not change in 2016.

As an equity portfolio manager, I am inundated daily with experts telling me why this event or that event will cause an economic acceleration or economic contraction. Just look at 2015. The drop in gas prices was supposed to cause a big acceleration in consumer spending…it didn't. The Chinese 2015 devaluation and worries of a hard landing were going to have material effects on the US economy…it didn't.

Until proven otherwise, I'm staying with the playbook that has worked. This time is not different. Stick with the slow but steady growth thesis in 2016.

US Equities

So what does this mean for US equities? Don't overreact. In the end, equity markets tend to have 10-15% corrections (as we saw in 2015), but recessions are what end bull markets. And until we exit this second 5-year period of potential subpar growth, excesses that sow seeds for the next recession can't begin to build.

I thought 2015 was going to be a "pause" year for US equities. Not a bad year, but not a great one either. In fairness, I felt that the return would be mid-single digits versus the reality of a 1% return for the S&P 500.[1]

The good news is my reasons for the "pause" have largely dissipated.

1. By the end of 2014, the S&P 500 three-year trailing annualized return was 20%.[1] A big number. The result was that passive investing (buying the market) became very popular. Wall Street strategists entered 2015 with lots of enthusiasm.

   As we commence 2016, I see far fewer articles about "simply buying the market", and Wall Street opinions have turned far more muted. All are good signs that exuberance has subsided.

2. Historically markets tend to trade sideways in periods of time surrounding the first Fed rate hike. Given how well anticipated the December move was, I felt the uncertainty would come in advance of this first hike.

   Historically, once this first move is behind us, the market resumes its upward movement unless the pace of further hikes is aggressive. Hasn't Janet Yellen fallen all over herself to say that the moves will be "measured"?

3. There is a high likelihood earnings growth will accelerate. You do not need a degree in mathematics to understand this one. Wall Street consensus at the outset of 2015 was for 11% earnings growth for the S&P in 2015.[2] While we won't have final Q4 numbers for another month or so, it's likely earnings growth will be barely positive in 2015. Voila. The essence of why the return of the market was barely positive. No earnings growth equals no equity returns.

   But drilling into why the consensus was so wide of the mark, virtually all the reductions in earnings projections came from the energy and materials sectors. As of the end of December, those estimates had been cut 50% and 20% respectively. While energy might not make much of a comeback in 2016, it will be near impossible to create the same magnitude of drag. Expectations embedded in 2016 estimates are horrid.

   Obviously we could have a disaster in another sector, but given our slow but steady economic outlook for 2016, we doubt it.

In the end, I think it's healthy to always remind oneself that there are really only three determinants of the return of the market. Earnings growth + dividend yield + change in PEs. As I have said, earnings growth should improve somewhat. Likely high single digits. And with an expectation of 1% - 2% from dividends, the only other question becomes, will PEs change? I tend to doubt it. As Sir John Templeton is famous for saying, "bull markets die of euphoria". But euphoria won't come with subpar GDP. There have been too many geopolitical shocks to unnerve investors. So it should be all about earnings. Focus on earnings and what companies say.

US

While it's more of the same for the market overall, the opportunity set for equities is adjusting somewhat.

Given investors' thirst for yields, we have felt that investors have overpayed for higher yielding equities, hence underpaying for true organic growth opportunities. As we enter 2016, we believe there are parts of growth that remain attractive. However, excessive valuations are building in parts of the technology and consumer discretionary sectors.

Likewise, given the carnage in some of the more cyclical sectors of value, namely energy, materials and parts of industrials, the valuation spread to these areas is getting extreme. This warrants gradually adjusting away from expensive growth sectors into these value groups.

Europe and Japan

As I said earlier, I doubt returns for Europe and Japan will lag the US. But as we saw in 2015, the excess returns are not significant. 2015 reminded us that we are in an anemic global economic environment, which means support from central banks becomes even more important.

What's clear to us is that Europe is simply two to three years behind the US in terms of recovery. GDP is only recently accelerating out of the malaise stage, and earnings growth still remains below the previous 2007 peak. We don't see nearly the excessive pricing differentials between growth and value as we do in the US.

Japan is a tougher call. The macro data refuses to improve, and the market performed quite well in anticipation that it would. At some point, expectations embedded in stock prices will likely get too far ahead of the macro results. That is a concern. Increasingly, continued fiscal policy moves are getting boxed-in, given the magnitude of public debt.

Alternatively, Japanese company earnings are growing at the fastest rate in the world as corporate governance measures are forcing up profitability ratios, not to mention increased dividends and share buybacks. We think it's worth maintaining a positive view, although this juxtaposition cannot continue forever.

[1] Source: Bloomberg

[2] Source: FactSet

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