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Stock Market Prospects Remain Solid Despite Corporate Earnings Decline
By Scott P. Noyes, CFA® CFP®

In anticipation of earnings season, Wall Street's expectations for first-quarter growth have been ratcheted down significantly. Earnings for the S&P 500 are expected to decline by 4.2% over the prior year due largely to the drop in oil prices and the rally in the U.S. dollar. In addition, unusually cold winter weather led to a slowdown in consumer spending and hindered industrial output.

The 45% collapse in oil prices over the last nine months has resulted in the layoff of an estimated 60,000 to 70,000 oil service workers as companies slash spending in hopes of surviving the downturn. These job cuts have been particularly high in oilfield services, exploration and production, manufacturing and supporting services. Many of these are solid, high-paying jobs with industry average annual salaries of $108,000. As the year progresses we should hear about more layoffs, bankruptcies and bad loans in the energy industry. In less than a year, this economic sector has moved from being an engine of growth to one of the weakest contributors. Earnings from oil and oil-related stocks are expected to suffer substantial declines over the next few quarters.

The 20% rally in the dollar since last summer is having a significant impact on the terms of trade and corporate profitability for export-focused U.S. companies as they find themselves at the mercy of lower overseas sales revenues. Corporate earnings pre-announcements have been decidedly negative with the strength of the dollar as a leading culprit. In order to shore up corporate earnings, cutbacks to export related employment is likely to occur.

This winter's bad weather has also had a negative impact on economic growth as weaker GDP growth results in less robust corporate earnings. Several leading forecasting firms estimated that the cold winter reduced economic growth by 1.0% to 1.4% this year. With a smaller area of the country impacted by record cold temperatures and snowfall, this decline is an improvement over last year's weather-related reduction in GDP growth of 1.6%.

These three factors have combined to create a quarter of weak GDP performance estimated at 0.5%. Overall, the market is expecting weak corporate earnings for the first quarter of 2015 and some are projecting a meaningful stock market correction as a result.

Economic Beneficiaries of the Oil Price Decline

Lower gas and energy prices are good for America. Aside from those employed in the U.S. energy sector, the decline in energy costs is a benefit to many consumers and businesses. Consumers spent $370 billion on gasoline last year and the 30% decline in gas prices should lead to savings of approximately $110 - $120 billion in 2015. This should act like a tax cut and go straight into additional consumption. Lower gas prices also benefit most businesses because it reduces shipping and production costs. Several economists estimate that lower gas prices should boost gross domestic product by 0.4% – 0.6% over the coming year. While the energy sector feels immediate pain due to reduced prices, the rest of the U.S. may enjoy the benefits of the energy price decline over the course of the year.

Economic Beneficiaries of the Stronger Dollar

U.S. consumers are perhaps the most significant beneficiaries of a stronger dollar as imported goods become less expensive. The U.S. imports approximately twice what it exports. A stronger dollar leads to lower import prices, lower inflation and an increase in consumer purchasing power. This increase in purchasing power provided by a stronger dollar, offsets some of the current wage stagnation and is a benefit to overall economic growth. Again, just as with lower oil prices consumers are big beneficiaries. It should be a great time to travel overseas!

Foreign-based exporters should also benefit from the stronger dollar. The profitability of companies such as BMW, Toyota, Siemens, Samsung and various foreign resource providers should improve substantially as consumers purchase lower-cost imported goods. Last year's economic strength in the U.S. manufacturing sector should dissipate as overseas producers become more competitive.

Inflation is Virtually Nonexistent

Overall, the CPI increased 0.7% in 2014 with significant declines in the second half of the year as a result of lower oil prices and reduced import costs. These trends have continued into 2015 with year-to-date inflation at -0.5%. While I expect the monthly CPI numbers to rebound in 2015, inflation is unlikely to reach 1.0% for the year. As the year progresses, oil prices are likely to find a new trading range, presumably $40 to $70 per barrel (the current price is $50.44). If trade restrictions on Iran are reduced, oil supply is likely to increase again and prices would remain in the lower half of the range. Inflation in the U.S. is also being held in check by the decline in prices for imported consumer goods due to the strength in the dollar. I could envision a scenario where inflation comes in negative for the full year 2015.

With the national unemployment rate at 5.5%, there should be some pressure to raise wages in order to attract and maintain employees. Over the past year average hourly earnings have risen by 2.1%, a positive but unconvincing sign of wage increases. We are likely to see a change in the mix of employment as oil and export sectors struggle and consumer and import consuming sectors improve. Overall, the tug of war between wage pressures and commodity price reductions should result in weak inflation for the forseeable future.

Fed Policy Likely to Remain on Hold

After the U.S. reported strong jobs data on December 5th, many economists expected the Fed to start preparing markets for a June 2015 interest rate increase. The prospect of a U.S. rate increase is a major factor contributing to the strength in the dollar. However, the combined impact of the strong dollar and falling oil prices have created economic difficulties that have caused the Federal Reserve to modify its position. With little threat from inflation, the Federal Reserve is likely to delay any rate increases for an extended period of time. In this environment the bond market has little reason to panic and increase rates.

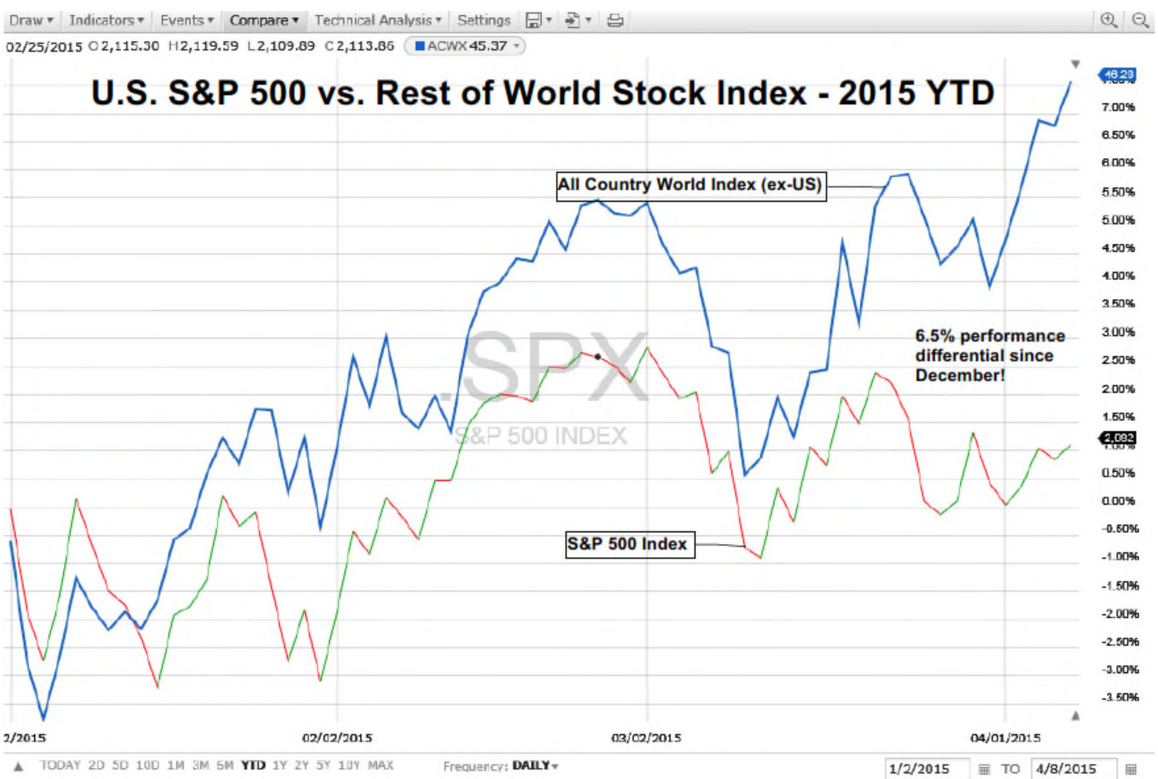
First-Quarter 2015 Market Performance

The most noticeable change in 2015 has been the reversal of winners and losers. In 2014, U.S. large-cap stocks were the big winners, but the year has started with foreign equities and small-cap stocks leading the pack. Table 1 depicts quarterly returns in dollar terms, but on a local currency basis, several of these regions outperformed by a much wider margin. Quantitative Easing in Europe and Japan has driven interest rates to near-zero levels and has become a major catalyst for the decline in the Euro currency. Concerns over Ukraine and Greece could easily heat-up again but are unlikely to become long-term problems. While I expect the dollar rally to stall or reverse for a few months, foreign stock markets are likely to continue outperforming U.S. markets during the first half of the year (Exhibit 1).

Table 1. Financial Market Returns for 1Q 2015

Stock Market Indexes		Bond Market Indexes	
Dow Jones Industrial Index	0.33%	Gov/Credit 1-3 yr Index	0.59%
S&P 500 Composite	0.95%	Gov/Credit 1-5 yr Index	0.96%
Russell 2000 Small Cap Idx	4.32%	Gov/Credit 5-10 yr Index	2.45%
MSCI World REIT Index	4.16%	Gov/Credit 20+ yr Index	3.36%
MSCI Europe	3.45%	US High Yield Index	2.52%
MSCI Japan	10.21%	Global Gov Bond Index	(4.63%)
MSCI Emerging Markets	2.24%		

Exhibit 1. Foreign Stocks Outperformed U.S. Stocks in 2015

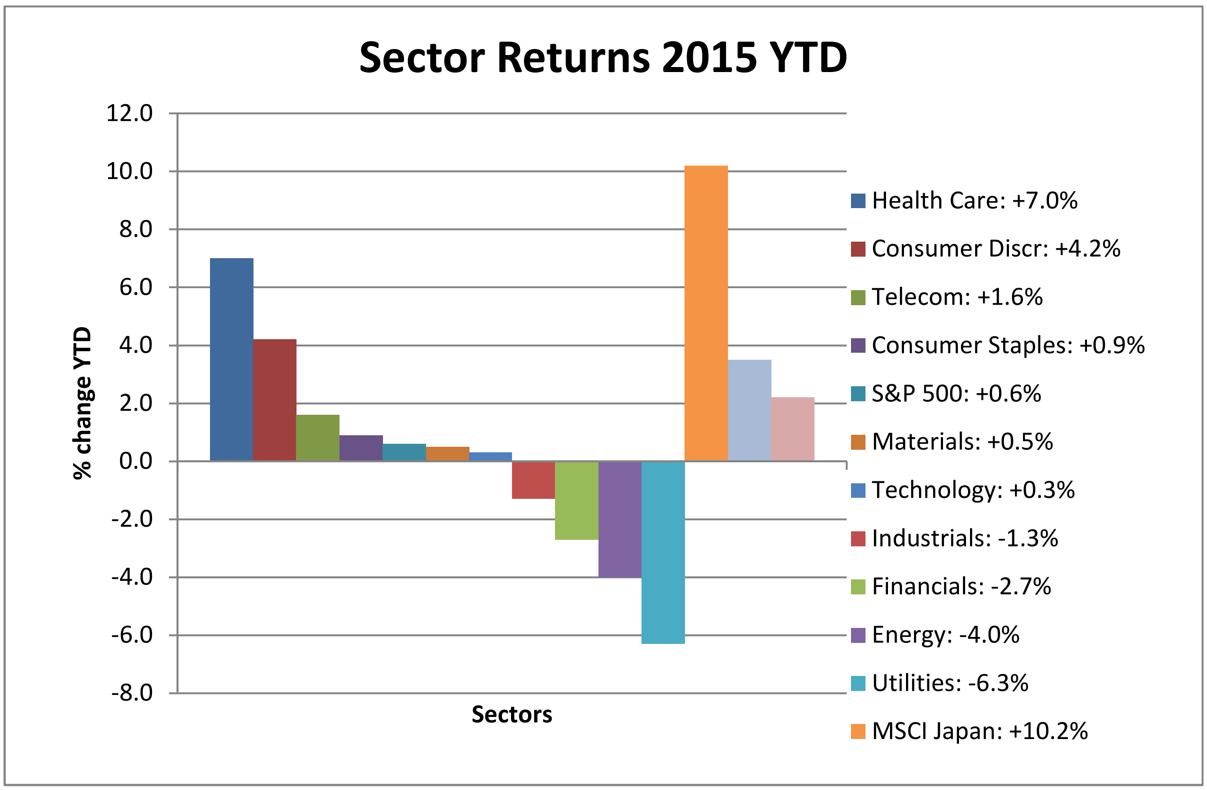


U.S. Stock Sector Performance in 2015

Within the U.S. stock market, there has been a significant shift in sector performance as well. Big winners in 2014 such as technology, financials and utilities have become laggards.

- Consumer Discretionary has rebounded and is seen as a beneficiary of lower oil prices and the stronger dollar.
- Energy and material sectors lagged in 2014 and continue to underperform in 2015.
- Health Care has been the strongest sector over the past few years and continues to perform well in 2015.

Exhibit 2 – Health Care and Consumer Discretionary Stocks lead the Performance Charts



Relentless Economic Growth in the U.S. Continues

While the U.S. economy is likely to slow in the first-quarter of 2015 to near zero levels due to weather, energy sector layoffs and declining exports, the intermediate-term prospects remain bright. Increased economic stimulus from lower energy prices and lower import prices should add approximately 1% to economic growth over the course of the year. I believe this means 2015 should result in another decent year for U.S. equities fueled by the following:

- Positive momentum in U.S. economic growth with low inflation
- Improved consumer spending
- Low commodity prices and financing costs
- A relatively liquid environment aided by stimulus from non-U.S. central banks.

Prospects for 2015

With the expectation that the bull market will continue in 2015, I have fully invested in equities and bonds up to your target asset allocation. Although equities are no longer a bargain, they offer better value than other financial assets and should outperform cash, bonds, and commodities. In today's market, there is no alternative to equities and our portfolios reflect the prospects I see for 2015.

- Despite a first-quarter slow down, relentless economic growth in the U.S. continues and the intermediate-term prospects remain bright. Increased economic stimulus from lower energy prices, improved consumer spending and the stronger dollar should add approximately 1% to economic growth over the course of the year.

- Many have been waiting for a rebound in inflation since the economic downturn ended in 2009, but the collapse in oil and commodity prices has extinguished that expectation for the near future.

- Against this deflationary backdrop, I doubt that the Fed will start any meaningful tightening process. The U.S. yield curve should continue to flatten as long-term rates trend lower and shorter-dated Treasuries face continued bearish headwinds.

- The U.S. Dollar is likely to trend higher over time. I believe parity between the Dollar and Euro could occur in a year or two. However, a multi-month rebound in the Euro is overdue and could occur if the Federal Reserve chooses to keep interest rates unchanged.

- Even in an environment of poor economic growth, the profitability of European companies should benefit from a weaker Euro and declining energy and commodity prices. European stocks appear inexpensive when compared to their U.S. brethren.

- Asset classes often perform differently from one year to the next. I believe that asset class performance has shifted from mega-cap companies to small- and mid-sized companies, whose sales are not as dependent on exports. In addition, I believe that the consumer discretionary and health care sectors will remain robust in 2015.

- In the short-term, strong seasonal equity buying patterns should continue through mid-May. Bull markets typically run until widespread euphoria or a big, unexpected negative event occurs which knocks the wind out of its sails. Currently, neither of these negative factors appears to be present.

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