Thursday, December 31, 2015

ECONOMIC OUTLOOK FOR 2016

- Next year the stock market will go up about seven percent, even though there will be three five percent corrections and one larger correction of ten percent.

The above bullet point could just be copied-and-pasted and be the only sentence we use for every obligatory year-ahead projection. Why? Because that's what happens, on average, every year. So why go out on a limb to try and project if it will be different this time? The answer is simple - risk management. Because, for whatever the reason du jour the media assigns to the event, once every three-and-a-half years the stock market will correct by twenty percent. The last time the stock market corrected that much (actually, it was about 19%) was in 2011, so you could argue that we're "due" a pretty big drop. And given that the Fed will be raising rates in 2016 and that we will be confronted with a Presidential election, a drop of the twenty percent magnitude really shouldn't be ruled out.

But, ultimately, who cares? I mean, how many 5-, 10- and 20- percent drops have we all gone through and forgotten? We get it – stock market corrections are only healthy in theory and in hindsight. As we go through them, they can be absolutely gut wrenching. But they happen fast and just about always sets the market up for higher highs.

So, why do we care? Recessions. It's all about recessions. On average every six years the US goes through a recession and the stock market, in sympathy, goes down 25-33%. And it's not quick. The decline can endure, thus upsetting cash management and withdrawal strategies for those in the distribution phase of their retirement, and shifting asset allocation plans for those in the growth phase of their retirement planning. Those 5-20% non-recessionary drops happen fast enough so that they are quickly forgotten, causing less emotional stress and reducing the threat of having to make changes to your plan at a less than stellar moment. These larger recessionary drops not only crush us emotionally (and let's be honest – we all get emotional about money), but puts us in a position where we can't simply wait a month or two to change investment plans, when the timing is more appropriate.

As a result, at BMM, we start the year with a pretty simple question – "What could happen that would cause the stock market to behave in a non-average manner?"

But before we get into the what's-and-the-why's, here's **the bottom line**: BMM is positioning clients for a high single-digit return in the stock market return in 2016, and expecting up to a twenty percent correction, likely from July through October.

(Note: anticipating a return based on a calendar year feels obligatory and insanely arbitrary. So high-single digit returns are more like a prediction of 2016-ish, give or take half a dozen weeks on either end of the year for measuring purposes).

For the record, a twenty-percent drop, we acknowledge, is pretty scary. While not the most likely scenario, a correction of that magnitude is not a remote possibility. For example (and we'll get more

into valuations shortly), for the S&P 500 to correct twenty percent it would have to drop roughly to its 52-year median P/E of 16.9, that would bring the S&P 500 to 1690 points (based on a combination of reported and projected 2015 operating earnings). However, over the last twenty months or so, the peak of oversold moments in the market have been close to 1,850 points (based on spikes of options prices, crowd sentiment, and positive reversal of stock prices after reaching high level of investor fear) , which would be closer to a twelve percent drop from current levels. In other words, ***while we expect a sizable correction, the correction is likely to be bigger (in the 20% range) only if the stock market goes up first***.

A double-digit decline in 2016 is all but given since a) on average it happens once every fourteen months anyhow – it's not extraordinary, b) earnings expectations by Wall Street analysts are higher than BMM expects, setting up the market for disappointment, c) as clear as the Fed has been regarding their pace and path of rising interest rates it's not as if the script is set in stone and perfectly known, and d) we expect the stock market to freak out (that's a technical term) when investors from all political parties start getting scared that their chosen candidate will lose the Presidential election.

A quick byline regarding Presidential election years – according to Strategas Research, the stock market is up an average of 11.3% in Presidential election years (however, take that hopeful data point with a grain of salt since years prior to election years tend to be very strong and last year it was just flat).

Stock Market Valuations

- Price-to-earnings ratios are already very high for the stock market and that limits the potential for returns without a dramatic expansion of earnings growth.
- Wall Street analysts expect earnings growth of 19% in 2016 for S&P 500 companies. BMM believes that is optimistic.
- A high-single digit return for the stock market over the course of the next twelve months or is expected, per current P/Es and expected earnings.

The NYSE Composite Index has a value of about $20 trillion. Of the 1,900 listed stocks in the index, about 1,500 of them are US companies. It's a broad index for sure. The median stock on the NYSE CI sells at about 25.6 times its latest 12-month trailing earnings. Low inflation and low interest rates help justify higher valuations, but this is higher than the peaks of both 2000 and 2007. The collapse of energy earnings can help explain away some of that loftiness, arguing not only was that a drag on earnings for the energy industry in 2015, but that the lower oil prices could help other industries' profits in 2016. But it still makes us nervous. ***The more familiar S&P 500 has a current average P/E of 20.7; the S&P 500 index finds it difficult to push past the 22-24 range.***(Again, 2015 earnings are based on combination of reported and projected 2015 operating earnings.)

Going into 2016, the concerns are eerily similar to those of 2015 – stretched valuations, below-trend economic growth, falling oil prices affecting the energy sector, the implications of a stronger dollar, and uncertainty regarding the movement of the Fed. The stock market now, as in 2015, has to deal with these same macroeconomic issues. ***This will leave the stock market vulnerable to more and larger***

corrections in 2016. However, so long as the US keeps out of recession, any deep correction is likely to be limited in magnitude and duration.

The US economy is expected to avoid recession (more on that later). Other good news is that the biggest obvious risk to the US economy is that the Fed will move rates too far too fast. But that is, at best, conjecture and not likely to happen. ***The path of rising interest rates will be gradual, allowing BMM to feel comfortable going into 2016 being more constructive on the US stock market than bonds or cash.***

Wall Street analysts can be optimistic. Analysts are expecting operating earnings for S&P 500 companies to jump 19% from calendar year 2015. Even considering year-over-year comparisons will be easier this year that is a lot of earnings growth. Call us skeptical (or overly cautious), but something closer to one-half that earnings growth is more achievable. So let's say ***an 8.5% rise in earnings (the long-term average) and zero expansion in the P/E ratio; that gets the S&P 500 to close to 2,244 points (a high-single digit return in the market).***

The calendar year after the stock market has made no gains tends to be a good one for stocks. Presidential years tend to be very good for the stock market. Slow tightening cycles by the Fed tend to be good for the stock market. But, more importantly, a growing economy with no realistic risk of a recession is good for the stock market. And that's what BMM projects for 2016. What do we consider "good"? Well, let's be honest. Although the media has conditioned many people to think otherwise, ***one year is pretty short-term. In that short-term we look for no long-lasting market blowups and the continued trend of the secular bull market.***

US economy

- The US labor market will reach full employment.
- Wage growth will continue to accelerate
- The path of higher interest rates will be slow and rates will remain low.
- US GDP will advance over 2%.

Over the last half-century or so, the average US economic expansion has been about six years. Our six years, it would seem, is up. But over the last couple decades US economic expansions are getting longer due, in large part, to technological efficiencies and more sophisticated management. So it's hard to tell based on age alone if we're "due" a recession at this point. Based on the economic data, the current expansion seems to still be more mid-cycle than late-cycle.

Economic expansions don't die of old age; they normally end when the economy overheats. The past few recessions began about three years after the economy reached full employment, leading to a an acceleration in wages and inflation and tighter monetary policy (keeping in mind, some of that mixture is a good thing). Should employment trends continue, the US should reach full employment by mid-2016. Using this one simple data point that means the next recession wouldn't be until mid-2019. This does not argue against the risk of double digit percentage points drops in the stock market over the

matter of months, but it does argue against the market being cut nearly in half (again) over the course of a year or so.

There are few signals warning of a US recession. There are no serious capacity constraints (per capacity utilization data). US sales to US customers are growing relatively well, and that pace of growth is picking up. Household formation post-Great Recession was held very low as people waited to have children, but now household formation is picking up (and will continue to do so given firm employment and stronger wage growth), and as a result residential real estate demand is firm.

One big traditional warning of a recession is lower energy prices. But the drop in oil prices has mostly been due to a rise in supply more so than a drop in demand (although the drop of the last fifteen or twenty dollars is heavily attributed to a growing crowded trade in the short-market, i.e. more to do with people selling out of fear than actual fundamentals). Low energy prices have led to regional economic slumps where selling oil is a big part of the local economy. And it has hurt the prices of junk bonds as a lot of junk bonds – aka high yield bonds – are exposed to energy. For example, about 15% of the high-yield bond ETF "JNK", with an average credit quality rating of "B" and paying a six-percent-plus yield, is invested in energy related bonds. Now that earnings in the sector and bond prices have adjusted, the mostly yet-to-be realized benefits of lower oil prices outweigh the costs. The oil price collapse and the resulting industry changes (layoffs, cancelled expansion projects) have slowed growth in the last couple of quarters, but these drags are expected to trough in the coming few months. Ultimately (though with a longer lag this time), low oil prices will have an effect similar to a tax cut, increasing disposable income and improving profitability in industrial production.

All that is good news, but the big economic news for 2016 will continue to be job creation. ***The US is on track to reach what most people consider to be full employment***, as measured by a 5% unemployment rate (which has been achieved) and a 9% underemployment rate (also known as the U-6 rate, which is at 9.5%; the u-6 rate includes so-called "discouraged" workers that, for example, want to work full time but can only find part-time jobs). If the current pace of job growth of more than 200,000 per month keeps up, and the working-age population continues to grow at about 100,000 per month, then our assumption of reaching full employment is simply math, and not optimism.

If it is optimism that you are looking for, consider that ***job openings are about as plentiful as they have ever been***. Today there are less than three underemployed workers for every open job. To give that some context, six years ago there was close to one position for every eleven underemployed workers, leaving too many workers competing for too few jobs***. This sets up the case for continued wage growth***.

Yes, an argument can be made that higher employment costs are a negative for profits and thus the economy. We acknowledged that earlier when we said recessions typically occur three years after employment reaches its full potential and wage pressure pushes the economy into overheating. But those few years before overheating are not dangerous – it's a boon to the economy as consumers unleash pent-up demand and buy goods and use services, which creates a fortunate cycle of additional job creation and economic growth.

In this case it is really more of extrapolating trends than relying on optimism. Using different methods, the Bureau of Labor Statistics and ADP Payroll Services calculates year-over-year wage growth at 2.3% and 4%, respectively. It won't happen right away, but using the less robust BLS numbers, wage growth is

expected to accelerate to about 3.5% (which is equal to the sum of inflation, which is expected to be near the Fed's 2% target, and the 1.5% trend of growth for labor productivity). Supporting the prediction for stronger wage growth is survey work done by the National Federation of Independent Business, which found that the net percentage of small firms planning raise compensation has risen to twenty percent, the survey's highest reading since 2001. Another positive leading indicator of future wage growth is that ADP is noticing a rise in wages paid to workers switching jobs. But beyond tracking data, the story is pretty straightforward – there was significant slack in the job market in the first few years of economic recovery since 2009, limiting worker's bargaining power and starting salaries. But now workers have more power to negotiate pay.

Back to the argument that increasing wage growth will, possibly for the first few years, be part of a fortunate cycle, consider that with labor costs so low since the Great Recession, businesses have felt little pressure to invest in labor-saving technologies. Admittedly, this does fall more into the category of optimism than math or trend extrapolation, but this could change to a trend (or at least a positive bump) as businesses realize that their labor costs are rising with the tightening job market. On the individual side, the correlation between year-over-year growth in nominal spending and wage growth is strong. The household financial obligations ratio (debt payments relative to disposable income) has stabilized near its lowest level since 1981 due to low interest rates and post-Great Recession household deleveraging, leaving for the possibility of a higher amount of discretionary spending.

Given the enormity of the US economy and all of the hidden levers and variables, we always find it mildly amusing to see confident projections of US Gross Domestic Product (GDP) growth narrowed down to the tenth of a percentage point. We get it – a regression analysis is built and the mathematical result tells the analyst a particular number. And while we admit, there is importance between the difference of 2 % or 2.5%, the assignment of a number (like projecting stock market gains) is a best guess. The most important thing is determining the trend (and/or any disruption to the trend). ***Our better guess is that the trend continues and US GPD growth for 2016 is in the 2 – 2.5% range.***

This year the best guess method gets a little more attention from us than usual because of the virtual guarantee of rising interest rates. And while the path of Fed policy has been well communicated and should lead to less economic disruption than usual, the uncertainty argues that a range of GDP estimates is wiser than a prediction to the tenth of a percentage point. There has been a conversation about rising interest rates having the potential to limit spending growth by raising the cost of borrowing (and thus pushing down GDP). ***The impact of rising interest rates in 2016 is likely to be small as consumers have a lot of fixed-rate debt and any rate increases will be gradual***. An interesting twist on this is that there may even be a positive influence for retirees holding large cash positions who may now get a raise in interest payments.

Bonds in a Rising Interest Rate Environment

Given that the Fed is all but guaranteed to raise interest rates, how much should we panic?

Yes, ***bond prices fall as yields rise. But there is no reason for panic***. Don't get us wrong – calling bonds a "conservative" investment may become an archaic description. Sure, volatility will remain far less than stocks. And for some people, that's the type of "conservative" they want.

The Fed has been extremely clear on their path, which is to keep monetary policy accommodative by keeping interest rates low and only raising them slowly. So this will mitigate some of the price declines. To give this some perspective, according to data pulled by Charles Schwab & Co regarding bond investing, "…history suggests that total returns – the combination of price changes plus yield – are unlikely to take a major hit…In fact, during the worst bond bear market in history – from the mid 1950's to the early 1980's – there were still only a handful of years in which the total return of intermediate-term US government bonds was negative. The worst decline was just 1.3%." So, in the short-term, conservative investors that hold bonds do not need to panic. However (and this is important), ***in the intermediate-term conservative investors will have to hold fewer bonds and more stocks***. ***Bonds may be less volatile, so you won't lose a lot of value in a short period of time, however, over a longer period of time you are likely to lose money in bonds slowly, if only relative to inflation.***

On the subject of bonds, it is important to note that not all bonds are created equally. Or, more to the point of this discussion, junk bonds prices are affected more by default concerns than by interest rates. Junk bonds have taken a big hit this year, with prices being pushed lower in large part due to concerns that bonds issued by energy companies would default. As mentioned earlier, many of those concerns will dissipate in the coming months. Holding any investment when it goes down is emotionally painful. But if you are a conservative investors looking for yield then these bonds have done their job paying as default perceptions have not become reality (that's not to dismiss the pain of having to swallow that bitter pill if you've seen the price of your investment go down, even if only temporarily).

Junk bonds have some attractive qualities in terms of possible price appreciation. First, redemptions are slowing as junk bond fund managers held net inflows in cash as opposed to buying bonds. As a result, when bond fund holders sell their funds, fund managers do not need to sell as many bonds to meet redemption needs. In October inflows exceeded purchases by the largest amount since December 2011. As a result, the cash/assets ratio of these funds hit 5.5%, the most in nearly two years. The price decline has been a result, in part, of selling begetting selling. The implied high yield default rate is about 12%. In 2009, the default rate for junk bonds topped out at 15%. Since 1983 (using Deutsche Bank data), the default rate for junk bonds has averaged 4.9%. (Interestingly, the average default rate from 1983 to 2002 was 6.9%; since then, the average has been just 1.5%.)Fitch argues for a default rate of 4.5% in 2016, which would be high compared to the numbers since 2002, but considerably below the implied rate of 12%, allowing for the possibility of appreciation on top of yield.

GENERAL DISCLOSURES

Website content document may include forward-looking statements. All statements other than statements of historical fact are forward-looking statements (including words such as “believe,” “estimate,” “anticipate,” “may,” “will,” “should,” and “expect”). Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct. Various factors could cause actual results or performance to differ materially from those discussed in such forward-looking statements.

Historical performance is not indicative of future results. The investment return will fluctuate with market conditions.

Performance is not indicative of any specific investment or future results. Views regarding the economy, securities markets or other specialized areas, like all predictors of future events, cannot be guaranteed to be accurate and may result in economic loss to the investor. Investment in securities, including mutual funds, involves the risk of loss.

TERMS OF USE

Berkshire Money Management, Inc. monitors this web site for security purposes to ensure it remains available to all users and for the purpose of protecting information in the system. By accessing this web site you are consenting to these monitoring activities.

Unauthorized attempts to defeat or circumvent security features; to use the system for other than intended purposes; to deny service to authorized users; to access, obtain, alter, damage or destroy information or interfere with the system or its operation in any other manner is prohibited. Evidence of such acts may be disclosed to law enforcement authorities and may result in criminal prosecution.

Berkshire Money Management, Inc. does not approve any website that is linked through this browser. Furthermore, Berkshire Money Management, Inc. is not responsible for content, and neither endorses nor makes warranty for information, accuracy, content or presentation of the site or sites in question.

STANDARD & POOR'S

The S&P 500 Index (S&P) has been used as a comparative benchmark because the goal of the above account is to provide equity-like returns. The S&P is one of the world’s most recognized indexes by investors and the investment industry for the equity market. The S&P, however, is not a managed portfolio and is not subject to advisory fees or trading costs. Investors cannot invest directly in the S&P 500 Index. The S&P returns also reflect the reinvestment of dividends. Berkshire Money Management is aware of the benchmark comparison guidelines set forward in the SEC Clover No-Action Letter (1986) and compares clients’ performance results to a benchmark or a combination of benchmarks most closely resembling clients’ actual portfolio holdings. However, investors should be aware that the referenced benchmark funds may have a different composition, volatility, risk, investment philosophy, holding times, and/or other investment-related factors that may affect the benchmark funds’ ultimate performance results. Therefore, an investor’s individual results may vary significantly from the benchmark’s performance.

The S&P 500 Index (S&P) has been used as a comparative benchmark because the goal of the above account is to provide equity-like returns. The S&P is one of the world’s most recognized indexes by investors and the investment industry for the equity market. The S&P, however, is not a managed portfolio and is not subject to advisory fees or trading costs. Investors cannot invest directly in the S&P 500 Index. The S&P returns also reflect the reinvestment of dividends.

DOW

The Dow Jones Industrial Average (NYSE: DJI, also called the DJIA, Dow 30, INDP, or informally the Dow Jones or The Dow) is one of several stock market indices, created by nineteenth-century Wall Street Journal editor and Dow Jones & Company co-founder Charles Dow. The Dow average is computed from the stock prices of 30 of the largest and most widely held public companies in the United States. Clients of BMM may have portfolios that differ substantially from the composition of the DOW and therefore, their performance may vary significantly from that of the Dow. The Dow is used for illustrative purposes only, as one indicator of the overall US economy, and its past, present, or future performance should not be viewed as an indicator or comparison point for BMM client performance.

Privacy Notice

FACTS	WHAT DOES BERKSHIRE MONEY MANAGEMENT DO WITH YOUR PERSONAL INFORMATION?
Why?	Financial companies choose how they share your personal information. Federal law gives consumers the right to limit some but not all sharing. Federal law also requires us to tell you how we collect, share, and protect your personal information. Please read this notice carefully to understand what we do.
What?	The types of personal information we collect and share depend on the product or service you have with us. This information can include: ■ Social Security Number and Account Balances ■ Transaction History and Risk Tolerance ■ Retirement Assets and Wire Transfer Instructions
How?	All financial companies need to share customers' personal information to run their everyday business. In the section below, we list the reasons financial companies can share their customers' personal information; the reasons Berkshire Money Management chooses to share; and whether you can limit this sharing.

Reasons we can share your personal information	Does Berkshire Money Management share?	Can you limit this sharing?
For our everyday business purposes— such as to process your transactions, maintain your account(s), respond to court orders and legal investigations, or report to credit bureaus	YES	NO
For our marketing purposes— to offer our products and services to you	NO	WE DO NOT SHARE
For joint marketing with other financial companies	NO	WE DO NOT SHARE
For our affiliates' everyday business purposes— information about your transactions and experiences	NO	WE DO NOT SHARE
For our affiliates' everyday business purposes— information about your creditworthiness	NO	WE DO NOT SHARE
For nonaffiliates to market to you	NO	WE DO NOT SHARE

Questions?	Call 888-232-6072 or go to www.berkshiremm.com

Who we are	
Who is providing this notice?	Berkshire Money Management, 392 Merrill Road, Pittsfield, MA 01201
What we do	
How does Berkshire Money Management protect my personal information?	To protect your personal information from unauthorized access and use, we use security measures that comply with federal law. These measures include computer safeguards and secured files and buildings.
How does Berkshire Money Management collect my personal information?	We collect your personal information, for example, when you ■ Open an account or enter into an Investment Advisory Contract ■ Tell us where to send the money ■ Give us your contact information ■ Seek advice about your investments
Why can't I limit all sharing?	Federal law gives you the right to limit only ■ sharing for affiliates' everyday business purposes—information about your creditworthiness ■ affiliates from using your information to market to you ■ sharing for nonaffiliates to market to you State laws and individual companies may give you additional rights to limit sharing.
Definitions	
Affiliates	Companies related by common ownership or control. They can be financial and nonfinancial companies. ■ Berkshire Money Management has no affiliates
Nonaffiliates	Companies not related by common ownership or control. They can be financial and nonfinancial companies. ■ Berkshire Money Management does not share with nonaffiliates so they can market to you
Joint marketing	A formal agreement between nonaffiliated financial companies that together market financial products or services to you. ■ Berkshire Money Management does not participate in joint marketing