2016 Outlook: Do you fear the turtle?

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As an indecisive year draws to a close—the S&P 500 crossed the flat line a *record 26 times* in 2015—the market remains in a difficult position. While the seasonal backdrop is certainly supportive through January, daily, weekly and monthly momentum indicators are not oversold and continue to weaken. Individuals continue to dump equity funds, market breadth remains narrow, the rally off the August lows failed to generate the internal surge often seen in the early innings of a durable advance, and credit conditions are still suggesting caution, with high-yield spreads ending 2015 at their highest level in nearly 3 years. The macro backdrop isn't great either. Global growth is slowing, while in the U.S., real GDP remains stuck in a 2%-2.5% rut. Ironically, the ability of companies to make money in this environment may be supportive of this frustrating norm. While the top line of developed-market companies has been rising much slower than in previous recoveries, profits have grown at a very decent pace, a result of operating leverage that has grown steadily over the last quarter century. In other words, companies have learned to generate profits in a low-growth environment and have been successful at expanding margins. One of the key reasons, Empirical Research says, is the improved use of capital, i.e., with returns on capital improving, margins can improve without the capital intensity typical of past cycles. A consequence is that a capital-light business model comes with a capital spending-light recovery, which means the accelerator effect on GDP from that spending will be muted and the recovery is destined to remain sluggish.

Two divergences are worrisome: one is the widening gap between earnings and sales results. The proportion of companies beating on earnings per share (EPS) was 60% in Q3 2015, the highest in five years, while the proportion missing on sales (59%) was the highest in three years—with the gap between the two ratios the widest since Q1 2009. Another trend worth watching, Bank of America says, is pro forma (adjusted) vs. reported S&P EPS. Since late last year, adjusted EPS has exceeded reported EPS by more than 30%, well above the 10% gap for most of 2013 and 2014 and the widest since the global financial crisis. Nearly 60% of the difference was attributable to the energy and metals, mining & machinery sectors, where asset impairments/write-downs were the biggest contributors. Another 20% of the difference was related to heath care (chiefly pharma, biotech and equipment/supplies), largely due to acquisition-related costs/impairments. Consensus is calling for 18% EPS growth next year vs. the long-term average of 8.5%, with a weaker dollar helping multinationals with overseas earnings translations. From a sector perspective, reaching consensus would likely require the energy sector to return to profitability—consensus expects energy to swing from a $2.76 per-share loss in 2015 to a $16.23 profit in 2016. But the potential for lower-oil-prices-for-longer calls this rebound into question. Should the same factors that drove down earnings in 2015 remain in place in 2016, EPS could struggle to grow at all, JP Morgan says.

When we look at history, we do not have good evidence of a decline in oil prices leading to a U.S. recession—in fact, it's just the opposite: *rising* oil prices very frequently cause recessions. There are certainly still stress points abroad. But when looking at the global recessions of the past 40 years, Strategas Research finds the U.S. has tended to be in recession first. That makes sense, given that U.S. consumers have tended to be a key source of end demand. There are lingering risks as we start the New Year (still weak commodity prices, China's currency weakening, elevated corporate credit spreads, geopolitical instability). Moreover, S&P transports—a good market/economic indicator—have been weak. But if oil can stabilize and if investors can gain more confidence on China's economy (slowing but not collapsing), then 2016 should look better overall. Clearly, the U.S. consumer is starting 2016 in the best shape in years (*see more about this in my special report next week*). Unemployment is at a 7-year low; gasoline is cheap, interest rates are still low even with Fed liftoff and wages are rising. On the macro front, housing looks to be recovering, autos are going strong and services are still expanding despite manufacturing's woes. If consumers keep buying homes and cars, it's hard to argue there's too much wrong. Even the government is set to be a contributor—its new fiscal budget and tax package is expected to add 70 basis points to GDP in the coming year, an election year (*more below*). As the Fed raises rates at a turtle speed in 2016, instead of focusing intensely on minor tail risks, investors may well come around to the view the economy is moving closer to full capacity and that life is indeed getting better. I see the turtle, still dragging that heavy wallet full of dividends, walking by with his hat and horn, ready to celebrate the New Year.

What else

What happens in election years? Post-WWII, the S&P has climbed an average of 6.6% during election years. The market has tended to struggle during years when the incumbent party has lost. Holding onto the presidency is not easy: the

last time the Democrats won a third consecutive term was 1940, when FDR ran for a third time. The last non-sitting Democrat to win the presidency after the party had held the office for two terms was Martin Van Buren in 1836. Regardless of the reasons, the S&P has risen an average of 2.2% during election years when the incumbent party has lost.

Why isn't anyone talking about Asian immigration? The current dialogue regarding refugees and religion is overlooking already ongoing major positive shifts in legal U.S. immigration. For years, the main region of origin is Asia. Not only are Asian-Americans the fastest growing racial group, they are the best educated and highest-income group of recent U.S. immigrants. Nearly half of Asian-Americans 25-years-old and up have a bachelor's degree or higher, nearly double the U.S. average. The figure for recent Asian immigrants is an even more impressive 61% with a college degree. Median annual household income is $66,000 compared to $49,800 for the general public. The rate of increase in the Hispanic population, which had been a key driver in U.S. population growth, has slowed considerably, reflecting fewer entrants and increased emigration. It is very positive that 73% of Asian-American immigrants say that the opportunity to get ahead is better in America vs. 5% who think it is better in their country of origin.

Inflation Watch With Fed policy normalization now under way, the more pertinent questions become what will be the pace of future rate hikes and what will be the key determinants of that pace. The December 16th policy statement and subsequent press conference by Chair Janet Yellen focused more on inflation than labor markets as determinants of future policy. And understandably so, as the labor market is close to full employment, while the Fed's longer-term inflation target of 2% remains elusive. In fact, by Ned Davis Research's count, the word "inflation" was mentioned during the press conference nearly twice as often as any labor market reference, including "labor," "employment," "unemployment" and "payrolls." As we head into 2016, various measures of inflation have firmed, and have us on inflation watch next year.

Washington's favorite game? Kick the can Before leaving town for the holidays, Congress passed a stimulus package to juice the economy ahead of the 2016 election. This tax-cut-and-spending measure will boost GDP seven-tenths of a point, all else being equal, Strategas estimates. But now that Congress has ripped off the austerity patch the federal budget deficit will likely increase in 2016 by nearly 1 percent of GDP. This will be the first budget deficit increase since 2011 and the U.S debt-to-GDP ratio will start to increase again. Budget deficit increases are dollar negative, all else being equal, and coincide with the trade deficit increasing at the same time.

Truth be told, I don't believe in the Tooth Fairy either Popularized by the Stock Trader's Almanac, the Santa Claus Rally (SCR) is the seasonal tendency for equities to rally during the last five trading days of the year through the first two trading days of the New Year. Since 1928, the S&P has averaged a 1.8% gain and traded higher 78% (68 out of 87 years) of the time through this 7-day period, vs. a 0.2% average gain and a 56% success rate during any 7-day period. This year's "Santa Clock" started December 24 and ends January 5. Perhaps worth noting, performance in the next 1-2 quarters has tended to be below average when the S&P closes lower during the SCR. For instance, the S&P has averaged a 1.3% loss and a 0.5% loss in the subsequent 3 and 6 months, respectively, following a negative SCR, vs. an average 2.8% gain and 5.3% gain, respectively

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Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

High-yield, lower-rated securities generally entail greater market, credit, and liquidity risk than investment-grade securities and may include higher volatility and higher risk of default.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

There are no guarantees that dividend-paying stocks will continue to pay dividends.

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