Weekly Commentary **December 31, 2015**

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Poor Year Ends on Downtick; Looking Ahead to 2016

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The typical year-end rally in stocks is not happening as equity investors are concerned about the Fed overtightening in an economic environment of commodity deflation and lackluster growth. This morning we had both a very weak jobless claims and Chicago PMI report, although the former could have been influenced by year-end season adjustment problems and the latter will either be confirmed or not on Monday, when the national ISM data are released. The most important event next week is, as always, the labor market report and the early read is a 200k increase with the unemployment rate remaining at 5.0%. This is only a tad below the average of the last three months at 218k and the last 12 months of 220k. The payroll increase is still clearly above the increase in the trend supply of workers unless the participation rate increases. If these payrolls increases persist into 2016 the unemployment rate will continue to fall and continue to put pressure on the Fed to hike. The best scenario is for the participation rate to rise and take pressure off the labor market, a development that could stay the Fed's increase in March.

Let's turn to the year-end valuation of the market. At current levels the S&P 500 is selling for about 19.2 times this year's conservative S&P operating earnings and about 21.4 times GAAP reported earnings. If we take the PE at 20, this valuation corresponds to a 5% earnings yield and therefore a 5% forward looking real return on equities. This return assumes PE ratios remain stable and per share earnings growth comes only from buybacks, which are about 3% per year, the other 2% of the return coming from dividends. Given that the 10 year TIPS bond is trading at 0.70%, this gives us a 4.3% edge for stocks over bonds, almost a percentage point higher than the historical 3.5% equity premium. This premium could stay higher than average for several reasons. One is the increasing risk aversion of aging investors or the perception of increased risks in the equity markets. It could also stay high because investors regard Treasury bonds as a negative beta asset, i.e., investors will bid up Treasury bonds for several reasons, including a negative shock to the economy coming a downward shift in demand, a deflationary shock, a terrorist attack, or the Fed halting its rates hikes if the economy goes south. Whatever the source, a 5% real equity return is not bad and it assumes that the only source of per share real earnings gains comes from buybacks. If we see any stability in commodity prices or rise in consumer spending, per share earnings should rise much faster from this year's very depressed levels. This is the bullish scenario for stocks in 2016 and is why I am projecting a 10% to 12% equity return next year.
