January 19, 2016

WHERE'S THE STOCK MARKET HEADED IN 2016? HERE'S HOW TO MAKE YOUR OWN FORECAST

Wall Street's recent decline was the worst five-day start to the year ever for the US stock market as the benchmark S&P 500 fell 6 percent following repeated waves of selling during the first week of the year. (Bloomberg) The Dow, meanwhile, fell 1,082 points during the first week of 2016. (Bloomberg) That's the most for this blue-chip index since 2011 as it closed the week at 16,346.45 which also marked a decline of about 6 percent. (Bloomberg)

The real drama was in the tech-heavy Nasdaq composite, which plunged 7.3 percent leaving it more than 10 percent below its July record close and officially back in correction territory. (Bloomberg) That index is heavily weighted with technology and biotech companies, both of which were high fliers last year.

Stocks are selling off around the world because of major volatility in China's stock market. That's because, as we explained in a recent article, we are in slow-to-no-growth world with China's economic woes representing the most recent headline for slow global growth.

Indeed, fears of a bigger-than-expected slowdown in the world's second-biggest economy are on the rise, which is a negative for markets as China has been one of the world's biggest drivers of growth in recent years. Fears range from China exporting recession to the rest of the world to China causing another meltdown in the global financial markets. There is also great concern that Chinese authorities are making the situation worse — and that China's willingness to let its currency, the yuan, weaken signals an even weaker economic situation in China than the government is willing to publically admit.

This treacherous sledding on Wall Street has left many investors feeling shaken with many believing that there is more pain to come.

What's the next move in the financial markets?

We frankly don't know and anyone that tells you that they do is either a fool or a fraud. However, as we recently wrote, we expect the markets to be volatile as the deflation-inflation tug-of-war continues to play out across the globe which will make it difficult for stocks to make much headway from their beginning of year levels.

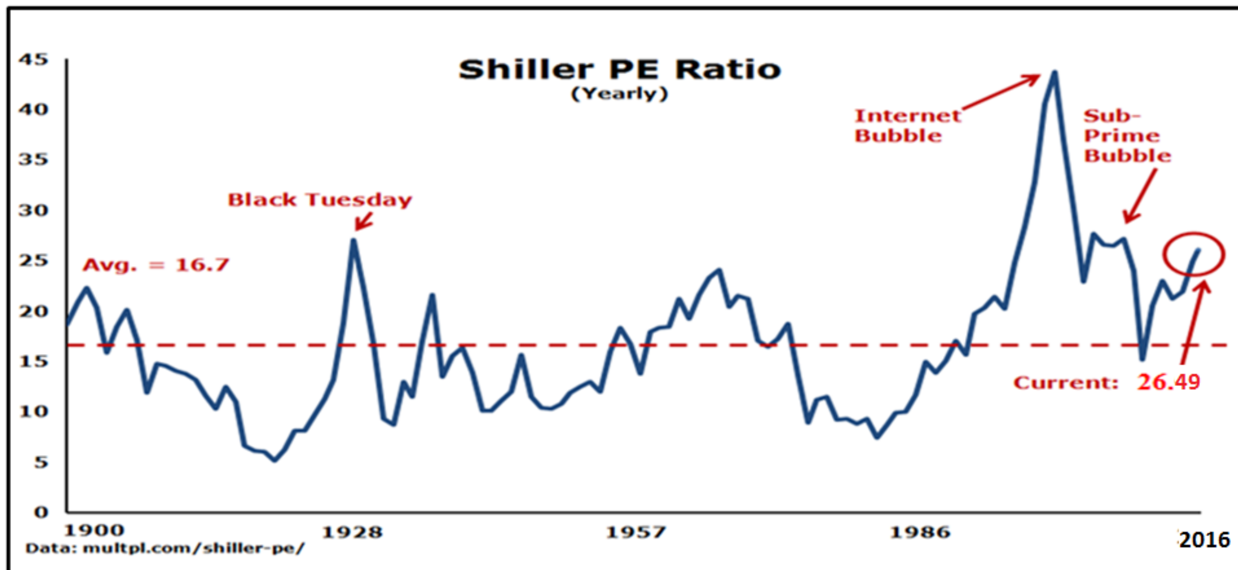
But instead of relying on us or any of the mainstream media pundits to tell you where the market is headed for 2016, we're going to show you how to make your own stock market forecast. That's right, we're going to explain how to use a simple, yet powerful, model to make your very own 2016 stock market forecast.

Recall that we've previously introduced you to a simple yet powerful 3-factor model for analyzing stock market returns. The three factors in the model are easy to identify and they are beginning dividend yield, earnings growth and change in the price-earnings ratio. When you add all three factors together, the result is total stock market return.

OK, let's get started. The first step in forecasting this year's stock market return is obtaining the dividend yield on the S&P 500 at the beginning of the year. This number is easy to find because it's readily available from a number of sources on the internet. At the beginning of 2015, it was 2.11 percent, according to multpl.com.

The next step is estimating the earnings growth for the S&P 500 in 2016. After doing some research, you'll find that Wall Street analysts' estimates range from a pessimistic -2 percent to an optimistic 10 percent. As you'll see as you read on, a range — instead of an exact number — will work just fine for our forecast.

Now comes the hard part: developing an estimate for the change in the stock market's price-earnings ratio. But we have a solution for this issue. Take a look at the chart below:



This chart reports what is known as the "Shiller PE Ratio" from 1900 to its level at the beginning of 2016. While there are several conventional methods to calculate price-earnings ratios (any of them will work in our 3-factor model), we prefer the Shiller method because it normalizes the price-earnings ratios over economic cycles. You can learn more about the Shiller PE ratio at http://www.investopedia.com/terms/p/pe10ratio.asp . You can also find an up-to-date chart of the Shiller PE ratio at http://www.multpl.com/shiller-pe/ for future use.

As you can see, the Shiller PE ratio at the beginning of 2016 was 26.49 which is well above the historical average of 16.7 and is approaching the level it attained just before the sub-prime bubble burst. But in the current low-interest-rate environment, many believe an elevated level can be justified.

Our task now becomes estimating the year-end Shiller PE level. This is a challenge but the way around this problem is to use a range — just as we did with the earnings growth component of the model. For our example, let's use a range of 16 on the low end (which is about the historical average) and 30 on the high end (which is above the level experienced before Black Tuesday and the Sub-Prime Crisis but below the Internet Bubble peak).

Let’s pause for a moment to summarize where we are: We are calculating a US stock market forecast for 2016 using a 3-factor model with a beginning dividend yield of 2.11 percent, 2016 earnings growth of -2 to 10 percent and an ending Shiller PE multiple of 16 to 30.

Now let’s sharpen our pencils and get started doing the arithmetic. Ha, just joking.

To make this easier for you, we’ve done all the calculations and presented them in the table below. If you want to know how the calculations are made, you can email us and we’ll send you the excel spreadsheet.

		Earnings Growth						
		-2.0%	**0**	**2.0%**	**4.0%**	**6.0%**	**8.0%**	**10.0%**
	16	-38.4%	-36.4%	-34.4%	-32.4%	-30.4%	-28.4%	-26.4%
	18	-30.7%	-28.7%	-26.7%	-24.7%	-22.7%	-20.7%	-18.7%
Year End	**20**	-23.0%	-21.0%	-19.0%	-17.0%	-15.0%	-13.0%	-11.0%
Shiller PE	**22**	-15.3%	-13.3%	-11.3%	-9.3%	-7.3%	-5.3%	-3.3%
Ratio	**24**	-7.6%	-5.6%	-3.6%	-1.6%	0.4%	2.4%	4.4%
	26	0.1%	2.1%	4.1%	6.1%	8.1%	10.1%	12.1%
	28	7.8%	9.8%	11.8%	13.8%	15.8%	17.8%	19.8%
	30	15.5%	17.5%	19.5%	21.5%	23.5%	25.5%	27.5%

Beginning Dividend Yield	**2.1%**
Beginning Shiller PE Ratio	**26**

What does all this mean? First off, if you take a middle of the road approach and assume that earnings growth for the year comes in at around 6 percent and the market can hold onto its beginning of the year PE multiple of about 26 (it declined to about 23.5, according to multpl.com, during the recent China related sell-off), the table tells us that the market will post an 8.1 percent return for the year. To find this number, simply look at the 6 percent earnings growth column and then follow down to the 26 in the year end Shiller PE ratio row.

If you are more of a pessimist and expect no earnings growth and the PE ratio to contract to 20 by the end of the year, then your forecast is for the market to plunge by 21 percent. On the other hand, an optimistic view, would be to assume 8 percent earnings growth and a PE multiple expansion to 30, which would propel the US stock market to a positive 25.5 percent return for 2016.

As you can see for yourself, there are lots of other possible scenarios.

At Plimsoll, we see a muddle-through environment where earnings rebound a bit benefit from 2015’s energy price collapse and in aggregate growing at around 6 percent for 2016. We expect the PE multiple to contract a little— as investors begin to accept the reality of a slow-to-no growth world and begin to understand the limitations of the world’s central banks in fighting the forces of deflation – closing the year at around 24. If these assumptions are correct, then the resulting return for the US stock market will be essentially flat in 2016.

So there you have it: You now have a model to make your own 2016 US stock market forecast so you can stay above the fray and ignore the day-to-day noise put forth by the mainstream investment media which is of little to no use for the thoughtful investor.

The bottom line for profitable investing in this environment —as we noted in our last article— is to use volatility as a tool to buy growth at the right price. After all, it was Warren Buffett who said: “Price is what you pay and value is what you get.”

Keep an eye out for a future article in which we’ll explain why PE multiples are so volatile in the short-run and how changes in investor emotions can cause them to change on a dime.

Our very best,

The Plimsoll Team

And

Plimsoll Global Allocation Committee

S&P 500 - A broad-based market index, comprised of 500 large-cap companies, generally considered representative of the stock market as a whole.

Dividend Yield: A financial ratio that indicates how much a company pays out in dividends year relative to its share price.

Earnings Per Share (EPS): The portion of a company's profit allocated to each outstanding share of common stock, which serves as an indicator of a company's profitability.

Price-Earnings Ratio (P/E Ratio): A valuation ratio of a company's current share price compared to its earnings per-share. In general, a high P/E suggests that investors are expecting higher earnings growth in the future compared to companies with a lower P/E.

Information provided in this article is general in nature, is provided for informational purposes only, and should not be construed as investment advice. The views expressed by the author are based upon the data available at the time the article was written. Any such views are subject to change at any time based on market or other conditions. Hartland disclaims any liability for any direct or incidental loss incurred by applying any of the information in this article. All investment decisions must be evaluated as to whether it is consistent with your investment objectives, risk tolerance, and financial situation.

The performance data shown represent past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.