ARGUS®

WEEKLY ECONOMIC COMMENTARY

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Q&A: Concerns, Themes and Key Forecasts for 2016

***QUESTION**: Although markets were essentially flat last year, so much happened. The Fed finally hiked rates; oil prices continued their slide; China's growth stalled; and the bull market withstood its first correction since 2011. Given that backdrop, what does Argus regard as its key forecasts for 2015?*

ARGUS ANSWER: At a high level, Argus has six key forecasts for the year.

- We think U.S. GDP growth will continue in the 2.5% range and the economy will once again avoid a recession.
- We think the Federal Reserve will move slowly on rates this year, with only 2-4 hikes by year-end.
- We look for the dollar to stabilize.
- We forecast oil prices will average $40 this year, with a range of $32-$55.
- We look for China growth to continue, though the growth will be more focused on consumer services and less on infrastructure.
- We think a combination of low rates and good economic growth can support 8%-10% returns in stocks.

***QUESTION**: Can you dig a bit deeper into the economy and the Fed?*

ARGUS ANSWER: Let's start with the economy. Between 2Q15 and 3Q15, GDP growth experienced a large swing mainly based on trends in inventories. GDP trends quarter-over-quarter are often impacted by one-off events of that kind. In any given quarter, IT investing might be strong but exports weaken. Or housing will rise, but government spending will fall.

The key factor that keeps us confident about the economy is the trend in consumer spending. Consumer spending, which accounts for two-thirds of the economy, has been advancing at a 3% rate over the past four quarters. Consumers are benefiting from declining unemployment, rising asset prices and increased home values, at least compared to 2009. Wages have also begun to creep higher.

We look for the consumer to keep the overall domestic economy on the growth path in 2016. Given moderate winter weather on the East Coast and in the Midwest so far this year, along with predictions that El Nino will keep temperatures above-average, GDP growth in the first quarter of 2016 should avoid the kind of storm-driven falloffs that the economy experienced in the first quarters of 2014 and 2015.

As for the Fed and interest rates, Argus believes the central bank will actually be more focused on what isn't working for the economy. As we noted, at least some element of the economy tends to be weak in any given quarter. A rapid series of rate hikes would run the risk of reducing consumer spending on housing and investments in IT equipment. The Fed doesn't want to see that. A sharp spike in rates could also cut into corporate profit margins. In an era of slow-top-line growth, companies may resort to layoffs in order to drive profit growth. We are beginning to see this already. Again, this is something the Fed will want to avoid.

Altogether, Argus believes the Fed will be following these at-the-margin factors very closely and will be very hesitant to move aggressively in 2016.

***QUESTION**: You mentioned slow top-line growth, and the strong dollar certainly has not helped. Yet your outlook for dollar stabilization is against the consensus, as many expect the dollar to continue to head higher on the relative strength of the U.S. economy. What are you seeing that's different here?*

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ARGUS ANSWER: The rise of the dollar was one of the most important trends for the markets in 2015. The greenback appreciated almost 12% last year after gaining 10% in 2014, driven by domestic economic strength and relative weakness in the economies of key trading partners such as Japan and numerous European nations. Domestic and foreign currency markets also priced in prospects for the Fed's first rate-hiking cycle in nearly a decade.

But after a multi-year run, the dollar is less than 10% from its cycle peak set back in 2002. We don't see another year of double-digit gains in 2016. Not only is the Fed's rate cycle at least partly priced into the currency; the Fed's rate hikes will ultimately begin to slow the U.S. economy.

Further, Japan and Europe are starting to benefit from their QE programs, which remain in place while the U.S. Fed taps on the brakes. In short, we don't think the U.S. economy will appear as strong against its peer group as it did in 2014-2015.

There's also something for the Fed to worry about here. A stronger dollar raises risks for growth in emerging markets overseas. Ours is a true global economy; U.S. exporters need overseas economies to be healthy in order to sell goods to them. If the Fed raises rates too fast, and attracts too much capital into the U.S. and away from emerging markets, these economies may not be able to afford U.S. goods, and our economic growth may start to sputter more quickly than we expect.

These are a few of the reasons that we think the dollar will be relatively stable in 2016. This should help corporate earnings and the stock market this year.

***QUESTION**: What is the Argus outlook for the stock market? As we headed into December, Argus stated that stocks were about 5% undervalued; stocks experienced further weakness into year-end. Is Argus still bullish on equities?*

ARGUS ANSWER: We remain bullish, based on the level of stock prices, bond prices, earnings, interest rates and inflation.

Since 2009, our model, which is based on these factors, has consistently concluded that stocks are undervalued, with a trough of about a 50% discount back in 2009. That compares to an overvaluation peak in 2007-2008 of about 50%.

So the model, and the market, is a bit like a pendulum. Obviously, stocks have recovered over these past seven years. Given current interest rate and earnings trends, we think the market is about 5% below fair value. Because we routinely see stocks move above fair value and stay there, we have set a target price for the S&P 500 in 2016 at 2275.

***QUESTION**: Let's dig a little deeper into style and size. Within the domestic stock market, does Argus favor large-caps over small-caps? And do you prefer growth or value?*

ARGUS ANSWER: Small-cap stocks underperformed in 2015, as the Russell 2000 dropped 5.7%. Large-caps have now outperformed small-caps over the past five-year period as well (60%-43%), while the two classes are essentially equal over the 10-year period (55%-59%).

On valuation, large-cap stocks appear to be the better value, based on our review of trends in P/E ratios, price/sales ratios and dividend yields. And with the Federal Reserve raising interest rates, less-risky assets could be poised for outperformance. Our recommended exposure to small- and mid-caps is 15% of equity allocation, in line with the benchmark weighting.

In terms of growth and value, growth stocks sharply outperformed in 2015 (ahead by 1020 basis points) and driven by the FANG stocks (Facebook, Amazon, Netflix, and Google-turned-Alphabet). We expect better breadth in 2016, though investors will continue to pay a premium for companies generating revenue growth along with EPS growth. Putting that all together, we expect value to perform better in 2016.

***QUESTION**: How should investors factor your forecast for low oil prices into their clients' portfolios?*

ARGUS ANSWER: We think the price per barrel of West Texas Intermediate Crude will average $40 in 2016. That's below the average of $50 in 2015 and $90-plus in 2013-2014. Low oil prices are not good for highly indebted exploration & production companies; we would avoid them. But low oil prices are good for refiners, as they thrive on the high volumes created by cheap gasoline and more miles driven. And we would not be surprised to see well-capitalized integrated oil companies snap up assets on the cheap. We have an Under-Weight recommendation on Oil, but the sector still represents 6.5% of the market capitalization of the S&P 500. Our top oil picks are refiners and large-cap potential consolidators in the international integrated and E&P group.

We also think the Industrial sector makes sense here. This group underperformed in 2015 because of trends in the dollar and oil patch. The best firms should be cycling through those trends in the next quarter or two; strong-dollar distorted comparisons have begun to moderate, and the earnings outlook should improve.

***QUESTION**: What sectors does Argus regard as most promising given the current environment? And what sectors would you avoid?*

ARGUS ANSWER: We rebalance our recommended sector weightings four times a year using a multi-input model that considers EPS growth, stock momentum, absolute and relative valuation, safety & quality, and analyst conviction. Based on our latest analysis, we recommend that investors Over-Weight four sectors: Technology, Healthcare, Industrial and Consumer Discretionary.

We have already touched on Consumer Discretionary and Industrial. In Technology, we look for the Internet of Things (IoT) to move from development phase to implementation in 2016. The establishment and mainstreaming of IoT, which enables millions of devices to communicate with one another, is being driven by customized development of wireless communications and sensor technologies and by key themes including smart home, driverless cars, predictive analytics, and increased national vigilance and cyber-security.

IoT should begin to benefit a range of information processing and communications equipment vendors; software companies; and semiconductor, sensor and process control companies. As such, IoT not only impacts Technology companies, it is a major growth opportunity for industrial companies participating in process controls and automation, along with defense names heavily invested in information, intelligence, reconnaissance, and surveillance.

As for Healthcare, this group has consistently been a top-performing sector in the U.S. market since the dark days of 2008-2009. Healthcare's long outperformance has largely been driven by a resurgence in promising new products from pharmaceutical companies' pipelines. The latest crop of new drugs – treating conditions such as multiple sclerosis, hepatitis B, diabetes and cancer, among others – rivals the batch produced during the mid-1990s that included blockbuster treatments for high cholesterol, depression, anemia and ED. We expect this R&D Renaissance to continue driving Healthcare outperformance in 2016.

Looking into 2016, many are worried that drug pricing may come under scrutiny during the Presidential primaries. We have little doubt that lawmakers will focus on the issue, but we think they will be looking more closely at companies that buy generic drugs and immediately jack up prices, as opposed to the companies that are spending heavily (15%-30% of sales or more) on innovative R&D.

QUESTION*: What other investment trends does Argus think will be important as the year progresses?*

ARGUS ANSWER: Given high stock prices, record levels of cash at corporations and an economy growing at 2.5%, corporate managers may look to spur growth through acquisition activity, as they did in 2015 in the Insurance, Pharmaceutical, Technology and Chemical sectors, among others.

We also think that dividend income is going to continue to be an important element of total return. But there's a subtle difference between investing in high-yield stocks and in dividend growth stocks. High-yield stocks typically have dividends that pay out in the 5%-8% range. They are perceived as being at risk in a rising rate environment. This is because at the margin, as interest rates move higher, equity investors could be drawn to the relative safety of bonds over high-yield stocks. Further, high-yielding equities may maintain fixed differentials to bond yields: as bond yields rise, so too do dividend yields, meaning the stock price declines. Finally, a yield in the 7%-10% range could signal a dividend at risk, particularly in the Energy sector.

By contrast, companies that are growing dividends at a double-digit rate are signaling something else: that their balance sheets and cash flows are strong and their outlook is positive, amid market uncertainty. We have found that sweet spot for yield is about 1.50%-2.25%.

Another key trend Argus has uncovered is sustainable impact investing. Many people know this as Socially Responsible Investing, but the discipline has evolved. No longer is the focus of such strategies on what not to do: no guns, no tobacco, no gambling. Instead, the focus has swung to best practices to sustain the company, the climate and shareholders. We have a list of Argus companies with high sustainable ratings in our upcoming Special Situations report.

In fact, all of these investment themes are regularly highlighted in popular Argus reports such as Special Situations, Market Watch, Market Digest and our Portfolio Selector.

QUESTION*: What should we be worried about?*

ARGUS ANSWER: Unexpected events tend to hit hardest. But well-know factors also constitute risk. For one, a fall in oil prices to the mid-to-low $20s would likely signal that China's growth has completely stalled. That would not be good for global or domestic GDP growth.

For another, if the Fed hikes rates too frequently, then we are likely to see a sharp economic slowdown and potential bear market in 2017-2018. Our studies have shown that stocks are generally okay for the first year after the Fed begins to hike rates; but the second year can be a problem.

For a third, we think it is important to keep in mind that the economy has grown for six consecutive years and the stock market has risen or been relatively flat for seven years. We are no longer in the "early innings" of economic recovery or of a bull market. The rising tide will not lift all boats. Investors will need to be focused on factors such as top-line growth and balance sheet strength as growth in this later stage of the cycle becomes harder to achieve.

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