ARGUS®

WEEKLY STAFF REPORT

May 18, 2015
Vol. 82, No. 68

Turbulence in the Rate Environment: Our Monthly Survey of the Economy, Interest Rates, Markets and Sectors

IN THIS ISSUE

Many investors are making an easy comparison between winter-impacted GDP for 1Q15 and winter-impacted GDP for 1Q14. Beyond the now-fading memory of frozen fingers and toes, the two periods have little in common. Last year's first-quarter was characterized by consumer-spending exhaustion, loss of risk appetite, and high-yield sector leadership as bond yields worked lower.

The 2015 first quarter featured huge swings in interest rates, commodity prices and currencies. Long-dormant Europe came alive, while rate-cutting China finally became a hot stock market again. In the U.S., high-yield names are getting crushed on prospects for rising rates. And the best-earning sectors have underperformed during the 1Q15 earnings season, while the worst earners lead the performance pack.

The biggest difference between 1Q14 and 1Q15 is what comes next: the Fed remains on course to enact more restrictive monetary policy, and soon. Given the Fed's dual mandate, the turbulent events transfixing the market are secondary to the metrics around inflation and unemployment that actually drive Fed policy. The Fed could begin raising rates as soon as June and likely no later than September.

THE ECONOMY, INTEREST RATES, AND EARNINGS

Winter 2015, like its predecessor, was sufficiently fierce to stall the economy and maybe even cause economic contraction. The advance reading on 1Q15 GDP was 0.2%, better than last year's 21% contraction – for now. Recent trade balance data appears likely to tip that slight advance over to a slight decline.

As usual, there were both positives and negatives to take away from the GDP report. In 2014, Old Man Winter himself was the primary obstacle. The economy in 1Q15 had to contend with near-record snow, ice, and cold, of course, but also strong dollar impacts on trade and competitiveness; along with the collapse in oil prices that decimated energy sector employment and capital spending.

Deceleration from 2.2% growth in 4Q14 to 0.2% growth in 1Q15 reflected lower real personal consumption expenditures (PCE), the downturn in exports, lower government spending, and particularly weak non-residential investment. Non-residential fixed investment – a proxy for corporate capital spending – was down 3.4% in 1Q15. The primary drag was a record 23% decline in non-residential structures, which we believe results from an absolute halt in energy-patch capital investment.

(continued on next page)

Strong dollar hit overseas competitiveness, as exports dropped an estimated 7% in 1Q15; based on March trade data, that number could be revised lower. Federal spending inched up 0.3%, but state and local consumption contracted by 1.5%.

In the silver lining department, real PCE was up 1.9% in 1Q15. While that is down from 4%-plus growth in the holiday quarter, 1Q real PCE signals that the consumer recovery is far from done. Real gross domestic purchases, which includes purchases of both goods produced here and goods produced overseas, was up 1.5% – down from 3.2% in 4Q14, but better than 0.2% absolute GDP growth for 1Q15.

We still look for roughly 3% growth in the remaining quarters of 2015, which would drive something like 2.5% growth for the full year of 2015. But, similar to what happened in 2014, growth in the middle quarters of this year must bounce back sharply for full-year GPD to reach 2.5% growth. Our preliminary forecast for 2016 calls for 2.5% growth, featuring a gradual moderation in growth across the year as higher interest rates begin to bite in the second year of the Fed's rate-tightening cycle.

Whipsaw movements continue in interest rates. For the past year or more, the only consistent thing about bonds is their inconsistency. At this time, the market appears to be readying for a period of rising rates, given the imminence of the first Fed rate hike – perhaps in September, but possibly as soon as next month.

The 10-year yield, which ran from 2.25% early in March to 1.9% early in April, is now back in the 2.2% range. Yields rose across late April into early May on better data and the solid April jobs report, much as bond yields fell in the prior mid-month period in response to worsening economic data and feeble March nonfarm payrolls.

The flattening we had seen in the yield curve earlier this year has abated. At the same time, rates are not back to where they were a year ago, particularly at the long end. Investor expectations for a rate increase are now situated somewhere in the June to September timeframe, and that is causing volatility in the middle of the curve. The two-year yield went from 0.75% in March to 0.49% in April to 0.63% in May. The five-year yield went from 1.69% in March to 1.29% in April to 1.56% in May, which puts the five-year yield about in line with where it was at this time last year.

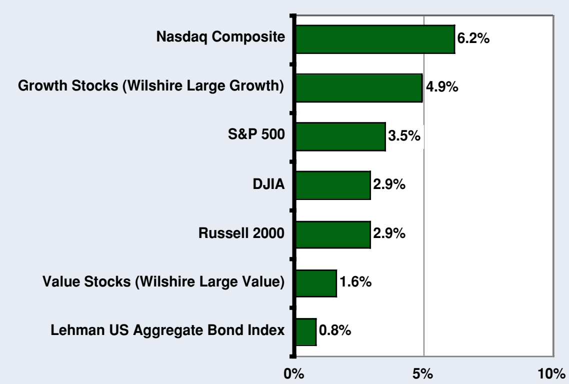
A year ago at this time, yields were moving down, following the unexpectedly prolonged winter and signs of consumer exhaustion in housing and discretionary spending. This time around, the consumer appears to be in good shape; the housing and automotive segments are still trending at high levels. Strong dollar and weak energy hurt first-quarter GPD; both remain headwinds for the domestic economy and corporate earnings.

(continued on next page)

MAJOR INDEX

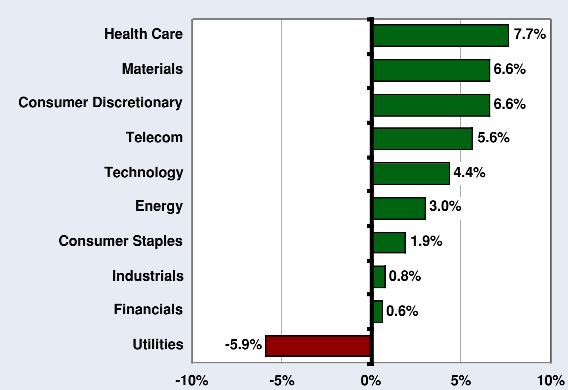
DATA AS OF MAY 8, 2015

Year-To-Date Return



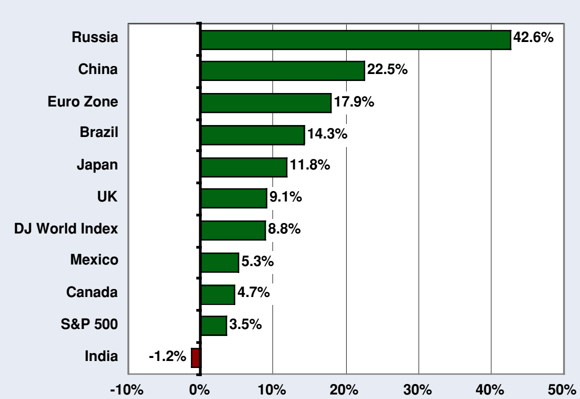
SECTOR PERFORMANCE

Year-To-Date Performance



INTERNATIONAL EQUITY MARKET PERFORMANCE

Year-To-Date Return



Source: Dow Jones, Argus Research

But remember that the Fed's dual mandate is based on full employment and price stability, not a particular level of GDP growth. With unemployment at 5.4% and inflation meeting the 2% growth target, the Fed's dual mandate has arguably been fulfilled. More than any talk of tightening, actual implementation of restrictive monetary policy will likely push up the entire yield-curve.

We continue to believe the US Federal Reserve is on track for its first quarter-point rate hike at mid-year or possibly soon after. We expect a very go-slow approach to additional hikes, with the Fed funds rate highly likely to end 2015 still below 1%.

We have made no further changes to our 2015 EPS outlook, after cutting our target in March to $126, from an earlier $131. Earlier this year, we were modeling 9% year-over-year EPS growth from 2014. We now look for 2015 EPS growth in the 6% range. While 1Q15 earnings met our expectations for low-single-digit growth, earnings were certainly better than the consensus call for a 5% contraction. On that basis, we will likely see full-year consensus EPS growth estimates move higher.

The winter weather played a negative role in first-quarter earnings, but this year it was a supporting role. Most of the pressure on 1Q15 earnings stemmed from strong dollar impacts on currency repatriation and weakened competitive position. The primary drag has been energy earnings. Including energy, S&P 500 earnings were up less than 3% in 1Q15. Excluding energy, earnings rose more than 8%.

The strong dollar and the corollary weak euro is having the expected salutary effects on eurozone competitiveness – but few investors thought that positive impact would manifest so soon. Euro zone GDP is expected to grow 0.5%, which would mark one of the few times since the great recession that Europe has grown faster than the U.S. In Asia, China's third rate hike this year signals risks in that economy, but may also begin to stimulate growth.

We expect EPS growth to be somewhat back-end-loaded in 2015. Off the reduced base, we look for EPS growth of 10% for 2016, to the $139 range. Our 2016 forecast could be negatively impacted by the timing of Fed monetary policy, particularly if the Fed raises rates frequently and in half-point chunks. Still, we think our earnings growth forecast can withstand up to two percentage points of higher rates, given the current level of zero.

DOMESTIC AND GLOBAL MARKETS

We have been spoiled by multiple years in which the U.S. stock market was up in double digits by mid-year. The market has inched ahead this year, and it may seem like a slow crawl; beneath the surface, however, significant style changes are occurring.

The market this year is growth-y. Currently, the Wilshire Growth index is up 4.9% and holds a 330 basis point lead over the Wilshire Value index. But preference for growth over value does not mean that investors have swung exclusively to small- and mid-cap names and away from large-caps. The DJIA and the Russell 2000 are both up just under 3% for the year. And the S&P 500 is doing slightly better with a 3.5% gain, even amid expectations (unfounded) that EPS growth would be negative in 1Q15.

Total returns for the Lehman US Aggregate Bond index continue to melt away. The index is up just 0.8% year-to-date, compared with a 3% gain at this time last year. With the first Fed rate hike somewhere between one and four months away, it is hard to see how this index can hold its slim gain for the year. On the other hand, and in a reversal of the usual formula, investors have been selling the rumor of a rate hike for so long, they may surprise us by buying the fact.

Sector performance has turned topsy-turvy, with last month's losers in the lead and last month's winners in the garbage can. An analysis of full-year sector performance can be misleading, because it does not capture recent sector leadership shifts. Still, the numbers don't lie; and while growth may be back in fashion for now, we could just as easily see a shift to defensive and high yield if economic growth weakens.

The best performer year-to-date is Healthcare, up nearly 8% despite some recent profit-taking. After that primarily defensive sector, risk-on and economically sensitive sectors such as Consumer Discretionary and Materials follow with nearly 7% appreciation. Technology and Energy are mid-pack with mid- to low single-digit gains, while Industrials and Financial Services are barely above breakeven.

The annual decline in Utilities has worsened over the past month and the sector is down nearly 6% year-to-date. Utilities, which led all sectors in 2011 and nearly was top sector in 2014, is like a Super Bowl winner that can't make the playoffs the next year. We expect the pressure on interest rates to continue impacting all sectors with a preponderance of high yield names, given fixed differentials between equity yields and the 10-year yield.

In terms of sector weightings, the unusual volatility in interest rates, coupled with fast-moving currency and commodity trends, has caused unpredictable sector performance shifts that have rejiggered sector weightings. Notably, earnings performance is not being reflected in stock price performance. In several areas, earnings losers are market winners, and visa versa. Energy earnings are down about 50% in 1Q15; but energy stocks are on fire, based on the recovery to-date in energy prices. That has caused Energy weighting to rebound to 8.5%, up 50 basis points in just one month.

Technology earnings were mixed, with almost all sector net growth complements of Apple. But Technology added 20 basis points of sector weight in a month and, at a 19.9% weighting, is near that magical 20% weighting.

On the downside, Healthcare earnings have been strong. But over the past month, investors cashed out

Healthcare winners to buy Energy stocks. That caused Healthcare sector weighting to slip 30 basis points in one month to 14.6%. Consumer Discretionary and Financial Services both had strong earnings quarters, but both are down fractionally over the past month.

On a year-over-year basis, long-standing trends are intact; Energy has a smaller weight, and Healthcare a larger weight. But the accelerating volatility in interest rates, currencies and commodities may signal a major change in sector preference, positioning and performance going forward.

In terms of global market performance, it may not make sense, but it continues to be true: nations that cut interest rates and engage in quantitative easing have the best stock markets. China may not yet be at the QE stage, but it has cut interest rates several times this year, and there are likely more to come..

Europe appears positioned for positive GPD growth this year as the weak euro improves its global competitiveness. The Eurozone, also benefiting from being in the early stages of QE, is up 18% year-to-date. Russia is engaging in all kinds of fiscal and monetary stimulus, and seems to have weathered the worst of half-hearted international sanctions

On average, the global indexes in our survey group are up 13% this year, compared with the tepid 3% gain for the S&P 500. While the U.S. remains a global powerhouse, quite frankly our rate cutting days are behind; and it is clear that higher rates lie ahead in the U.S.

At this point, higher rates will likely benefit various investor and demographic classes that have been left behind, such as senior citizens on fixed incomes. But for the near term, QE dynamics have made the U.S. stock market less attractive to global investors than it was three or four years ago.

CONCLUSION

After eight years without a rate hike, a new reality is about to take hold. We believe economic and earnings fundamentals are strong enough to withstand this 180 degree change, and that the stock market can continue to move higher. But get ready for further turbulence along the way.

Jim Kelleher, CFA,
Director of Research

TECHNICAL TRENDS COMMENTARY

On May 8, the S&P 500 closed above 2,110 for the fifth time this year, though what to make of it is anyone's guess. The close at 2,116 slightly broke a recently established pattern of lower highs, but that was only three tightly bunched lower highs; through late April, the S&P 500 had been in a month-plus pattern of rising highs. The month-long pattern of higher lows also has been supplanted by a few recent lower lows. In all, the chart is inconclusive.

The rally driver on May 8 was a "Goldilocks" jobs number in the 220k range. A reading above 300K would have triggered fear of imminent tightening and likely would have tanked the market. A reading under 150K would confirm that recent soft economic data signals real deceleration. The jobs report sent neither signal, setting up another inconclusive week in this inconclusive trading year.

Yet after the strong rally following the jobs report, the U.S. stock market was back to the blahs on May 11. The torrent of positive EPS reports that drove the late-April and early-May market has slowed to a stream and will soon be a trickle.

Pundits wondering why the U.S. market can't get going may be missing the point. It's not our earnings and data that is suspect; it's that the QE ball is in somebody else's court.

The evidence is hard to ignore. As of the close on 5/8/15, the S&P 500 had delivered total return of 3.5% year to date. The Eurozone, which is in the very early innings of its QE program, is up about 18% YTD. China does not have QE, but it has cut interest rates three times this year (and with a sputtering economy, will likely enact several more rate cuts before the year is over). The leading Chinese market, the Shanghai Composite, is up over 22% year to date in 2015.

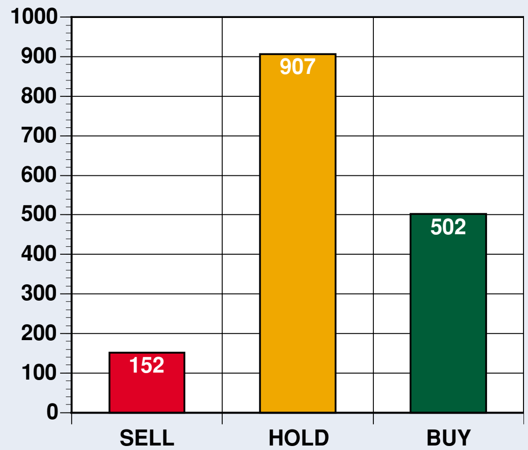
We are not writing off the U.S. market for 2015. But U.S. bulls likely cannot count on overseas money. U.S. retail investors are on the fence, and U.S. institutional investors have grown less bullish as earnings season has wound down.

There are elements about the 2015 market that remind us of 2011. After that flat year, the market was energized for a strong 2012-14 run. If we can avoid 2011's big mid-year crash, 2015 may be another consolidation year ahead of a multi-year bull run.

Jim Kelleher, CFA,
Director of Research

SPECIAL SITUATIONS & SCREENS

ARGUS RESEARCH RATING DISTRIBUTION



ARGUS RATING SYSTEM

Argus uses three ratings for stocks: BUY, HOLD and SELL. Stocks are rated relative to a benchmark, the S&P 500.

A BUY-rated stock is expected to outperform the S&P 500 on a risk-adjusted basis over a 12-month period. To make this determination, Argus Analysts set target prices, use beta as the measure of risk, and compare risk-adjusted stock returns to the S&P 500 forecasts set by the Argus Market Strategist.

A HOLD-rated stock is expected to perform in line with the S&P 500.

A SELL-rated stock is expected to underperform the S&P 500.

MASTER LIST CHANGES

		Rating		Date
	Stock	From	To	Change
Fiserv Inc	FISV	BUY	HOLD	5/7/15

RECENT BUY UPGRADES

	Stock Symbol	Raised to BUY On this date
Fiserv Inc	FISV	5/7/15