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2011 and 2015: Parallels & Differences in Two Rough Years

This year is shaping up as the worst stock market year since 2011. Like 2011, 2015's stock market performance has been bedeviled by a range of issues both homegrown and international.

The parallels between 2011 and 2015 are not exact, but there are some uncanny resemblances, particularly in the stock charts. In 2011, much as it does today, the stock market faced a combination of economic, geopolitical and policy challenges that stretched from the U.S. to around the globe. Despite these challenges, underlying strength in fundamentals in 2011 was sufficient to awaken value investors and reverse the course of a downward trending market in the year's final months.

Of course that hasn't happened yet in 2015; stocks are still trending down. As in 2011, a better-than-average fall rally will be required to get full-year performance to flat for the year.

But flat in 2011 turned out to be a good thing for market returns in subsequent years. The upside of flat or down years is that they can revive a bull rally that had been running out of steam. That's what investors are hoping for in 2015 heading into the final quarter.

2011 & 2015: THE STOCK CHARTS

On the final trading day of 2011, the S&P 500 closed at 1,257.60, or less than a point below its 2010 closing price of 1,257.84. The S&P 500 was positive for 2011, based on slightly more than 2% of dividend income. But on a capital appreciation basis, 2011 marks the only negative year in the bull market that began in March 2009.

The factors hurting the stock market this year are so familiar to us that their clamor tends to drown out challenges faced, and overcome, in prior years. In the haze of time, 2011 may seem bucolic, part of the long rally that began in March 2009 and has pushed the market to new all-time highs. In fact, as of the end of 3Q11 on 9/30/11, the S&P 500 was down 10.1% for 2011. The S&P 500 at mid-year 2011 was up 5.0%, so the 3Q collapse was particularly dramatic.

As of 9/15/15 and with 12 trading days left in 3Q15, the S&P 500 was down 5.1% for the year. Rather than representing a sharp turn from mid-year, the index is giving us more of the same: the S&P 500 was barely ahead by 0.2% at mid-year 2015.

The S&P 500's recovery to flatline for 2011 required a heroic autumn, with most of the gain centered in October 2011 (up 10.8%), followed by a 1.2% November decline and wrapping up with a 1.6% December gain. What can we expect in autumn 2015? Since 1980, the S&P 500 has averaged capital appreciation of 4.5% for the fourth quarter. To get to a flat performance for 2015, we will need a slightly more positive tone across the remainder of September, followed by at least average capital appreciation for the fourth quarters since 1980.

A final technical link between 2011 and 2015 is provided by daily rate of change on the S&P 500. Daily rate of change (DRC) is determined by squaring daily percentage changes and then averaging their square roots to negate the self-cancelling effects of plus and minus days. DRC tends to be high (above 1%) in strongly trending years, such as 2008 and 2009, but it can also be high in inconclusive years in which bulls and bears are wrestling for control.

Thus, DRC was 1.04% in 2011, the only year (excluding 2009) during the ongoing bull market in which DRC was above 1.0%. That was followed by three "uncontested bull" years of 2012-2014, in which the market roared ahead in

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double digits and for which DRC averaged a tepid 0.55%.

For 2015 to date, DRC has averaged 0.70%. But DRC was 1.15% in August, has been 1.41% so far in September, and is averaging 0.94% for 3Q15 to date. As in 2011, bulls and bears in 2015 are pulling so hard on either end that the stock market is hardly going anywhere.

2011 & 2015: THE DOMESTIC ECONOMY

In 2011, the leading domestic challenge in the front of the market was not economic; it was policy-based, and it was decidedly self-inflicted. After rousing wins in the 2010 midterm elections, the GOP was emboldened to reclaim political momentum from the White House. The ideological struggle was centered around government spending, as the deficit approached $1.3 trillion for the October 2011 fiscal year (the cycle peak was $1.4 trillion for 2009). The chosen battlefield was the federal debt ceiling, set to expire on 7/31/11. Although consensus on extending the debt ceiling was reached before deadline, the bitter partisan divide and brinksmanship prompted a selloff that carried from the final week of July into mid-August.

Our legacy of this battle was sequestration. Though disliked then and now, sequestration – along with restored tax rates and, primarily, higher tax receipts in an expanding economy, enabled the government to cut its deficit to one-third of peak levels.

GDP growth in 2011 was far from spectacular, averaging less than 1% per quarter in the first half of that year. Yet GDP was in a rising trend in 2H11, growing 1.8% in 3Q11 and 3.0% in 4Q11. At the time, the U.S. was still executing the shaky handoff from public sector stimulus (TARP, first-time homebuyers credit, “Cash for Clunkers”) to the private sector economy.

In 2015, the leading domestic economic challenges are strong dollar and the related impacts of weak commodities and energy pricing. Strong dollar reduces overseas competitiveness of U.S. multinational companies, hurting exports. The deceleration in China’s economy has disrupted global trade, slammed resource-dependent emerging economies, and reduced global demand for energy and for basic materials. Within the U.S., in the early years of recovery the energy complex had been one of the best sources of growth in employment and capital spending. The now year-long weakness in energy prices has slammed hiring and shut down capital investment in the oil patch.

Despite these challenges, U.S. GDP growth has been reasonably good. On a trailing four-quarter basis (3Q14 through 2Q15), U.S. GDP growth has averaged 2.9%. On a trailing five-quarter basis, U.S. GDP growth has averaged 3.2%. The other side of the coin, when it comes to weak energy pricing, is cheap gasoline and home heating costs. Coupled with jobs growth and rising wages, cheap gas is fueling a boom in the domestic consumer economy.

In 2015, as in 2011, challenges facing the domestic economy are real. But the core economy appears sufficiently strong to fuel further growth even amid global disruptions from China and elsewhere in the emerging world.

2011 & 2015: THE GLOBAL & POLICY ENVIRONMENT

In 2011, we first began to hear about Europe’s sovereign debt crisis. That crisis was actually long in the making. Following creation of the Eurozone and during the pre-2008 crisis years, many smaller European nations were profligate with the common currency, creating government and pension infrastructures that were out of whack with tax receipts. The 2008-2009 Global Recession revealed these huge gaps between outlays and receipts, and by 2011 the sovereign debt issued by many peripheral European nations was plunging in value.

By mid-2011, seemingly all of Europe was enmeshed in the sovereign debt crisis. While Portuguese debt should not have mattered in Peoria, recall that Peoria is home to Caterpillar Inc. The profit lure of globalization also brings pitfalls.

The impacts on U.S. business of European weakness were likely overstated; U.S. GDP growth was strong in the back half of 2011. One key: even in its best years, the Eurozone never grew very much. During the worst of the sovereign debt crisis, the Eurozone did not shrink very much.

Flash ahead four years. China is the world’s number two economy, and its tremors are seemingly shaking the world. China is executing the transition from a production & export economy to a consumption economy. The government is simultaneously seeking to minimize shadow economy excesses and reduce speculation in the housing sector. These painful transitions are likely necessary for long-term economic health. At the same time, the Chinese government has been absolutely ham-handed in trying to prop up the Chinese stock market. Every intervention awakens greater fears and leads to renewed selling. China’s communist leaders are learning this free-market lesson the hard way.

The other major global challenge at present is the disconnect between Federal Reserve rate policy in the U.S. and central bank policy everywhere else. As U.S. Fed policy becomes more restrictive, policy around the world is becoming more accommodative. If concern about imminent tightening is exacerbating dollar strength, won’t the first Fed rate hike really make the dollar surge?

The dollar has likely priced in the first round of Fed rate hikes. We would argue that stock, bond and currency markets here and abroad would be better off with the certainty that comes from clear Federal Reserve policy, rather than the endless will-they-or-won’t-they speculation that is keeping markets unstable.

Still, Argus Chief Investment Strategist Peter Canelo believes the Fed will have to consider factors beyond our shores. China is seeking to devalue the yuan and cut interest rates simultaneously. A first Fed rate hike might trigger an uncontrollable drop in the yuan, which could threaten a broader global economic slowdown. On that basis, Investment Strategist Canelo believes the Fed may hold off on its first hike until December.

2011 & 2015: EARNINGS & VALUATIONS

Perhaps the clearest divide between 2011 and 2015 is earnings growth. For 2011, S&P 500 earnings growth was 17.6%. In 2011, earnings had just reached new peak levels after collapsing in 2008 and early 2009. The pre-recession peak in S&P 500 earnings was $87 in 2006, followed by $82 in 2007 and $49 in 2008. From $56 in 2009, S&P 5000 earnings rose 48% in 2010 to $83 before reaching $98 in 2011.

For 2015, Argus is modeling that S&P 500 earnings will grow 3%, to $123 – and we are ahead of consensus. Backing out energy earnings, however, S&P 500 earnings for over 90% of the market will grow in the 7%-9% range. As we move into late 2015, energy earnings comparisons will become more neutral to the overall market, and we look for 10% growth in 2016 EPS.

The S&P 500 finished 2010 trading at 13.7-times trailing 12-month earnings. Because the index level did not change in 2011, the S&P 500 finished 2011 trading at 13.2-times trailing 12-month earnings.

This time around, the S&P 500 finished 2014 trading at 17.2-times trailing 12-month earnings. With the index down year-to-date while earnings are creeping higher, the S&P 500 currently trades at about 15.9-times forecast 2015 earnings and at 14.5-times forecast 2016 earnings.

The market multiple on forecast 2016 earnings is not too far above the 2011 trailing market multiple. In neither case do we see signs of worrisome overvaluation. With the bulk of S&P 500 earnings still tied to the U.S., and with jobs, GDP, and the consumer economy all moving in the right direction, the market appears attractively valued with room to reaccelerate.

CONCLUSION

The key lesson of 2011 is that a stand-still market in a period of still-solid fundamentals allowed a rewinding of the valuation clock. In the three years following 2011, meaning 2012 through 2014, the S&P 500 averaged capital appreciation of about 18% and total return of about 20%.

From its beginnings in March 2009, the bull market has reached 78 months – longer than the 60-month average bull market. However, bulls do not die of old age. As in 2011, a stand-still year could turn the bull's drinking trough into a fountain of youth.

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