Current Perspectives

By Bill O'Grady and Mark Keller

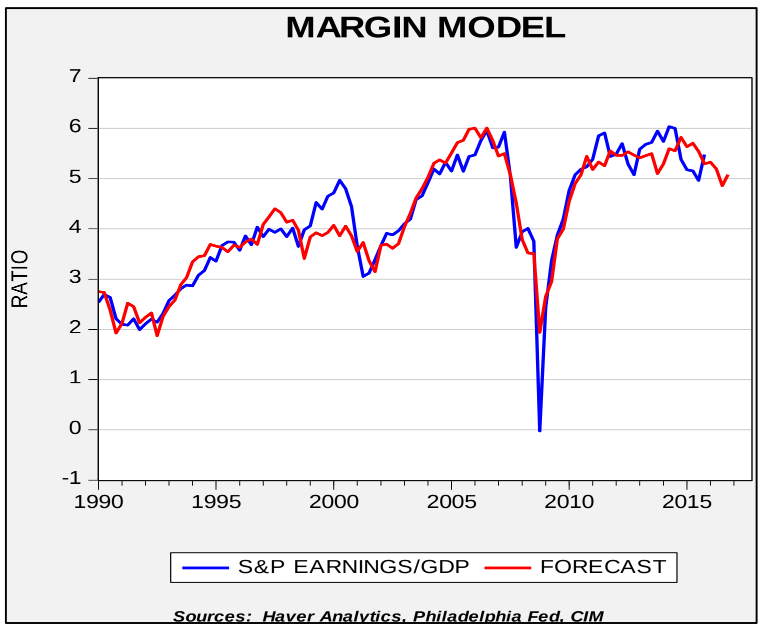
2016: An Update

Summary: This report is an addendum to our original 2016 forecast. In our original [2016 Outlook](), we forecasted a year-end S&P 500 of 2214.39, based on earnings of $121.67 and a P/E of 18.2x. As we will document below, we have revised our forecast to 2033.35, with earnings of $109.32 and a P/E of 18.6x. There are two factors behind the lower adjustment. First, our forecast for profit margins has contracted, and second, economic forecasts have been revised lower. The slowdown in economic growth, as forecast by the Professional Forecasters Survey from the Philadelphia FRB, accounts for $2.45 of the decline in earnings. The drop in expected margins accounts for the remaining $9.90.

For now, we have not changed our interest rate forecasts even though the 10-year yield is below the lower end of our forecast range. We expect a recession to be avoided which likely means that yields will move back into our expected range in the coming weeks.

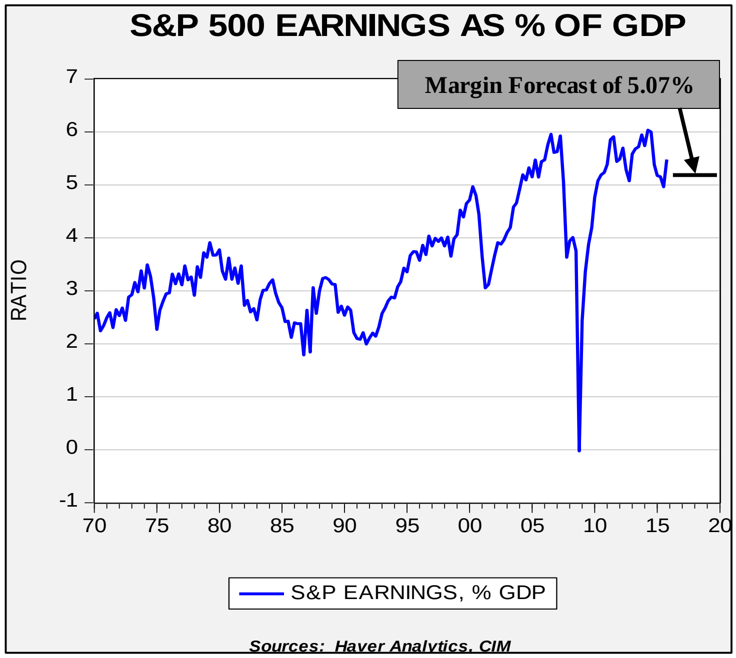
The Adjustment to Equities

The primary reason for the reduction in our earnings forecast is due to a lower forecast for margins. We estimate S&P 500 earnings based on nominal GDP and the level of margin. We use the Philadelphia FRB survey of professional forecasters for our GDP forecast and use a proprietary model to estimate the percentage of GDP that S&P 500 earnings will represent. The model uses unit labor costs, the ratio of exports to GDP, fed funds, credit spreads, the expectations for national income product accounts profits to GDP, corporate cash flow data and the dollar's exchange rate as independent variables.

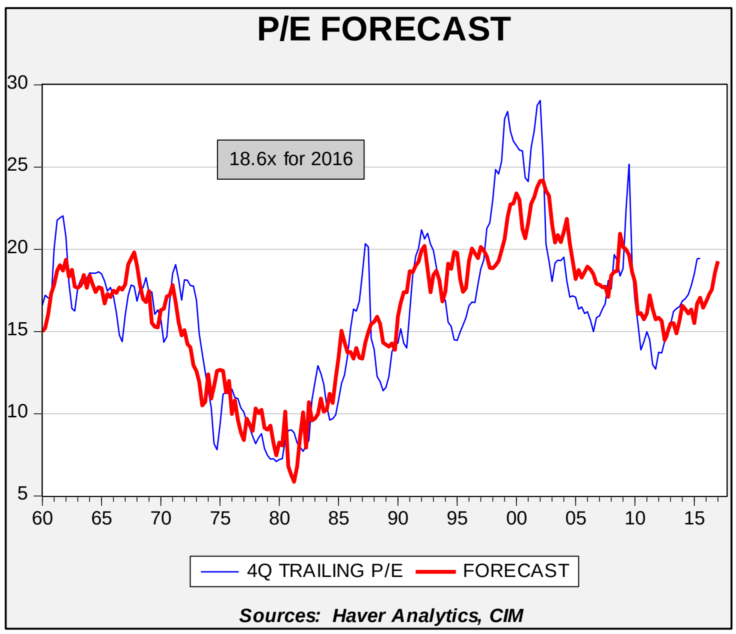


The forecast through 2016 shows steadily contracting margins. The factors that have deteriorated since our initial forecast are cash flows and credit spreads.

Although we have downgraded our earnings estimates, we have boosted our P/E forecast from 18.2x to 18.6x. Our P/E model uses the ratio of Americans ages 35 to 54 compared to the total,[1] corporate bond yields, consumer sentiment, fed funds and trend inflation. The primary support for the increase in our multiple is a lower estimate for fed funds. We expect the FOMC to raise rates once this year.



The current P/E is running ahead of our forecast; thus, we may see continued choppy markets in the first half of the year. However, we believe the current multiple will be justified as the year progresses. The combination of earnings expectations of $109.32 and a P/E of 18.6x results in a year-end forecast for the S&P 500 of 2033.35, which is down 0.5% from last year.



The four caveats we outlined in the earlier report remain in force. If policymakers err by tightening too much, the elections dampen investor sentiment, the global economy drags the U.S. into recession or a geopolitical event of sufficient magnitude occurs, our forecasts will be too optimistic. At present, we still think that the highest probability outcome is a mostly flat year for equities.

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This report was prepared by Bill O'Grady and Mark Keller of Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change. This information does not constitute a solicitation or an offer to buy or sell any security.

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[1] These are the accelerating earnings years and the period when households begin investing in earnest.