HBK Wealth Management
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WEEKLY ECONOMIC COMMENTARY

This Week's Economic Review and Outlook

January 2015

Our roads to success may have twists and turns and ups and downs; together we can navigate a course and enjoy the scenery along the way.

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Key Takeaways

- This week we examine how the U.S. economy in 1985 compares with 2015, focusing on factors such as the pace of the current economic expansion, the political balance in Washington, consumer sentiment, and the role of the Fed's monetary policy.

Back to the Future in 2015

Happy New Year. The Hollywood blockbuster *Back to the Future* was released 30 years ago, in 1985, and is garnering some headlines lately as its sequel, *Back to the Future II,* was mainly set in 2015. The original film, set in 1985, sees the main characters use a time traveling DeLorean--that's a car for those of you born after 1975--to travel back to 1955, and at the end of the film, briefly, to this year, 2015. The quick visit to 2015 at the end of the first film set the stage for the sequel, *Back to the Future II,* which was released in 1989. Although some of what was depicted as 2015 in *Back to the Future II*--hoverboards, flying cars, sneakers with automatic shoelaces, fax machines everywhere, time travel, and the Cubs winning the World Series--has yet to happen (sorry Cubs fans), some things about life in 2015 did come true. Flat-panel TVs, hands-free gaming, cameras everywhere, video chatting, and yes, even drones, all appear as staples of everyday life in 2015.

Back to the Future II doesn't tell us much about the economy in 2015, however, although most of the economic activity in the film seems to revolve around selling 1980s nostalgia and casino gambling. But how might 2015's economy compare with 1985's, which is often thought of as part of the roaring 1980s and, in some respects, a golden age for the U.S. economy?

Click here to view Figure 1.

Back to the Past: The U.S. Economy in 1985

Although 1985 was only the second full year of economic expansion after the back-to-back recessions of the early 1980s (1980 and 1981-82) ended in November 1982, that year saw 4.2% economic growth as measured by real gross domestic product (GDP), well above the economy's long-term average (1960-2014) growth rate of 3.1%. The economy created an average of 175,000 private sector jobs per month, and consumer spending contributed nearly three quarters of the economic growth. The Federal Reserve (Fed), which both raised and lowered rates in 1984, raised rates in early 1985, but then cut rates in the second half of the year, while inflation as measured by the Consumer Price Index (CPI) ranged between 3.5 and 4.0% for much of the year. After falling 15% in 1984, oil prices were essentially unchanged in 1985, before plunging in 1986. (Please see the *Weekly Economic Commentary,* "Before and After: Monitoring the Effects of Falling Oil Prices," December 22, 2014.)

In 1985, exports accounted for just over 6% of GDP, and the dollar--after running up more than 50% since the end of the 1981-82 recession--peaked in early 1985 and ended the year little changed from its value at the end of 1984. The federal budget deficit, which ballooned to 6% of GDP in the aftermath of the severe 1981-82 recession, improved to 5% of GDP in 1985, on its way to an eight-year low of 2.7% in 1989. As 1985 began, Republican President Ronald Reagan--after winning re-election in a landslide in November 1984--was facing a Democratic House of Representatives and a Republican Senate. Consumer sentiment, as measured by the University of Michigan's Consumer Sentiment Index, averaged 93 in 1985, the highest in more than a decade, aside from 1984. In retrospect, 1985 marked the third year of the economic expansion that began in November 1982 and would last for nearly eight years, ending in July 1990.

What We Expect in 2015

As noted in our *Outlook 2015: In Transit* publication, we expect that 2015 will mark the sixth year of the economic expansion that began in June 2009, and that the odds of recession in the next year remain low, suggesting that the current economic expansion may match, or even surpass the 92-month expansion that began in 1982. We expect real GDP growth to run at just over the long-term growth rate of 3.0%, led by business spending, housing, and the consumer. We expect the Fed to begin raising rates later this year, and that the economy will consistently create between 225,000 and 250,000 jobs per month. Inflation may be pulled down by falling oil prices in early 2015; but later in the year, as wages begin to accelerate, inflation may turn higher.

In 2014, exports accounted for 14% of U.S. GDP, nearly double 1985's level, making the U.S. economy more vulnerable to global growth in 2015 than it was in 1985. The U.S. dollar, which is up 15% since the end of the 2007-09 Great Recession, may continue to move higher in 2015 as the U.S. economy continues to improve and the Fed tightens monetary policy, even as economies and central banks of many major U.S. trading partners stagnate and cut rates or enact more stimulus [Figure 2]. The nonpartisan Congressional Budget Office expects that the U.S. federal budget deficit will shrink to 2.6% of GDP in fiscal 2015, from 2.9% in fiscal 2014, and the recent high of 9.8% of GDP in 2009. As we note in our *Outlook 2015* publication, as President Obama starts his final two years in office, he'll have to work with a Republican-controlled Congress, opening the possibility of productive compromise that might create some movement out of the gridlock that has plagued Washington in recent years. Consumer sentiment ended 2014 at the same level it averaged in 1985 (93.6), hitting a new seven-year high [Figure 3]. Also noted in the *Outlook*, we expect the economy to continue to expand in 2015. By the end of the year, the expansion that began in June 2009 will be the fourth-longest post-WWII expansion, just behind the 1982-1990 expansion--which included *Back to the Future's* 1985--that lasted 92 months. As for the flying cars, time travel, and the Cubs, we'll leave that to Hollywood.

Have a great year!

Click here for Figures 2 and 3.

IMPORTANT DISCLOSURES

Because of its narrow focus, investing in a single sector, such as energy or manufacturing, will be subject to greater volatility than investing more broadly across many sectors and companies.

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Weekly Market Commentary | Week of January 5, 2015

Key Takeaways

- The fourth quarter of 2014 will be a tale of two earnings seasons: the best of times and the worst of times.
- Despite a substantial drag from the energy sector, we expect another good earnings season overall.
- We expect more winners from cheap oil than losers, although the energy sector faces significant challenges.

A Tale of Two Earnings Seasons

The fourth quarter of 2014 will be a tale of two earnings seasons: the best of times and the worst of times. Companies that benefit from lower energy prices should generally report positive results and have mostly optimistic comments about their business outlooks. Conversely, companies within or connected to the energy sector will likely have a difficult time due to the sharp, swift decline in oil prices. Overall, we expect the winners from cheap oil to outnumber the losers, with another good performance by corporate America. Alcoa unofficially kicks off earnings season on January 12, 2015.

Q4 Earnings Likely to Be Good, Despite Energy Drag

Despite a substantial drag from the energy sector, we expect another good earnings season overall for the just completed fourth quarter. Consensus estimates from Thomson Reuters are calling for a 4% year-over-year increase in S&P 500 earnings per share for the quarter, even while absorbing an expected 20% decline in energy sector earnings. We see some potential upside from cheaper energy and other commodity input costs for consumer companies and manufacturers (those without close ties to the energy sector), which may help earnings achieve their average historical upside surprise of about 3%. The biggest cost component for S&P 500 companies, wages, has not yet exerted enough upward pressure on corporate cost structures to raise concerns about profit margins, which continued to expand throughout 2014 and currently remain at record highs.

Our favorite earnings indicator, the Institute for Supply Management (ISM) Manufacturing Index, has continued to signal mid- to high-single-digit earnings gains for late 2014 and early 2015. Although the index pulled back in December 2014, due partly to reduced energy sector spending plans, it remains solidly in expansion territory at over 55 (50 is the breakpoint between growth and contraction). The three-month average is near the highest levels since the end of the Great Recession.

The pace of economic growth in the United States also bodes well for earnings. After the weather-depressed contraction during the first quarter of 2014, gross domestic product (GDP) growth exceeded 4% annualized during the second and third quarters and is on track for near 3% growth for the fourth quarter, based on available data as of year-end 2014. This pace of growth should support the low- to mid-single-digit revenue gains necessary to drive forecasted earnings gains, even when factoring in energy sector impacts.

The "Ex-Energy" Quarter

Earnings and other financial statistics are often expressed excluding a particular sector due to one-off irregularities. "Ex-financials" is one example in recent years due to the fall, then rise, of the financial sector in the aftermath of the 2008 financial crisis.

This earnings season, earnings "ex-energy" will likely become a commonly heard phrase because of the sector's expected divergence. Analysts and strategists will likely strip out energy and assess how earnings for the S&P 500 would look if that sector is excluded. The divergent path that the sector's earnings have taken [Figure 1] will likely be the top story during this earnings period (overtaking Europe, which was last quarter's top story, and the strength of the U.S. dollar). Over just the past three months, energy sector earnings estimates for the next four quarters have tumbled 29%, compared with the S&P 500 overall which--despite including energy--has seen estimates fall just 2% during this period.

Click here for Figure 1, S&P 500 Earnings Estimates Have Held Up Well As Energy Estimates Have Plummeted

S&P 500 earnings have many drivers. But the sharp drop in oil prices (more than 50% from last year's peak in June 2014) will bring energy to the forefront this earnings season. The energy sector is expected see a 20% year-over-year earnings decline in the fourth quarter, based on Thomson Reuters consensus estimates. The only other sector expected to see a decline is materials, also commodity based, and that sector's expected earnings decline is less than 2% [Figure 2]. In fact, energy is such an outlier that removing it lifts S&P 500 earnings by about two percentage points (boosting consensus from 4% to 6%). The industrials sector provides an additional energy-related drag by being the destination for substantial capital investment by energy companies, indicating that removing energy could lead to more than a two-point boost to S&P 500 earnings.

Click here for Figure 2, Energy Earnings Expected to Contract Substantially

The Upside to Oil's Decline

The flip side of lower energy prices hurting energy sector earnings comes from the sectors that have benefitted from lower oil and other commodity prices. The most obvious is the consumer discretionary sector, as lower prices at the gas pump and cheaper home heating bills help boost discretionary income. Manufacturers also benefit from cheaper fuel and raw materials. Airlines and automakers are big beneficiaries as well, although commodity-hedging activities do partially dampen the positive impact.

Oil Is Not the Only Challenge

Europe may continue to be a drag for S&P 500 company profits, given the Eurozone is on the brink of another recession (based on latest GDP data) and has very low inflation, which gives businesses operating there less pricing power. S&P 500 companies generate roughly 15% of earnings from the Eurozone. Much less concerning, but still a risk, is exposure to the big oil-producing emerging market (EM) countries, Russia in particular. We estimate exposure to these EM countries, some of which are in or near recession, at only about 1-2% of overall S&P 500 profits. The strength in the U.S. dollar may also be a drag on overall earnings again, as foreign-sourced profits (particularly in Europe) are translated into fewer dollars.

Conclusion

The fourth quarter will be a tale of two earnings seasons. For the energy sector, it will no doubt be a very difficult earnings season due to the sharp drop in oil prices. Conversely, companies that benefit from lower energy prices may report solid results and have positive comments about their outlooks amid the favorable economic backdrop in the United States. Overall, we expect more winners from cheap oil than losers, with another good performance by corporate America.

IMPORTANT DISCLOSURES

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Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

All investing involves risk including loss of principal.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Institute for Supply Management (ISM) Index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

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