2015 Outlook: Follow the Dollar

Jan. 8, 2015 | By Rick Golod

Executive Summary

Global equities could see another year of gains in 2015, led by the developed markets. But volatility is also likely to increase, as the markets adjust to life after quantitative easing (QE) in the US, lower energy prices, a stronger US dollar and further moderation in the pace of China's economy. Spikes in volatility could drive investors toward higher-quality, noncyclical stocks, despite their more expensive valuations.

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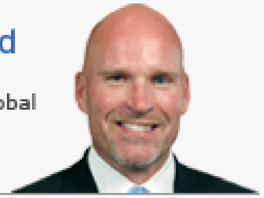


- **Overweight US.** The US consumer is likely to keep powering the economy above a 3% growth rate, quarter-over-quarter. Falling energy prices, dollar strength, job growth and wage gains are likely to bolster consumer confidence and disposable income, offsetting the drag on corporate earnings. In this environment, I believe the consumer discretionary, technology and health care sectors may benefit, favoring large-cap and growth stocks over small-caps and value.
- **Overweight Europe.** As Europe’s economic prospects continue to look dim, the probability of a QE program from the European Central Bank (ECB) has increased. The timing remains uncertain, but a potential QE program could be the key catalyst for a strong move in equity prices.
- **Neutral weight Japan.** Japanese equities may continue to benefit from QE, as the yen/dollar exchange rate weakens. But some of the currency weakness may be already priced into the market.
- **Underweight emerging markets**. Overall, contagion risk, the potential for economic crisis to spread across the asset class, is increasing, and I believe emerging market equities may lag developed market equities this year. But investment opportunities may arise among individual countries, as overly pessimistic sentiment may unfairly punish the "good" along with the "bad."

January Quick Take

Global perspectives

Two questions are likely to shape investor success in 2015:

1. Will central bank liquidity continue to trump fundamentals?
2. Will low global interest rates and soft economic growth outside the US continue to drive capital away from cyclical companies and into their more expensively priced, high-quality, dividend-paying, large-cap, noncyclical counterparts?

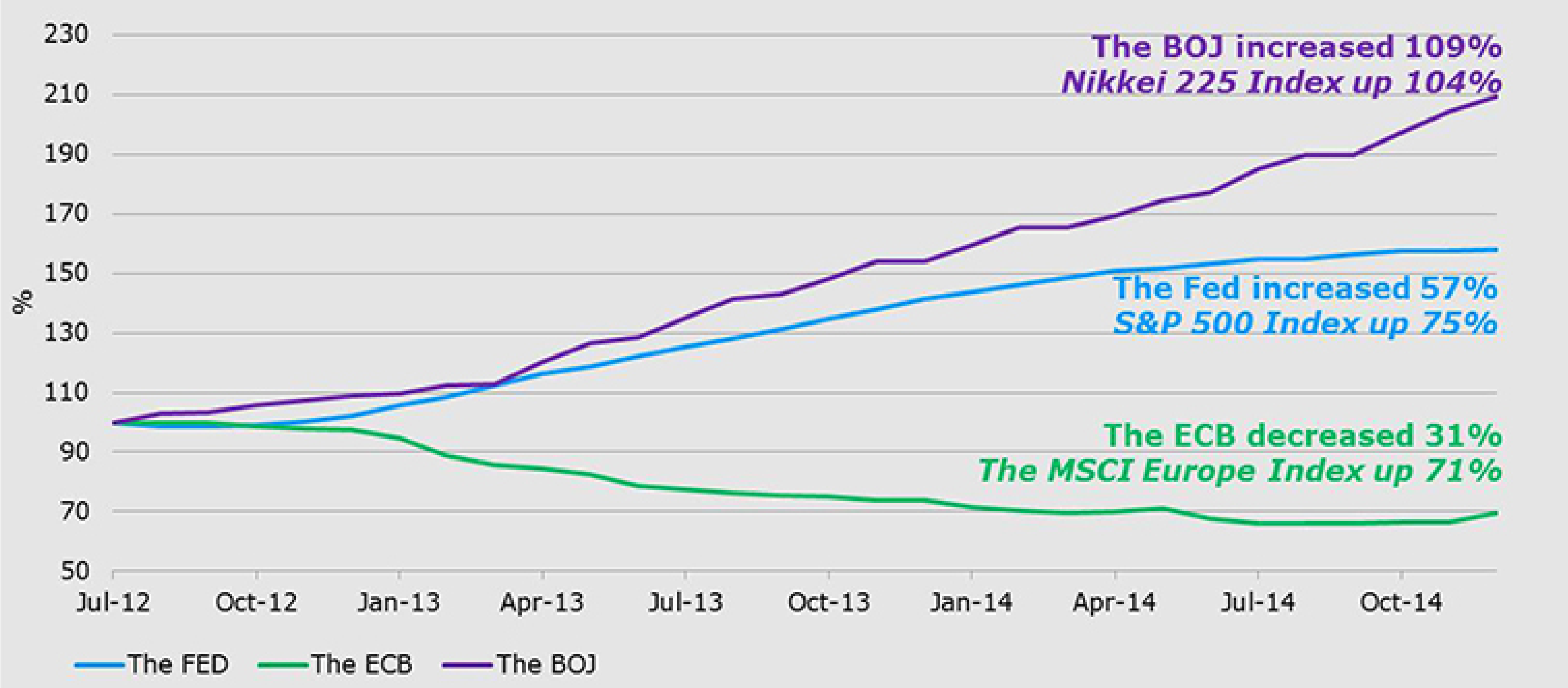
Below, I expand on my main themes for the global equity markets in 2015, discussing my expectations for each region.

1. The US continues to look more attractive than Japan and Europe.

Over the past two-and-a-half years, the developed regions with the most aggressive monetary policy have shown the best equity performance (see chart). Japan, which was up 104% over that time span, came in first. The US, up 75%, was second, and Europe, up 71%, was third. (Japan, the US and Europe are represented by the Nikkei 225 Index, the S&P 500 Index and the MSCI Europe Index, respectively, in local currency terms.)

Money Moves Markets

Greater central bank balance sheet expansion resulted in greater equity market gains, 2012-2014



Past performance is no guarantee of future results. An investment cannot be made directly in an index.
Source: Bloomberg L.P., data as of Dec. 31, 2014

Expected changes in monetary policy this year, and the potential impact on cross currency exchange rates (yen/dollar, euro/dollar, yen/euro) suggest the order of equity outperformance could change to the point where we see Japan leading, followed by Europe and then the US.

However, I believe other influences may come into play that warrant an overweight to US equities. The US economy could benefit the most from European deflationary woes, as well as from Japan's attempt to debase its currency, in addition to China's record trade surplus.

What's more, since 1984, US equities have tended to outperform international equities (as represented by the MSCI All Country World Index ex US), when the year-over-year percentage change in the Organisation for Economic Cooperation and Development (OECD) Composite Leading Indicator is below 2%. This is important because the indicator's most current reading is 1.54%.

2. Despite more expensive valuations, high-quality, dividend-paying stocks may continue to outperform cyclical stocks.

I believe low interest rates and the search for quality may trump the potential for cyclical stock outperformance and continue to move capital into high-quality, dividend-paying/raising, large-cap companies, despite what appears to be high valuations relative to their cyclical counterparts.

3. Fundamentals and valuations argue for overweighting developed markets relative to emerging markets.

On a fundamental basis, the case for overweighting the developed markets over emerging markets is quite simple. For example, the gross domestic product (GDP) growth divide between the emerging markets and developed markets is expected to be at the lowest level since 2000. The difference in valuations between emerging market and developed market equities is not compelling enough to make a case for overweighting emerging markets, especially considering their sensitivity to declining commodity prices, a rising dollar and tighter financial conditions.

US: Overweight

1. The US economy continues to grow above 3% quarter-over-quarter, with jobs growth and wage gains.

The US economy no longer needs the US Federal Reserve's (Fed) accommodative monetary policy. The most comprehensive measure on the condition of the US economy, the Chicago Fed National Activity Index, posted a +0.73 reading on Nov. 30 — the strongest level since the recovery began in the first quarter of 2009.

Despite slowing to 6.1% in November from 7.4% in July, the year-over-year percentage change in the Conference Board's Leading Economic Indicator (LEI) — a gauge of future economic growth — has generally accelerated since July 2012 and continues to suggest strong growth in the months ahead. This barometer of future economic growth has had a correlation of 0.92 with GDP growth over the past 10 years. The upcoming LEI reading is expected to surprise to the upside, as it has been highly correlated to lower Brent crude prices.

Looking at the jobs market, the unemployment rate declined 1.2 percentage points in 2014 — the strongest annual drop in 30 years. There are more people working, working longer hours and making more money. This trend is likely to continue, lending further support to an economy that has been growing above 3.5% quarter-over-quarter in four out of the past five quarters.

2. Energy prices and interest rates continue to fall, which benefits the US economy.

Contrary to what some pundits are saying, in my opinion, the decline in energy prices and interest rates could be a huge boon to economic growth, which is why I think a little perspective is warranted here.

Oil and gas capital spending (capex) represents approximately 0.8% of total US GDP, while consumer spending contributes 72% to GDP, or 60 times more than oil and gas expenditures.

In dollar terms, the 40% decline in gas prices from the June 2014 peak of $3.68 to $2.23 as of Jan. 1 could add approximately $217 billion in additional consumer disposable income within a year's time, which could add another 1% to GDP growth.

The economic impact from the potential job losses in the energy sector has also been overstated, in my opinion. Oil- and gas-related employment has been one of the fastest-growing segments in our economy, adding 819,000 jobs since its low in 2009. However, overall employment growth, excluding oil and gas, has increased by 9,500,000 jobs during the same time period.

Furthermore, in the past, demand-driven energy price declines have been associated with recessions, while supply-driven declines tended to precede above-average economic growth. Professor James Hamilton of the University of California, San Diego, an expert on the relationship between oil prices and the US economy, estimates that about one-third of the current decline in energy prices was demand-driven. And as China moves away from investment growth being the key driver of its GDP, global energy needs are likely to continue to diminish.

The supply side also appears likely to remain robust, with additional supply coming from the US and Saudi Arabia. Lower energy prices could potentially remove marginal producers, providing Saudi Arabia greater pricing power in the future. Geopolitically, it's in the best interest of the US to encourage more energy production. Lower energy prices have punished some of the world's political "bad boys," including Russia, Iran and Venezuela.

I'm not a conspiracy theorist, but I would call it a case of politics meets opportunity. This past November, a consultant for the US secretary of defense invited me to meet with the director and deputy director of the Department of Defense's Office of Net Assessment (ONA) at the Pentagon. The ONA determines the future needs of the military based on a five- to 10-year economic and political outlook. The office is of such high value that Congress recently provided for its funding in perpetuity.

During our meeting, many of their questions focused on my views on Russia and China. It is not unprecedented for the US to utilize economic might over military might to influence Russia. For example, President Ronald Reagan's Strategic Defense Initiative, also known as "Star Wars," would have bankrupted Russia if it tried to match the US program, which I believe played a pivotal role in the breakup of the former Soviet Union.

Today, Russia's economy has suffered massive hardship due to the drop in energy prices. I believe it's just a matter of time before the economic pain outweighs whatever gain Russian President Vladimir Putin is seeking. That being said, the longer President Putin remains obstinate, the longer energy prices could stay lower.

Moreover, a stronger dollar, which I believe will likely persist in 2015, would weigh further on energy prices. Over the past 12 months, Brent crude oil prices have been 97% negatively correlated to the direction of the dollar.

3. The benefits of a stronger dollar may outweigh the drawbacks.

A stronger dollar is a call with high consensus on Wall Street, and one that is warranted, in my opinion. As economic growth and monetary policy in the US continue to diverge from those of Europe and Japan, the dollar/yen and dollar/euro exchange rates are likely to continue strengthening.

In my opinion, a stronger dollar is not necessarily an impediment to GDP or earnings growth and should continue to exert downward pressure on energy prices, increasing consumer's confidence and disposable income. This all should lead to stronger economic growth, I believe.

In fact, the headwinds of a stronger dollar and lower energy prices on corporate earnings should be more than offset by stronger domestic corporate and consumer spending. The energy sector comprises only 9.8% of the market capitalization of the S&P 500 Index. 2015 consensus earnings for the S&P 500 Index are $125.58, which I believe is reasonable, considering GDP growth, additional profit margin expansion and share buybacks.

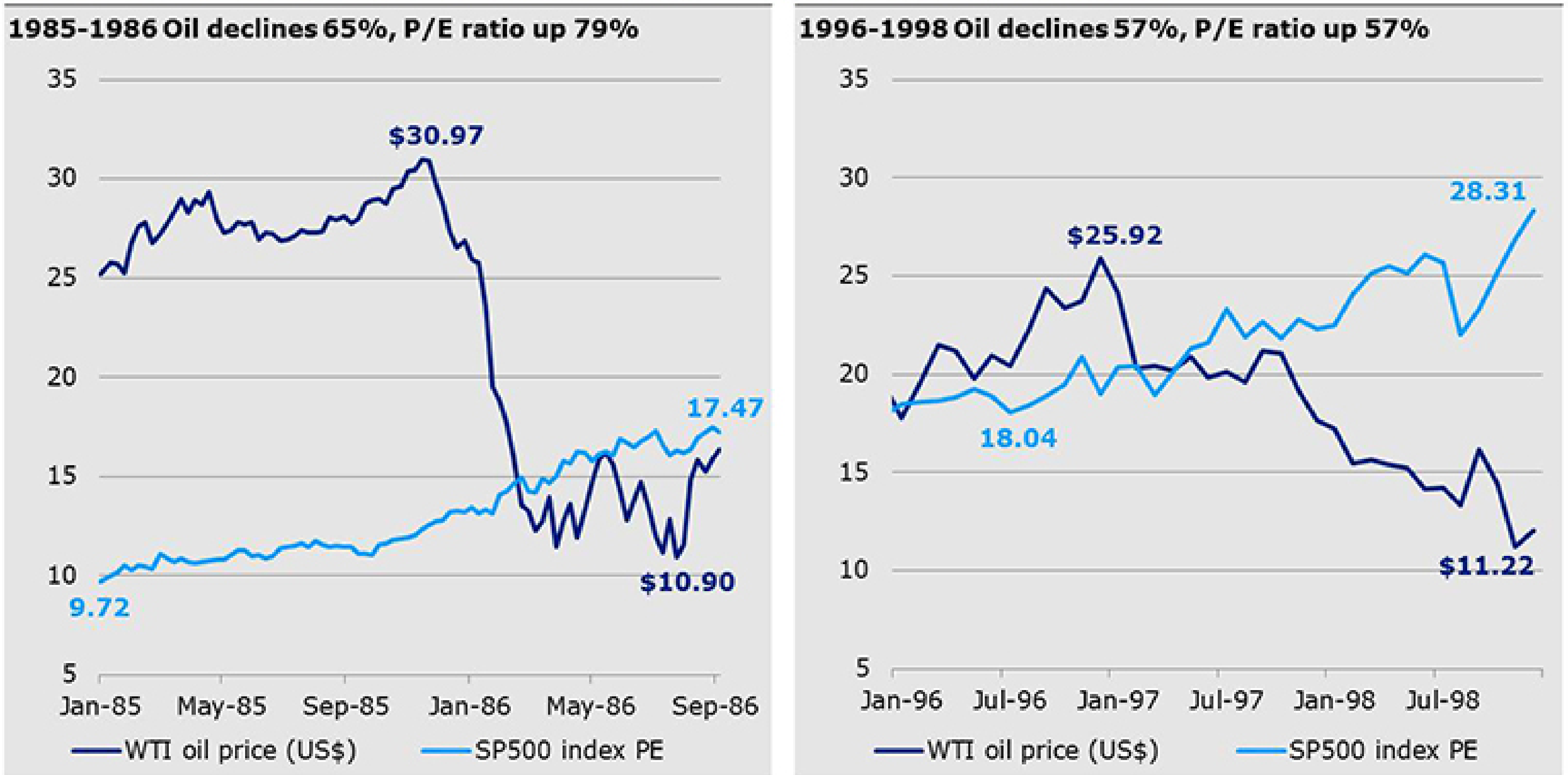
4. US equities are likely to post another year of gains.

This year should be great for US equity returns. If, like me, you need more substance than a factoid — such as the S&P 500 Index never having had a negative return in a year that ends in five since 1935 — consider the following (while remembering the past performance is not a guarantee of future results):

- Since 1935, the third year of the presidential cycle has generated the best S&P 500 Index returns. The median annual return has been 12.3%.
- Going back to 1994, one year before a Fed rate hike, the S&P 500 Index has averaged a gain of 17%.
- Since 1985, at the current Wall Street consensus equity allocation or lower (as measured by the Bank of America/Merrill Lynch Sell Side Indicator), the S&P 500 Index has generated positive returns 97% of the time, averaging double-digit returns.
- In the past three decades, rising earnings and rising price-earnings (P/E) multiples have generated the highest S&P 500 Index returns compared with periods where one or neither factor is rising, with only modest corrections. I would also point out that P/E multiples historically have tended to rise when the dollar strengthens and when energy prices fall.

The chart below shows that during the past two instances when energy prices dropped 40% or more, P/E multiples exploded higher.

Past Oil Price Corrections Saw Big P/E Expansion



Source: Bloomberg L.P. Past performance is no guarantee of future results. An investment cannot be made directly in an index.

- From 1985 to 1986, oil prices declined 65%, P/Es nearly doubled from 9.72x to 17.47x, and the S&P 500 Index appreciated 86% over that time frame.
- From 1996 to 1998, oil prices were down 57%, P/E multiples increased 57% — from 18.04x to 28.31x, and the S&P 500 Index gained 89% in that period.

In each case, the dollar was strengthening, inflation (as measured by the Consumer Price Index) was declining, and developed market growth exceeded 4.5% — the two strongest periods of global growth in the past 25 years.

As a value investor, I can't put a 22x multiple on 2015 earnings. However, I believe the appropriate P/E is 18.6x, given the current inflation rate, economic uncertainty, earnings uncertainty and potential global growth.

Therefore, it wouldn't surprise me to see the S&P 500 Index reach a level of 2,335 ($125.58 X 18.6x), with risk to the upside.

5. Consumer discretionary, technology and health care may outperform, and a rotation in leadership from large-cap growth to large-cap value may be delayed.

The anticipated fed rate hike, a lack of growth overseas and spikes in volatility have recently moved global investors toward quality stocks with predictable earnings. This theme could continue in 2015, which I believe would favor large-cap stocks over small caps and growth stocks over value.

I suspect as US economic data surprises to the upside as a result of lower energy prices, market performance will eventually rotate away from the relatively expensive noncyclical sectors into the inexpensive cyclical sectors.

Back in 2009, the Fed's goal was to fix the banks, then real estate and then the consumer. In other words, fix Wall Street, then Main Street. Now is the time to invest in Main Street, in my opinion. The consumer discretionary, technology and health care sectors look most attractive to me, with a focus on companies with quality balance sheets and more attractive valuations.

Europe: Overweight

1. European economic growth remains weak.

The overweight allocation to Europe has nothing to do with expectations of an economic recovery. To be clear, Europe's growth prospects are very weak, and any action by the ECB isn't likely to have much impact on the economy, in my opinion.

The ECB's influence on the equity market, however, is a different story. A weak currency could certainly help European multinationals' earnings, but 86% of eurozone exports are transacted with countries other than the US. Over the past 10 years, European ex-UK stocks, as measured by the MSCI Europe ex UK Index, have been 80% correlated to the OECD Composite Leading Indicator, which remains in a downtrend.

2. QE, not fundamentals, may drive European equities higher.

Investors looking for improving fundamentals as a trigger to invest in the region may miss the same opportunity other fundamentally based investors missed in the US equity market from 2009 to 2012, and in the Japanese equity market from 2012 to the present.

The key trigger for higher equity prices will be an implementation of QE, in my opinion. The moment ECB President Mario Draghi begins expanding the ECB's balance sheet, the equity risk premium is likely to begin to decline, potentially driving stock prices higher. The timing of QE is less predictable, but I believe Mr. Draghi will begin purchasing bonds by the second quarter at the latest and possibly as early as the first quarter.

3. High-quality, dividend-paying European multinationals are likely to outperform.

Typically, with an increase in QE, cyclical stocks would be expected to outperform noncyclical sectors. That said, economic uncertainty could continue to drive capital into high-quality, dividend-paying multinationals, which is essentially what happened in the US equity market during the second half of 2014. In many respects, I believe the European equity markets may be a replay of the US market with the same asset classes potentially outperforming. The current environment in Europe looks more and more like the US did in 2011.

Japan: Neutral

1. Japanese equities could move higher again this year, but upside may be limited.

The doubling of the Nikkei 225 Index over the past two years had nothing to do with improving fundamentals and everything to do with liquidity from the Bank of Japan's (BOJ) QE that weakened the yen/dollar exchange rate, in my opinion. The Japanese stock market (the Nikkei 225 Index) has been 91% correlated to the yen/dollar exchange rate over the past 12 months. The BOJ's 60% increase in QE announced in November increases the odds the yen/dollar exchange rate will continue to weaken.

However, a weaker currency may already be priced into the market, which could limit an upward move in equity prices, especially as GDP growth, the quality of corporate balance sheets and the government's debt-to-GDP level continue to disappoint.

Japanese equities could see an additional tailwind from large capital inflows. The government pension fund is doubling its equity allocation, and the nation's first negative savings rate since record keeping began in 1955 may motivate Japanese savers to move capital into the equity market. Moving just 20% of savings into the stock market would be equivalent to 90% of Japan's market capitalization.

Emerging markets: Underweight

1. Emerging markets' economic backdrop remains negative.

We're beginning to see signs of contagion. In the week ending Dec. 12, emerging market equity outflows were the highest since January 2014, when economies from Argentina to Turkey looked unstable as the Fed began tapering its stimulus. The Bloomberg Emerging Market Currency Index, a custom index that tracks 20 widely traded emerging market currencies, fell to the lowest levels since 2003 on Dec. 15.

Emerging market strategists are comparing the current economic and market backdrop to 1998, when Russia fell into default and devaluation. That's because the ruble has declined 52% in the past year, Russia's central bank raised its lending rate from 10.5% to 17% last month, inflation is at 11.4%, and the economy could contract as much as 4.7% in 2015 if oil remains at $60, according to Russia's central bank.

As the Fed moves closer to its first rate hike since 2006, the World Bank predicts a potential 50% drop in private capital inflows into developing nations if long-term US yields rise one percentage point.

Unfortunately, the negative economic backdrop coincides with a period of unwinding the excesses (credit and overinvestment) that were built over the past decade. Earnings growth has been basically nonexistent since 2012 and, as mentioned earlier, the economic growth gap between emerging and developing markets is expected to be the narrowest since 2000.

The likelihood of a stronger dollar, lower commodity prices and tighter financial conditions supports underweighting this asset class, in my view.

2. Asia ex-Japan may outperform Latin America.

It would be unfair to lump all emerging market countries into one category. Unlike in 1998, many emerging market countries have flexible exchange rates, current account surpluses, access to internal financing and high foreign reserves. In other words, they are in a stronger financial position to weather potential headwinds.

Market contagion can often throw the "good" companies out with the "bad," which suggests opportunities exist for those willing to dig a little deeper.

In this environment, it's important to differentiate the oil importers from exporters, commodity-based from manufacturing-based economies, and countries that export more products to the US versus the rest of the world. These criteria lead me to favor Asia ex-Japan over Latin America, as I believe energy prices could remain lower for longer, benefiting countries that have performed well when consumer sectors have outperformed the commodity sectors. In Asia, these countries include the Philippines, Malaysia and Indonesia.

India remains a bright spot in the region, as the government's growth reforms are expected to deliver much stronger GDP growth in 2015.

Technically, despite a slowing economy and deteriorating fundamentals, Chinese stocks are in a bull market that may have more room to run. The government's crackdown on corruption and its ability to increase fiscal stimulus have increased investor confidence in this country's equity market.

Final thoughts

I have often said "liquidity trumps fundamentals until it doesn't." However, the regional allocations outlined here reflect my belief that liquidity may become a less important driver of equity outperformance and fundamentals will begin to matter more. The risk to this outlook is that I could be early in my assessment.

With volatility likely to pick up, particularly when compared with last year's low-volatility environment, capital could move into countries with stronger fundamentals, higher-quality stocks and markets that are already beaten down, instead of the "normal" cyclical stock outperformance.

Sources: Invesco; All data and information provided by Invesco as of Jan. 8, 2014, unless otherwise noted. Additional sources include: Thomson Reuters Datastream, Nov. 15, 2014-Jan. 6, 2015; Thomson Reuters, Credit Suisse, Sept. 17, 2014; Citigroup Global Markets, Dec. 8, 2014; Wells Fargo, Dec. 12, 2014; Invesco and Gluskin Sheff, Nov. 6, 2014; Cornerstone Macro, July 29-Nov. 12, 2014; J.P. Morgan, Dec. 5, 2014; Renaissance Macro Research, Dec. 16, 2014; Bank of America/Merrill Lynch, Nov. 3, 2014-Jan. 2, 2015; Ned Davis Research, December 2014; Goldman Sachs, Aug. 1, 2014; Credit Suisse, Sept. 17, 2014; Bloomberg News, "Memories of 1998 Rekindled in Routs From Russia to Venezuela," Dec. 15, 2014 and "Why 1998 Was Different, and Same, to Emerging-Market Crisis Now," Dec. 16, 2014; Bloomberg L.P. Sept. 30, 2014-Jan. 6, 2015; Bloomberg L.P., Jan. 1, 2015, and Gluskin Sheff. Estimate based on Gluskin Sheff Economist

David Rosenberg's rule of thumb that a penny change in gas prices translates to a roughly $1.5 billion change in consumer disposable income; Bloomberg L.P. S&P 500 Index returns measured from Sept. 25, 1985, to August 25, 1987, and from July 24, 1996, to July 16, 1998; Bloomberg L.P. Performance measured from July 31, 2012, to Nov. 28, 2014.

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All investing involves risk, including the risk of loss. Asset allocation/diversification does not eliminate this risk.

There can be no guarantee or assurance that companies will declare dividends in the future or that if declared, they will remain at current levels or increase over time.

A value style of investing is subject to the risk that the valuations never improve or that the returns will trail other styles of investing or the overall stock markets.

Growth stocks may be more susceptible to earnings disappointments, and value stocks may fail to rebound.

Stocks of small and mid-sized companies tend to be more vulnerable to adverse developments, may be more volatile, and may be illiquid or restricted as to resale.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Growth stocks tend to be more sensitive to changes in their earnings and can be more volatile.

Smaller companies offer the potential to grow quickly, but can be more volatile than larger-company stocks, particularly over the short term.

The dollar value of foreign investments will be affected by changes in the exchange rates between the dollar and the currencies in which those investments are traded.

An investment in emerging market countries carries greater risks compared to more developed economies.

International markets may be less liquid and can be more volatile than US markets.

Note: Not all products, materials or services available at all firms. Advisors, please contact your home office.

The **S&P 500®** Index is an unmanaged index considered representative of the US stock market. The **European Central Bank** (ECB) is the central bank responsible for the monetary policy of the European Union. The **Nikkei 225 Index** (or Nikkei Index) is a price-weighted index measuring the top 225 blue chip companies on the Tokyo Stock Exchange and is commonly considered representative of Japan's stock market. The **MSCI Europe Index** is a free-float-adjusted market-capitalization-weighted index designed to measure the equity market performance of the developed markets in Europe. The **MSCI Emerging Markets Index** is a free-float-adjusted market-capitalization index designed to measure equity market performance of emerging markets. The **MSCI All Country World ex-US Index** is a free-float-adjusted market-capitalization-weighted index designed to measure the equity market performance of developed and emerging markets, excluding the US. The **OECD composite leading indicator** (CLI) is designed to provide early signals of turning points (peaks and troughs) between expansions and slowdowns of economic activity. The **Chicago Fed National Activity Index** is a monthly measure of overall economic activity and related inflationary pressure. **The Conference Board Leading Economic Index** (LEI) is an economic indicator used to forecast changes in the business cycle based on a composite of 10 underlying components (including data on employment, manufacturing, consumer expectations, stock prices, money supply, interest rates, among others). **Correlation** measures the degree to which two variables move in tandem with one another. A **consensus estimate** reflects forecasters' average or mean predicted figure for data such as gross domestic product or a company's earnings. The **Sell Side Indicator** is Bank of America/Merrill Lynch's proprietary measure of Wall Street's bullishness on stocks and is considered to be a contrarian indicator. **Price-earnings (P/E) ratio**, also called multiple, is a common valuation metric for stocks that compares a stock's share price to its per-share earnings. The **Consumer Price Index** (CPI) measures changes in the prices of a representative basket of goods and services. The **MSCI Europe ex-UK Index** is free-float-adjusted market-capitalization weighted index designed to measure the equity market performance of the developed markets in Europe, excluding the UK. **Equity risk premium** is the excess return investors expect as compensation for assuming the risk of the equity market. **Debt-to-GDP ratio** is the ratio of a country's national debt to its gross domestic product, which is a gauge of the country's ability to pay back its debt. The **Bloomberg Emerging Market Currency Index** is a custom index that tracks the performance of 20 widely traded emerging market currencies.