Thoughts on the Economy and the Stock Market in 2016

As we enter the first trading day of 2016, just a few thoughts for you to contemplate. First, the 2015 year-end "Santa Claus" rally failed to materialize. The market was poised to rally into year-end but geo-political pressures (think oil, Saudi Arabia, China, etc) caused market uncertainty and it went into daily hyper-volatility mode near year-end--up big, down big, etc-- with the Dow and S&P 500 entering negative territory for the year (finishing -2.2% and .7%, respectively). The NASDAQ finished up 5.7%, boosted by outperformance of the tech sector.

2015 was the worst year for the market since 2008. So, does this mean the end of the bull market--a market that has been claimed over every year for the past several years by many market soothsayers.

And now we enter the first trading day of 2016 with a jolt--market disruption from China, causing the first trading day to enter another period of hyper-volatility, with the S&P 500 down some 2.1% as of mid-day, January 4, 2016--what does this (really) mean and should you be concerned?

In the short-term, the market can be an emotional wreck, with no clear signs of rationality. That is typical. And over the next few days, you will see the media pile on and explain what this market disruption means in terms of year-ahead performance, what its impact will be on the 2016 U.S. Presidential election--market bears will be on the prowl.

So, here's what I would suggest you do: nothing. I don't see 2016 as being a bad year for stocks. And I don't at this time see it as particularly outstanding, either. I see it ending the year positive, maybe high single digits. Maybe ever higher. Why? First, an economic recession is not in the cards. The economy continues to improve, with wage pressure starting to kick-in. Initial unemployment claims indicate no troubling trends. Domestic GDP will be positive but not all that great--probably 2-2.5%%. Inflation will start to push higher because of increasing wages and inventory slack. Oil has become a political pawn and predicting oil price movements is like playing the lottery but more likely than not oil prices have seen or will soon see their bottom and end the year higher from here--and meanwhile, historically low oil prices helps the consumer (think retail, cars, tech products) and thus consumer stocks.

Single family homes should continue their upward bias, creating more construction jobs, more wealth creation and an increasing economic multiplier effect on the economy. The so-called yield curve does not indicate recession and the FED and other developed country central banks remain accommodating, resulting in continued relatively low interest rates.

What drives the stock market is earnings and this is how we see 2016--today, the S&P 500 is currently trading at an earnings yield of 5.% (earnings/price, the inverse of the popular P/E ratio). Looking back over the past eighty five years, the S&P 500's earnings yield has averaged twice the yield of the 10-year U.S. Treasury rate. The current level is 2.25 times the yield on the 10-year Treasury. This would imply stocks still have room to run compared to Treasuries. Now, such statistics should also be considered in the context that the FED has artificially engineered an eight-year interest rate level--true--but the market is not evidencing relative over-priced numbers.

Oil is low, gold is low--commodities are just bad and likely to head even lower near-term. Holding a lot of cash is not a good move in a likely increasing inflationary economy and bonds are not anywhere near a bullish trend line--quite the opposite. So, if we have an accommodative FED, with mixed economic indicators but generally positive, where does one place his/her money in 2016?

Many pundits are saying the stock market is overvalued. Is it? The consensus forecast for 2016 has S&P earnings finishing 2016 somewhere around 125. Right now, the S&P 500 is trading at a level of 2002. This puts the year-end P/E around 16. This level is below the S&P's longer-term average of a 17 to 18 P/E. Just applying normal math, the S&P 500 should finish up around 2200, or 10% from today's level.

What hit market returns in 2015 and why the NASDAQ was up while the Dow and S&P down was trouble with oil/gas companies and commodities. Take those out and those indexes would have been positive. It is more likely than not earnings will be fine in 2016--maybe even surprise to the upside. Areas to concentrate positions include those sectors where consumers benefit as well as foreign developed markets, like Europe.

So, don't watch the daily freak show. Don't let the pundits get to you.