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- Sales and earnings under pressure because of energy, currency exchange rates
- Unemployment is low and employment costs maybe accelerating
- The Fed looks ready to raise rates in December (seriously)
- Inflation is low and likely to stay low
- Bond yields may decline despite Fed tightening
- S&P 500 fair value is about 2300 (up 12.5%)
- Long term Bull Market is intact, but the risk of an even stronger dollar is a concern

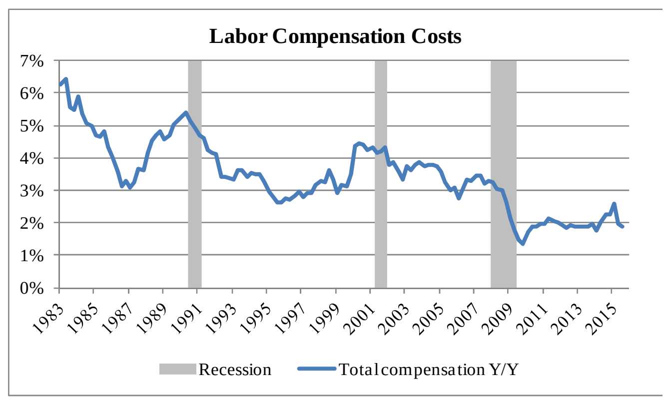
Earnings for the S&P 500 fell about 4% in the 2015 third quarter, although profits were up slightly excluding the energy sector. Sales were about flat, due partly to the strong currency. The average trade weighted value of the U.S. dollar was up 18% in this past quarter versus a year ago. About a third of the sales for the S&P 500 come from outside the U.S. and the dollar's strength means that sales made in foreign currencies get translated back into fewer USDs. To some extent this is offset because large U.S. multinationals also have production costs outside the U.S. which also get translated back to fewer dollars. And in any case, stock investors typically look past these effects because they tend to be transitional and there are benefits as well. For example, the strong dollar makes imports of raw materials and other goods relatively cheap. Also, U.S. multinationals that wish to purchase foreign companies or other assets have considerably more purchasing power. But as we shall discuss later, if dollar strength becomes too extreme, there can be significant negative effects.

The biggest drag on earnings for the S&P 500 in the recent quarter was a 57% drop in profits for the energy sector. Domestic oil and natural gas production has continued to rise, as has production from overseas operations, but revenues and earnings were crushed by a decline in energy prices. The domestic price of crude oil, for example, fell 51% to an average price of $45.15 a barrel in the 2015 third quarter, versus $91.16 a year before. We are not optimistic about the prospects for a quick turnaround. U.S. producers are finding new and efficient ways to extract oil and gas from the ground. And while production is falling in remote locations like North Dakota, where oil has to be transported by train, production continues to rise in parts of Texas that have easy access to seaports, oil pipelines and other infrastructure. Also, if oil prices rise materially, many wells now being shut can quickly be reopened and production increased. The good news is that profitability for the sector should at least stabilize near the current low levels and not be a drag on future growth in earnings for the S&P 500.

We've cut our expectation for S&P 500 earnings for 2015 to 119.00 from our 121.00 estimate last June. And our 2016 estimate is now 127.00, down from 130.00. The U.S. economy seems to have a fairly sustainable expansion underway and there are no major indicators of a recession on the horizon. Things like the Index of Leading Indicators, the ISM Manufacturing Index and the ISM New Orders Index, the shape of the yield curve and low inflation and capacity utilization all argue for continued expansion. Without a further drag from energy, a 6% to 7% gain in S&P 500 earnings next year looks reasonable.

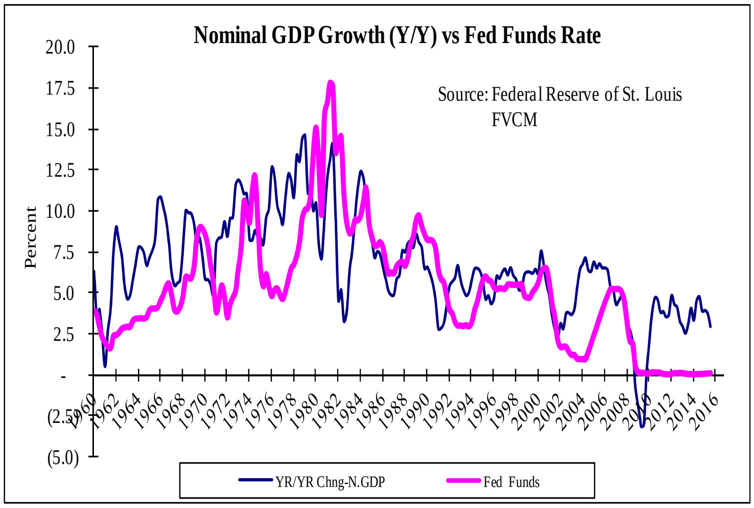
The eyes of the Federal Reserve are on the U.S. labor market, and the data is showing fairly good conditions. Employment has grown at an average rate of 235,000 per month over the past twelve months and the unemployment rate has now fallen to only 5.0%. Data on labor costs are a bit inconclusive. As of September 30th, the Employment Cost Index, which includes salaries and wages as well as benefits such as health insurance, was up only 1.9%, year- over-year, which is exactly the average rate of growth since 2009. However, average hourly earnings of private workers accelerated to a 2.5% year-over-year gain in October after hovering in the 2.0% to 2.2% range for quite some time. The Fed's concern is that, with the labor market tightening, labor costs will start to rise faster and could risk a pickup in inflation in the year or two ahead. The idea is that the Fed is better off gently applying the brakes now rather than have to step heavily on the brakes later.

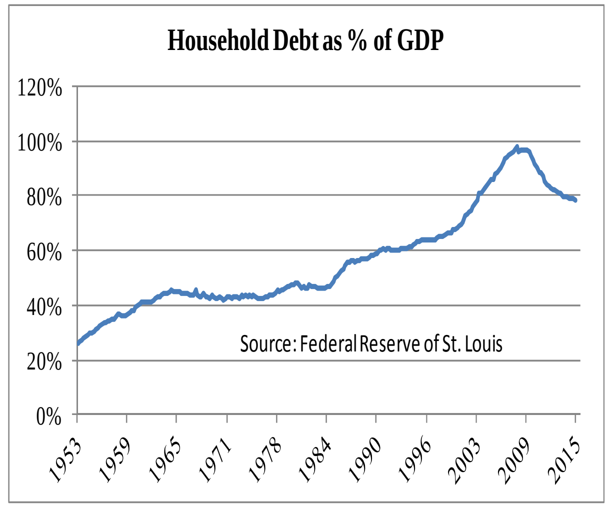
Source: The Federal Reserve of St. Louis



Source: The Federal Reserve of St. Louis

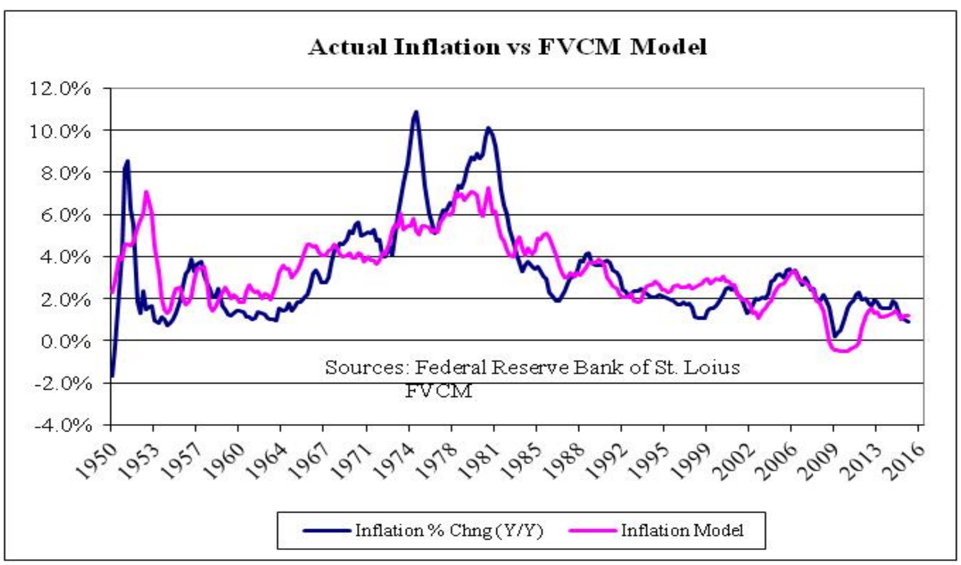
Because of the decline in the unemployment rate, the odds that the Fed will raise rates at its December meeting now are more than 50/50. In contrast to the current focus on unemployment, the evidence suggests that the Fed has historically reacted to trends in nominal GDP growth. When spending accelerated, the Fed's response has been to raise rates, while it has cut rates in response to falling spending (see chart below). Because nominal spending has grown at an average rate of 3.6% over the past three years, it certainly would appear that a more appropriate Fed Funds rate would be higher than the current level of approximately zero. However, we are not living in normal times. It is true that U.S. households have cut their debt to 78% of GDP, which is down from the peak of 98% in 2008, but debt is still high by historical standards. Especially now that speculation in the housing sector has been crushed, spending appears to be much more sensitive to changes in interest rates. There is a real possibility that a higher Fed Funds rate may lead to a deceleration in nominal spending from the current 3.6% average. And, if spending were to noticeably decelerate, the Fed could end up having to ease yet again. The bottom line is this: Yes, the Fed may raise rates in December, and perhaps a couple more times in 2016. However, if spending starts to slow, don't be surprised if we see a QE4. At the root of the western world's ills is debt, and that has not gone away.



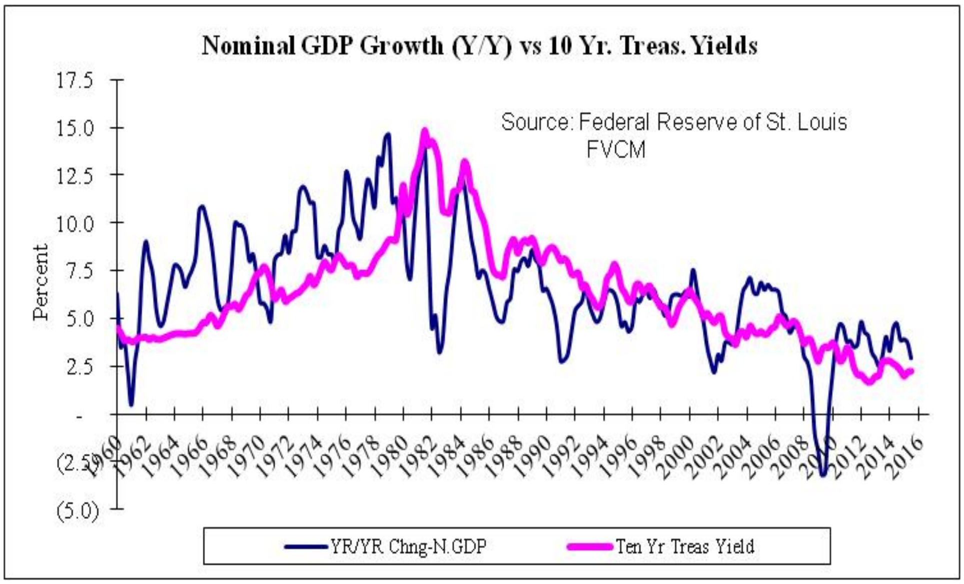


Despite the declining unemployment rate, significant upward pressure on inflation is not present. In order for inflation to accelerate, there must be a sustained acceleration in demand or, in rare cases, a supply shock. Inflation does not typically change course quickly. Based on our analysis, inflation follows the rate of spending growth over the previous three years. And because spending has been growing at a paltry 3.6% rate, our model indicates that a point of central tendency for inflation is about 1.2%. This is also consistent with real growth of 2.4%, which is in-line with the U.S. experience since the financial crisis. So unless confidence materially increases and people suddenly start to spend cash balances at a faster pace, the prospects for higher inflation are nil.

Note: in the chart below, which compares the actual level of inflation with our model, there are two large deviations: one in 1973/4 and again in 1979. These two spikes in inflation were due to the Arab oil embargo of 1973 and the Iranian crisis of 1979. For other periods, the model has had an excellent fit.



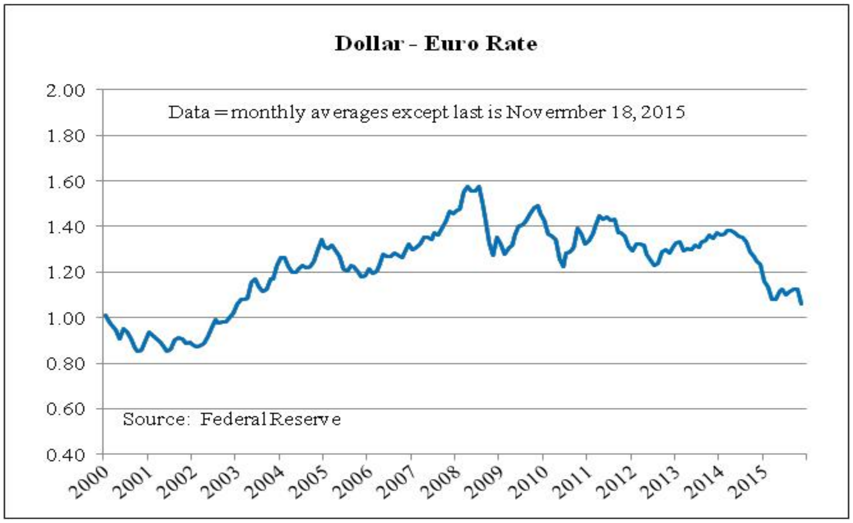
Bond yields are at about the right place too, and could even fall. Bond yields tend to follow the rate of nominal spending growth for the very reason that inflation follows nominal spending growth. Bond investors expect to be compensated by the loss of purchasing power caused by inflation. But when spending growth is low and inflation is low, bond yields can be low. Actually, we're in for an interesting experiment here. If the Fed does start to raise short term rates next month, and we start to see spending growth soften, don't be surprised to see bond yields fall from the current level of 2.2% on the 10 year U.S. Treasury bond. Also putting downward pressure on U.S. yields are the very low bond yields in Europe (German 10 year yield = 0.5%) and Japan (0.3%). Capital flows are being attracted by the relatively higher yields available in the U.S. and causing the strength in the dollar's foreign exchange value.



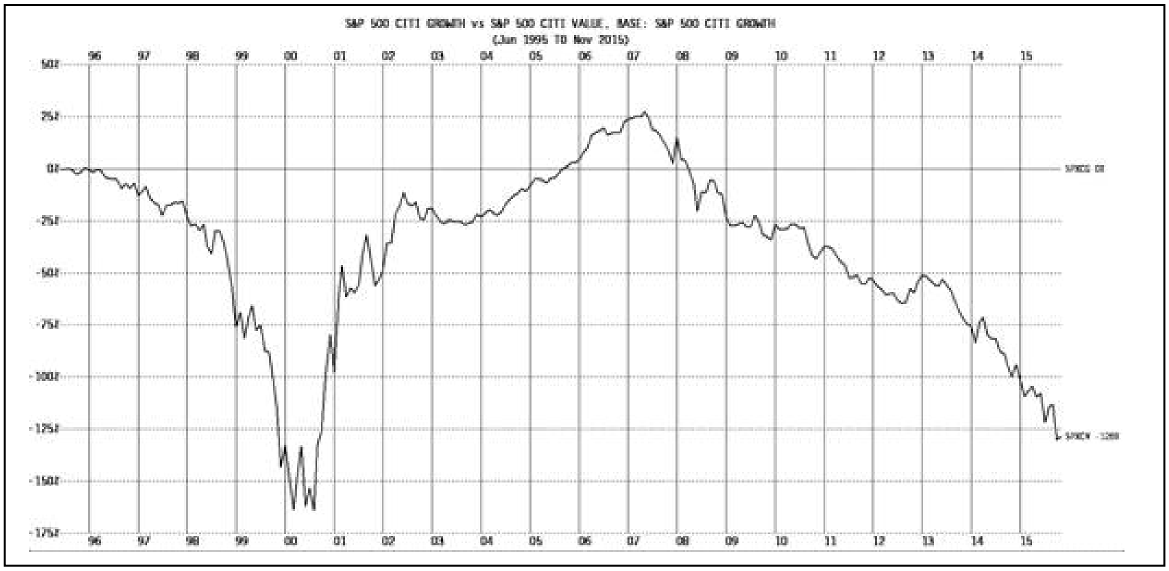
The S&P 500 would be fairly valued at 2300, about 12.5% above the current level, based on our model. Pundits who say that the stock market looks expensive compared to a historical average P/E, fail to take account for the fact that stocks, like bonds, are much more attractive and deserve higher valuations in a low inflation environment. An average P/E is as useless for analysis as is the historical average of bond yields. We use the Cyclically Adjusted PE (CAPE), as originally developed by Graham and Dodd of Columbia University, except that we use a six year trailing average for earnings rather than ten. This is done because six years has a better statistical relationship between the past and people's expectation for the future. We then model the six year CAPE with trailing six year inflation. The S&P 500, now trading at about 17 times our 2015 estimate for operating earnings and 16 times the 2016 estimate, may appear rich by some perspectives like a simple average. But in view of the low level of inflation, these multiples are better than fair.

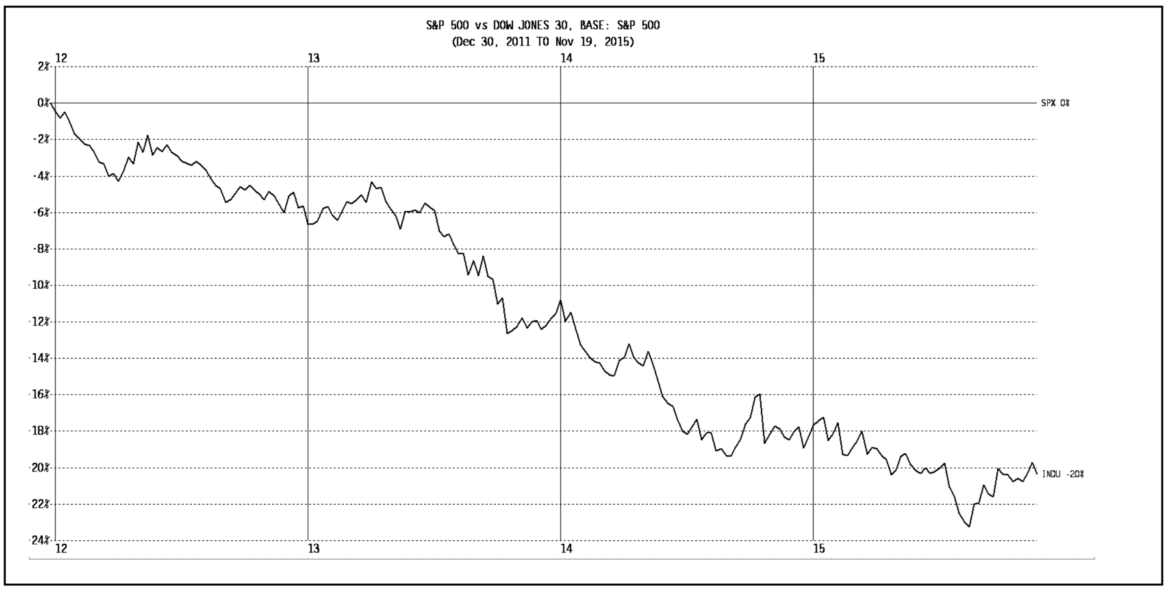
While stocks remain attractively valued, and the Bull Market which began in 2009 remains intact, we expect rising near term volatility due to currency considerations. As we previously mentioned, the equity markets generally discount changes in the currency markets because they are often seen as temporary and come with offsetting benefits or costs. This has generally been the case so far. However, if currency changes become extreme, it is possible that equities will suffer as investors demand better than normal stock valuations because risk is perceived as higher than normal. For example, the dollar/euro rate has generally hovered between 1.15 and 1.05 this year. If it were to remain in this range, the negative effects on U.S.

corporate sales profits would start to lessen in 2016. However, there are tentative signs that this relative stability may break down and the dollar may start to appreciate further against the Euro as well as other currencies (1 EUR = 0.85 USD is not unimaginable). Another big appreciation in the dollar may alarm investors. The central “problem” is that the Fed is poised to raise interest rates because of ongoing growth in the U.S., while Europe and Japan are experiencing ongoing quantitative easing (QE). Other countries like Brazil, Argentina, Venezuela and Russia have seen a breakdown in their currencies versus the dollar due to government mismanagement as well as declining demand for commodities. We remain bullish on stocks but the waters may be choppy until some market harmonization resumes.



Strength in growth stocks reflects a shortage of growth. There have been many academic studies that show the benefits of value investing over the long haul. However, real growth in the U.S. has fallen from the previous pace of about 3.3% p.a. to about 2.3%, and growth has almost disappeared in Europe and Japan. Investors looking for growth opportunities in safe markets have few opportunities. As such, businesses that are expanding on the narrow frontiers of cloud computing and biotechnology have been among the best performers over the past years, while some value stocks that are very cheap, have even gotten cheaper. As seen in the next page, the S&P Citi Value Index has been steadily underperforming the S&P Citi Growth Index since the start of the financial crisis in 2007. And the Dow Jones Industrial Average has underperformed the S&P 500 by 20% over the past four years even though Apple is a major component of the Dow. Value investing should prove to be a lasting way to accumulate wealth over time despite the results of recent years. A reversal is due. At this junction, we think there are some good old-school value companies worth holding on to through this “growth scare” period, partly due to their dividends. At the same time, there are some relatively attractively valued stocks in the fast growing areas of the market. A good blend of both makes for a decent balance of risk and expected return.





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