
Opportunity Knocks on the 2016 Door

By Ron Surz Thu, Jan 7, 2016

Ron Surz, the target date fund authority, is back with his annual market retrospective and forecast. He apologizes for missing the mark last year (he predicted a 19% drop in 2015), but believes that equity markets won't escape the bear this year.



In my 2014 end-of-year commentary, I forecast a 19% loss in 2015 for U.S. stocks, as measured by the S&P 500, when in fact the S&P actually earned a positive 1.4% return, so I was wrong. 2015 was disappointing, but not as bad as I thought it would be. The total U.S. stock market was down 1%. Other asset classes weren't so lucky, especially precious metals and commodities.

My fickle finger of gloom was misdirected in 2015; it should have pointed at other asset classes. But I'm repeating my forecast for a 19% loss in 2016, in stark contrast to Wall Street's 7% to 11% gain forecast. U.S. stock market fundamentals have deteriorated with lower dividend yields and higher price/earnings ratios, especially if you consider the effects of stock buybacks.

We're entering 2016 with a frothy and expensive stock market that begs to be humbled. I don't think it can dodge a bullet two years in a row. [This is an abbreviated version of the Surz report. You can find the full version, including all of the charts, [here](#).]

Winners and losers in 2015 and the 5 years ending 2015

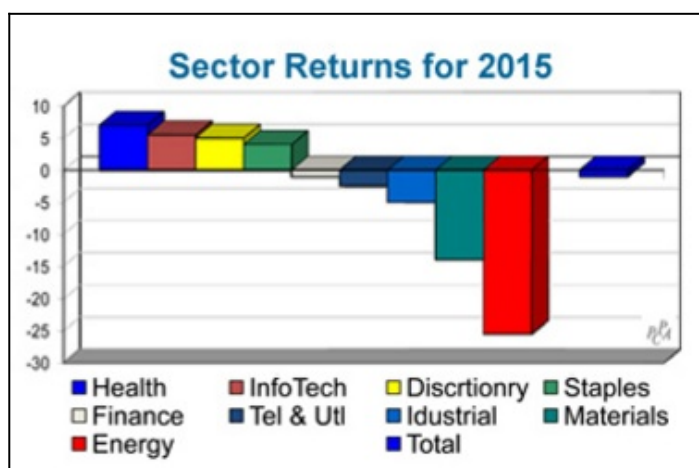
U.S. stocks. As in 2014, large-cap stocks led the way in 2015, with large-cap growth stocks performing best, earning 10.5%. By contrast, small-cap growth companies lost 15%. The S&P 500 returned 1.4%, exceeding the total market's 1% loss. On the sector front, healthcare fared best, earning 7%. By contrast, energy stocks lost 25.5%, and materials lost 14%. In a repeat of 2014, it was another bad year for infrastructure companies, and a good year for technology, both IT and medical.

The collapse of energy stocks this year and last year has been the big story. Energy stocks plummeted in the second half of 2014 and continued to decline in 2015 as oil prices crashed, due in large part to increased supply from fracking operations in the U.S. Crude oil

ended 2015 at \$38 per barrel, which is less than the cost of exploration in several countries like Brazil and the UK. Consequently oilrigs have been shut down as have pricier shale regions including Eagle Ford in Texas and Bakken in North Dakota.

OPEC is employing a strategy of putting oil producers out of business, at least temporarily. OPEC is increasing oil supply in the face of decreasing prices, a strategy that may be good for consumers in the short run, but can't be good in the long run. Lower prices increase consumption, so we use more of a commodity that has a limited supply. The day that this supply is used up has drawn closer, as has the day that energy prices rebound.

Larger companies have performed best over the past five years, especially large cap growth stocks. Healthcare and consumer discretionary companies have performed best. Infrastructure stocks - materials and energy - have performed worst.



Foreign stocks. Looking outside the U.S., foreign markets earned 1% in 2015, exceeding the U.S. stock market's 1% loss and exceeding EAFE's 0.5% return because, unlike the U.S., smaller companies performed best. Japan and Europe have seesawed over the years, thriving in 2013, suffering in 2014, and winning again this year. Canada was the worst performing country with a 20% (in \$US) loss.

Over the past five years, foreign market returns of 5% per year have lagged the U.S.'s 11% per year appreciation, but exceeded EAFE's 4% return. Europe and Japan have had the best performance, earning 8% per year. By contrast, Latin American markets have lost 3% per year. Unlike the U.S., value stocks have fared best over the past 5 years, earning twice as much as growth stocks, 7.5% versus 3.5% for growth.

The future: Winners and losers forecast for 2016

In “Searching for Alpha in Heat Maps,” published in early April 2013, I showed how heat maps could be used to profit from momentum effects. I then published my forecasts each quarter and momentum effects “worked,” with winners continuing to win and losers continuing to lose.

So now I’ll offer forecasts for the first quarter of 2016 using heat maps. A heat map shows shades of green for “good,” which in this case is good performance relative to the total market. By contrast, shades of red are bad, indicating underperformance. Yellow is neutral.

The table below is the U.S. heat map for the year ending December 31, 2015. We see that the best performing market segments are mostly in the healthcare sector and the large cap growth style. These would be the stocks to bet on if you want to make a momentum bet. Of course you could make a contrarian bet that these sectors will not do well.

U.S. Heat Map for the Year Ending December 31, 2015

	STAP	DISC	HLTH	MATL	TECH	ENER	INDU	UTEL	FINC	TOTL
LGVL	-0.9	-6.6	2.5	0.2	-11.8	-44.4	-5.1	-0.8	-1.5	-6.2
LGCO	3.7	8.8	12.5	-13.9	9.3	-22	-3.4	-9.6	0.2	2.8
LGGR	11.4	26.5	5.1	-8.8	26.4	-20.6	-0.4	45	-5	10.4
MDVL	26.8	-12.6	12.9	-15.3	0.3	-35.4	-4.8	-4.5	-0.1	-5.2
MDCO	7.3	-6.4	12.9	-7.8	7.2	-31.4	-6.8	-16.4	3.9	-2.6
MDGR	-8.9	2.1	7.5	-19.3	4.2	-28.3	-4.3	-11.4	-1	-2.5
SCVL	8.4	-8.9	0.6	-20.5	-0.8	-43.2	-12.1	-1.8	0	-7.1
SCCO	-5.5	-12.3	24.9	-41.6	5.9	-38.2	-15.5	5.8	0.6	-3.4
SCGR	-16.8	-20.3	0.8	-35.9	-7.2	-53.8	-29.8	-16.6	-17.7	-15.6
TOTL	3.9	4.8	6.6	-13.9	5.4	-25.5	-5.1	-2.4	-1.3	-1.0

Source: PPCA Inc

As for underperforming segments, energy and materials stocks are the place to look, especially smaller companies in these sectors. Many quantitative managers employ momentum in their models, buying the “green” and selling the “red.” Fundamental managers use heat maps as clues to segments of the market that are worth exploring, for both momentum and reversal potential.

Moving outside the U.S., the healthcare sector and the small cap growth style thrived in 2015, while energy stocks in all countries and styles have suffered, as has Canada.

The Past: The 90-year history of the U.S. capital markets

In forecasting the future, it helps to understand the past. Those who are unaware of the mistakes of the past are more likely to repeat them. In the final section of this report, I provide a longer-term 90-year history of stocks, bonds, T-bills and inflation.

There are many lessons to be learned from this history. Here are a few:

- T-bills paid less than inflation in 2015, earning 0.1% in a 1.3% inflationary environment. We paid the government to use their mattress, as we have for the past ten years, with a 1.21% return in a 1.85% inflationary environment.
- Bonds were more “efficient,” delivering more returns per unit of risk than stocks in the first 45 years, but they have been about as efficient in the most recent 45 years. The Sharpe ratio for bonds is 0.48 versus 0.34 for stocks in the first 45 years, but the Sharpe ratio for both is the about the same in the more recent 45 years. Both stocks and bonds have returned about 0.32% per unit of risk.
- Average inflation in the past 45 years has been more than twice that of the previous 45 years: 1.83% in 1926-1970 versus 4.09% in 1971-2015.
- Bonds returned 2% above inflation in the first 45 years, and that doubled to above 4% in the past 45 years.
- Stock market volatility was much higher in the 20-year period 1926-1945 than it has been since. Volatility subsided from 20-35% down to 15% in the most recent 70 years.
- By contrast, bond markets have become more volatile, more than doubling in the most recent 45 years to 9.23%, versus 4.52% in the first 45 years.