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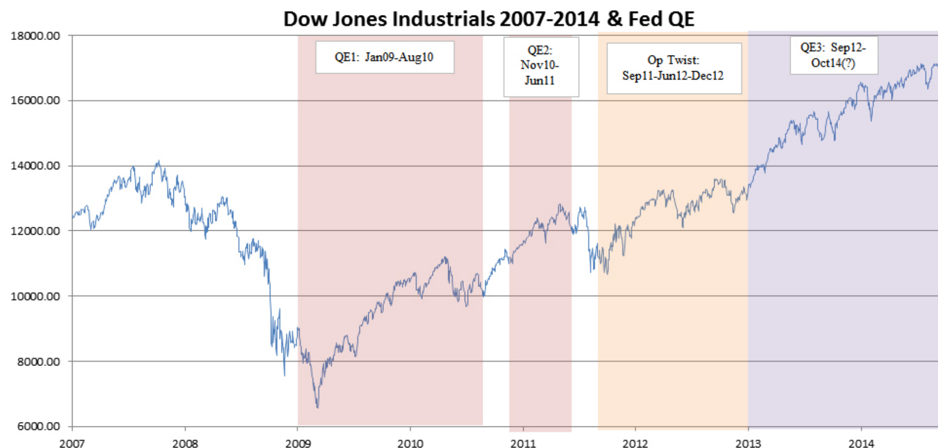
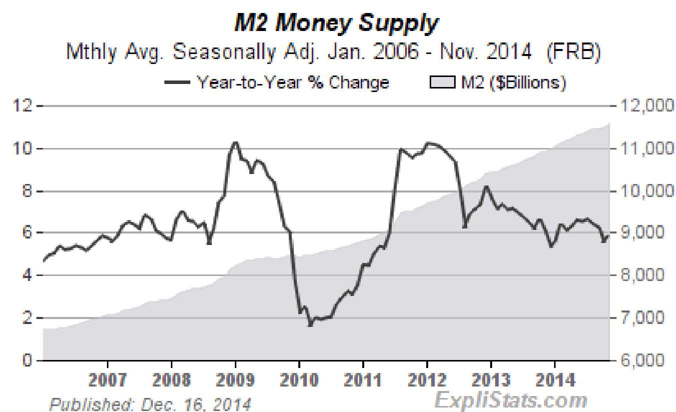
Archer 2015 Annual Outlook:

Just when we thought our year-end prediction of 9.5% was correct for 2014, the Fed in their infinite wisdom sprinkled fairy dust on the equity markets and poof we saw some expansion in the P/E multiple and now we are sitting at a near 15% return. By simply using the word "patience" the equity markets flourished and are now looking at moving higher into 2015. This is all welcome news. However, as we always say, let's not focus on the rear view mirror, but what is to come for 2015.

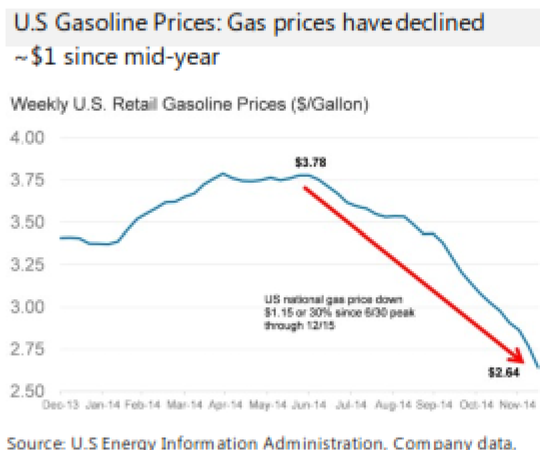
Some of the same catalysts we saw in 2014 should hold true for 2015 plus an additional catalyst. Interest rates are near non-existent and will remain so for some time. As you can see by the chart below, interest rates should remain low due to the far-reaching Fed. Now we are seeing the same thing across the pond in Europe. They recently just committed 1 Trillion Euros to print and keep interest rates low. These printing presses will keep running and some of that money will find its way over to the US keeping our interest rates low for a considerable amount of time.



This increase in monetary supply is not just ours to tout. In Europe where they need it most it will likely safeguard the countries over there from a hard recession. This will help our economy and stock markets in 2015. The more the Fed safeguards the market, the returns should keep moving higher, unemployment lower, and all is happy in wonderland. (See the next chart showing the continuing levels of increasing Money Supply each year.)



I think another catalyst for 2015 is the fall in Oil. As crude oil is now just below $53 per barrel, this should result in an $800 savings to the average household in 2015. With just over 117 Million households at $800 per year at these levels, this results in over $90 Billion in additional savings. If we couple this with the increased dollars being saved on refinancing across the country on mortgages, I would expect over $100 billion in new dollars being added to our economy through the consumer. This surplus will grow higher when you add the corporate savings from the fall of oil.

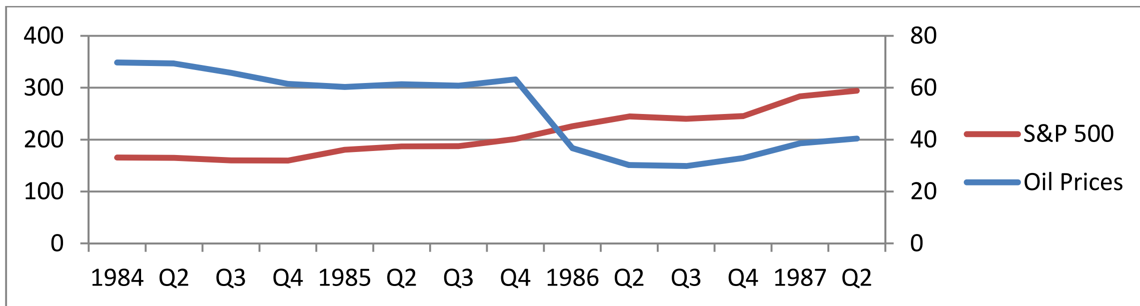


This fall in oil prices is not without its risks. Nearly 30% of the Capital Expenditures in the S&P 500 were made from Energy related stocks in the past year. Much of this will dry up. If we look back at history, many of us can remember that states like Texas, Louisiana, and Oklahoma all suffered to near depression levels when Texas Tea suffered a similar decline in 1984-1986. The one difference today is more states are involved with oil due to fracking, etc. In fact, many states are involved with oil: Texas, North Dakota, Alaska, California, Colorado, Oklahoma, etc. Take Colorado for instance, the oil industry employs over 100,000 people and spends $30 billion a year in Colorado alone.

The U.S. is not alone in the problems facing lower cost of oil. Countries like Russia, those in the Middle East and South America will bear a large brunt of the downturn. One of the reasons Europe as we mentioned earlier is

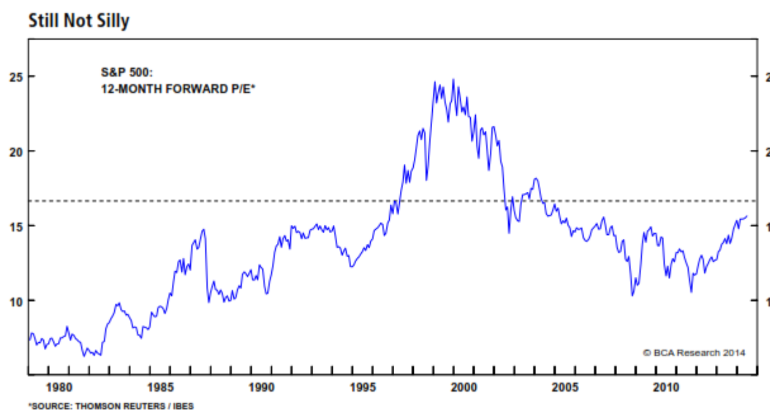
facing a possible recession is due to the decline in oil prices. Russians are key trading partners with Europe from a Consumer and National level. This decline in revenues to Europe is problematic and is assisting the European Countries in having their own bout of Quantitative Easing (QE).

Ultimately we believe the reduction in oil prices is a net positive as most companies use oil and clearly most consumers do as well. The last decline in oil of this significance that remained for a period of time is shown below. During this time, oil dropped nearly in half much like today and the stock market then climbed dramatically as well. Although we believe the positives outweigh the negatives, these positive returns in the market will likely come earlier in the year as opposed to later and could be muted in the light of more volatility as some of the excess shakes out in the stock market.



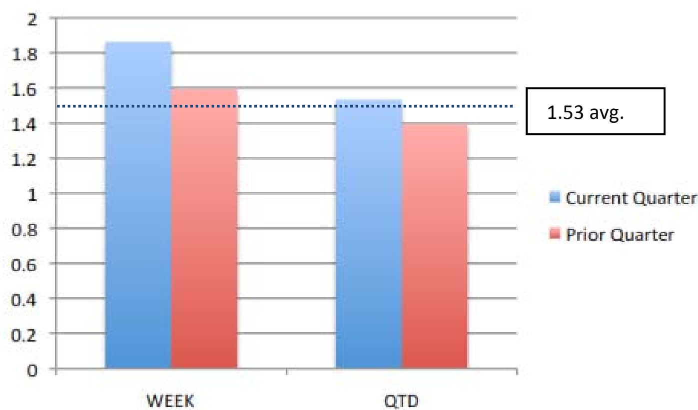
With that in mind, let's turn our attention to the earnings front to see where we are today vs what is expected in 2015. Last year we expected earnings to reach $120 for the S&P 500. I think we will fall just short of this at $118 give or take. We also said if we were to expect a multiple of 15.3x and the(past) expectation was $132 for 2015 as we reached the end of 2014, we would trade around 2020 on the S&P 500. (reprinted from the 2014 Outlook: One item we talk about when managing money is what is the "reversion to the mean"? Or what does the average market look like. When looking at the averages or mean first, we have a frame of reference to find the equilibrium point of what the market should be trading at. Since 1999, the average P/E multiple (Price to Earnings [next year earnings], if a company earns $1 and they trade at a 15 P/E then the stock will trade at $15) is 15.3x. However, the stock market rarely looks in the rear view mirror except during downturns.)

However, as we mentioned last year, when the pendulum swings, we can see the 15.3x number change to 16 or fall to 14 or more either way. In this low rate environment we are seeing signs of an increasing multiple. This is a net positive for the stock market in 2014, but we see it taking away some of the expected returns for 2015.



Current estimates for 2015 are estimated at approximately $128 for the S&P 500. This has declined over the last month because energy continues to be a drag on earnings. Earnings for the energy sector in September was expected to increase by 8% and now is expected to decline by 17%. We have also seen similar trends for the S&P overall where the earnings growth has been cut to 2.6% instead of the expected 8.4% at the end of September. These cuts could continue. If we do happen to hit the $128 mark we will be at close to a 16x multiple of the S&P which we would consider to be fairly valued in light of the low interest rates. See the chart above we posted in the mid-year outlook of 2014.

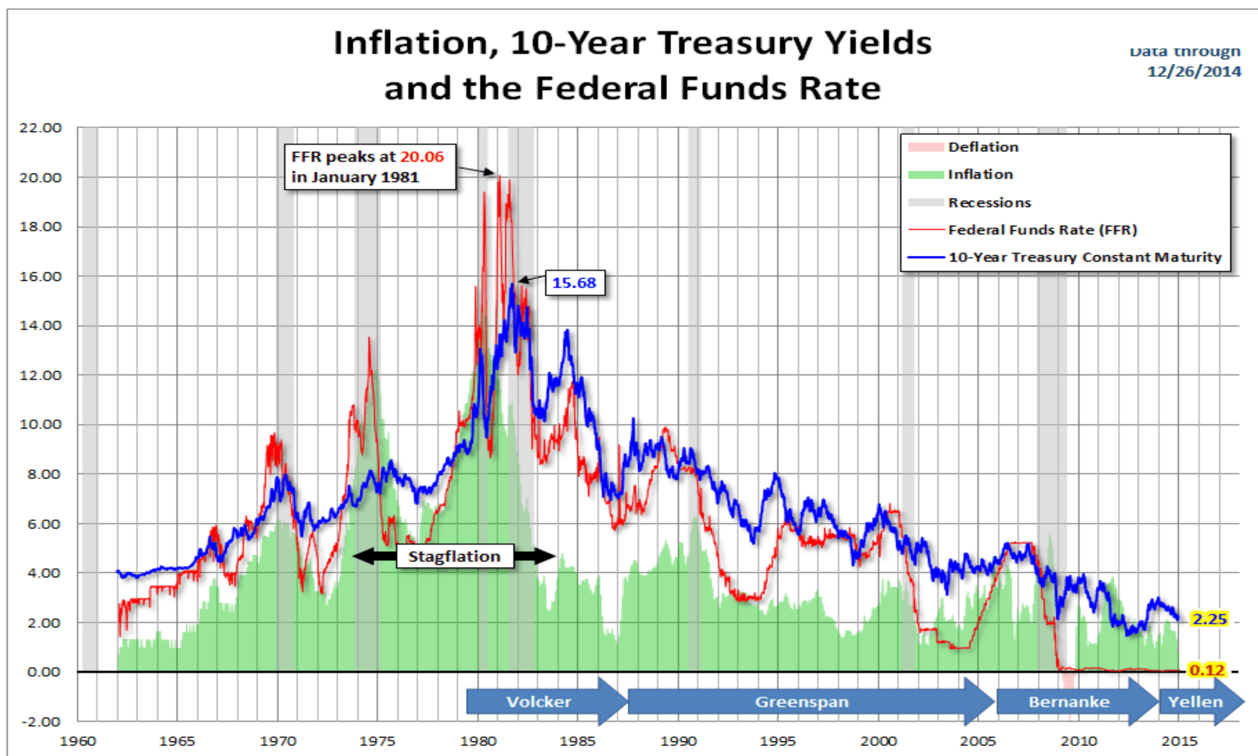
One way to note if earnings are progressing higher is to simply see if a company's earnings are higher or lower than they were a year ago (we use 12 months ago due to cyclicality). The general trend is higher, but any retrenchment below the averages is a sign earnings could be slowing. In the latest quarter we saw above average earnings growth. We would expect this to show some reversal in the earnings coming out over the next few months with the Energy sector leading the way lower. This decline in earnings could set the stage for some additional volatility in the first quarter of 2015. Once this subsides, we expect most will focus on the future earnings of the overall S&P 500 stocks. This should create a higher market.



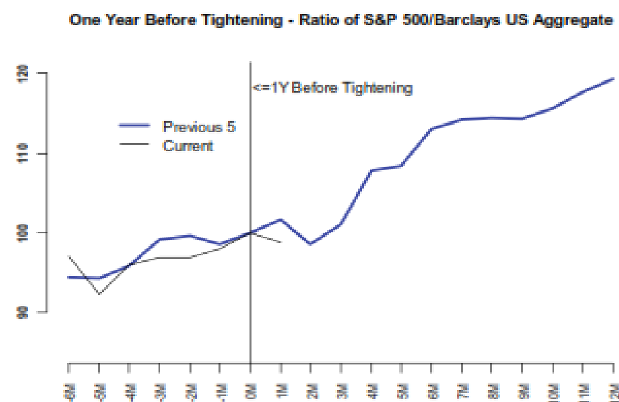
Of course, we are always looking forward so to get to the return of the S&P 500 for 2015, we would need to see where earnings will be at the end of 2015 for the following four quarters and what our multiple will be. Drum Roll……. If we see earnings at $135 (for 2016) x a 16.3 multiple = 2200 on the S&P 500. With the S&P trading at 2075 today, this implies a return of 6% for 2015. I am optimistic that maybe we are underestimating the lower oil prices and consumption of discretionary goods. I would not be surprised to see a 6-9% return in 2015.

Some of you may be asking: Why not put our money into bonds then. In 2014 we returned over 5% with much less risk than the stock market. The answer is not that simple. Yields today are already extremely low and since 2008 have remained in the +30% overvalued camp and are currently about 120% overvalued by some calculations. We have sounded like a broken record saying this year after year. The one thing we need to understand and come to grips with is this is not a free market for bonds. The Government has been controlling the interest rates and declare no particular interest in seeing them go higher. Remember the word "patience"…..

Another way to look at the bond market is to look at it the same way as we do the stock market based on an earnings multiple. If we do the calculations, the bond market in general is trading at 45x its earnings power. This is for a "Company" with no growth to speak of. Although we manage a bond fund and try to limit our risk to holdings we don't mind owning until they mature, many individuals do not have a long-term horizon to hold a bond until maturity. There is just too much interest rate risk. This risk can limit the returns you may enjoy if you have to sell early. This 45 multiple is just too high. We would not be surprised if at some point yields doubled from these levels which would mean the economy is running on its own two feet or inflation is rising. Even with all the above said, we expect a modest return from our bond holdings in 2015 and we do think there is an element of safety that comes with a return of your principal before a return on your principal. This is why we still advocate a balanced position…. By looking at the chart below you can see rates are at historical lows. We would fully expect these rates to stay low as long as the Fed Funds Rate (FFR) remains near zero.



One last point: We often get the question about the Fed raising rates or tightening. The question is often when they start to raise rates is this the time to get out of the market. The answer can be heard and seen fairly clearly. The idea of a rising rate environment often signals economic progress. We foresee the Fed raising rates in the first quarter of 2016, not 2015. Even if we are wrong, the previous 5 times the Fed tightened or raised interest rates, the stock market moved higher. We think this time is no different. In fact, the market is expecting it and is closely resembling the pattern of the previous five rate increases.



We will continue to keep you up to date on our posts at www.thearcherfunds.com. Remember to invest in a manner you are content with and focus on long-term investing. Although we speak about short-term gyrations in the market, it is difficult to trade the market with any kind of long-term accuracy if you are focused only on the short-term.

Regards,

The Archer Team

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