

Let's Try Again: S&P 2,375

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The future exists to keep forecasters humble. And our 2,375 forecast for the S&P 500 at year-end 2015 has done just that. We are humbled, but we do tip our hat to Jim Paulsen at Wells Fargo Asset Management who said that 2015 would be a tough year for US stocks.

Jim was right and we were wrong. To date, the S&P 500 has been basically flat in 2015, yet it did pay about a 2% dividend, which means the index beat gold, which is down about 10%, while the 10-year Treasury Note has had a total return of only about 1.5%. Oil is down 31% so far in 2015, European stocks and emerging markets disappointed as well. Japan is up 8.1% and the Nasdaq is still up 6.2% in 2015. All of this just goes to show how difficult it is to pick the perfect investment every year.

This is why we look at fundamentals. We don't think a recession is likely in 2016. We expect Plow Horse economic growth and resilient corporate profits. As a result, we believe US stocks are still undervalued. We view the 2015 pause, after six years of increases, as a pause that refreshes.

So here we go again. Not only do we believe Northwestern will beat Tennessee on New Year's Day, but we expect the S&P 500 to end 2016 at 2,375, 15.7% above current levels. This is based on our Capitalized Profits Model, which discounts corporate profits by the 10-year Treasury yield.

Given a 10-year Treasury yield that currently stands at 2.25%, the "raw" version of the model says the S&P 500 is "worth" 4,228. Yes, we realize that sounds insanely high. But this number is artificially high because current Fed policy is holding the yield curve "artificially low." Using a more reasonable 10-year discount rate of 4%, instead, gives us a "fair value" calculation of 2,378.

And if we're wrong about interest rates, if long-term yields remain stubbornly low much longer than we think, then we're being too pessimistic about equities. A discount rate of 3.25%, for example, would put fair value at 2,925. Another way to think of this is that if the "new normal" crowd is right and interest rates stay low, then stocks have to go to much higher levels before *future* returns would be expected to be held down significantly.

For now, we still think the 10-year yield is eventually headed for 4%. Over long periods of time, the 10-year yield tends to equal nominal GDP growth – real GDP growth plus

inflation. The Federal Reserve projects that nominal GDP growth will hover around 4% per year over the longer run, which is consistent with a 10-year yield of 4%.

Yes, the 10-year yield has fallen short of nominal GDP growth over the past five years, but over the past ten years (through the third quarter), the Note yield has averaged 3.17% while nominal GDP growth has averaged 3.18%. In other words, the so-called "broken" link between yields and the economy is a figment of the time period chosen.

However, because the Fed will lift rates in a gradual and patient manner, we forecast the 10-year yield ends next year at 3%. As a result, any danger to stocks will not be due to a rapid increase in interest rates. If you want to worry about our forecast for stocks, you should focus on profits.

We are not all that worried. Yes energy earnings are down, but we do expect real GDP to grow at a Plow Horse 2.5% annual rate in 2016. This is a slight acceleration from 2015, but no different than the 2.5% growth of 2013 and 2014.

Plow Horse economic growth should generate continued gains in the labor market. Payrolls should be up another 2.5 million, about the same as this year, and wage growth should accelerate, drawing more adults back into the labor force. As a result, the unemployment rate should continue to drop, but not quite as fast, hitting around 4.7% around Election Day. However, with fewer "discouraged" workers, the expansive U-6 definition of unemployment, what some call "true unemployment" will fall faster than the official rate.

Meanwhile, given loose monetary policy, inflation should pick up faster than most anticipate. We estimate a 2.5% increase in the CPI in 2016. As soon as energy prices stop falling, the other parts of consumer prices, which have been growing beneath the radar, will take over. For example, rent of shelter, which makes up about one-third of the CPI, is up 3.2% from a year ago and has accelerated for five years in a row. Medical care is up 2.9% in the past year.

All-in-all, 2016 looks like another year of healing from the Panic of 2008. The bull market continues to run and the economy continues to grow. If we knew how to move assets each and every year to get the "best" returns, we would trade the market much more, and benefit. But, so-called "macro-traders" don't win very often. As a result we stick with fundamentals, which say US stocks remain undervalued.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-29 / 9:00 am	Consumer Confidence – Dec	93.8	94.8		90.4
12-31 / 7:30 am	Initial Claims – Dec 27	270K	270K		267K
8:45 am	Chicago PMI – Dec	50.0	50.3		48.7