Midyear 2015: Slower Growth, Mixed Markets

Presented by Steven M. Seide

Where Are We Now?

Strong performance in the second half of 2014 positioned us for a good start to 2015. Since then, however, the news has been somewhat disappointing. A weak first quarter was largely attributed to winter weather and a strike at West Coast ports, but growth in the second quarter did not rebound as strongly as it did last year, and signs of slowing continue to appear.

The news is not bad: employment, for example, continues to grow strongly, with job increases at levels last seen in the mid-1990s. The housing market has continued its recovery as well, but other factors have slowed, including business investment and government spending. Even with the good employment news, wage increases have lagged expectations, and consumer spending has dropped below the growth rates of 2014. Rather than accelerating, growth has actually dropped back to the somewhat anemic pace we saw earlier in the recovery. In response to these developments, the stock market posted a weak first half as well.

What Are the Expectations for the Rest of the Year?

As we look into the second half of 2015, I believe we can expect these underlying economic trends to continue. Growth in most areas will likely be slower than expected, though it will be sustainable. With employment continuing to rise, and wages continuing to grow (albeit slowly), I expect consumer spending will also increase at a sustainable pace. Combined with an ongoing housing recovery, this should provide a solid base for slow growth.

Indeed, given the negative factors so far this year—weather, the West Coast port strike, declines in oil drilling investment, and now political unrest in Europe and stock market turmoil in China—it is quite possible growth will accelerate again, but that’s only speculative at this point.

All things considered, I expect to see real economic growth of around 2.25 percent, with the possibility of stronger results. With wage income growing at around 4 percent on a nominal basis, business investment growing at around 6 percent, and government spending showing slow growth around 2 percent, this 2.25-percent figure appears both reasonable and achievable. Combined with inflation of around 1.5 percent for the year, nominal growth should approach 3.75 percent.

A Look at the Risks

Economic risks. There are risks both ways here. On the upside, if wage growth were to increase, consumer spending power could increase more quickly. If consumer borrowing were to pick up—and there are signs that it is starting to—spending could grow even more. Business investment could respond to improving demand and rise more than expected. Local and state governments could increase investment and hiring more than expected.

On the downside, risks are primarily external, with Europe as the biggest. As I write this, Germany and Greece are going head to head, and a Greek exit from the eurozone—and potentially from the European Union itself—is a real possibility. Even if differences are papered over once more, the real issues will still be there. China also remains a risk factor, with its recent stock market crash as the most obvious sign of slowing growth and potential instability. Either of these could result in systemic damage, with consequent negative effects on the U.S. economy and financial markets.

The major domestic downside risk involves the effects of rising interest rates when the Federal Reserve (Fed) finally starts to raise them. Although expectations vary, there is general consensus that rate increases should start by the end of 2015. If rates rise too far too fast, the economy could slow. The Fed is aware of this, however, so it is unlikely to do anything that would jeopardize continued economic expansion.

Financial risks. The stock market, on the other hand, may be challenged throughout the rest of this year. After a weak first quarter for corporate earnings—and significant turmoil—valuations have stabilized and are unlikely to increase much further. At the same time, many of the factors that slowed earnings growth earlier this year are passing, which should help it to accelerate during the second half of the year. Overall, I expect earnings growth to exceed gross domestic product (GDP) growth for the remainder of 2015, while valuations remain stable, with the net result of moderate continuing appreciation to be around 2,200 for the S&P 500.

Although earnings should continue to grow, slower economic growth in the U.S. and turbulence abroad will continue to act as headwinds. Combined with a rise in interest rates, that lack of multiple expansion could make bonds more attractive as an investment and lower the present value of the earnings stream even more. Therefore, the risks to the market are mostly on the downside.

In conclusion, I believe that the economy will continue to normalize, which should support the notion that the U.S. will remain as the primary global growth engine and stable haven. Still, the second half of 2015 is likely to present more downside risk than upside opportunity for the financial markets, as investors adjust to the prospect of continued political turbulence around the world.

Disclosures: *Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. All indices are unmanaged and are not available for direct investment by the public. Past performance is not indicative of future results. Diversification does not assure a profit or protect against loss in declining markets. The S&P 500 is based on the average performance of the 500 industrial stocks monitored by Standard & Poor's. Emerging market investments involve higher risks than investments from developed countries and also involve increased risks due to differences in accounting methods, foreign taxation, political instability, and currency fluctuation.*

###

For Registered Representatives: Steven M. Seide is a financial consultant located at 110 John Robert Thomas Drive, Exton, PA 19341. He offers securities as a Registered Representative of Commonwealth Financial Network®, Member FINRA/SIPC. He can be reached at (610) 280-9330 or at sms@seidefinancial.com.

Authored by Brad McMillan, CFA®, CAIA, MAI, senior vice president, chief investment officer, at Commonwealth Financial Network.