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A good year

January 2—The economic recovery in the U.S., now in its sixth year, produced much good news in 2014:

• The S&P 500 rose 11.4%, and the Dow Jones Industrial Average posted a 7.5% gain on the year, following the stellar performance of stocks in 2013.

• The six months of economic growth that included the 5% spurt in the third quarter were best half-year period since 2003.

• 2.7 million jobs were added through November, the best year for employment growth since 1999.

• Oil prices decline sharply in 2014, bringing major relief at the gas pump to U.S. consumers. All signs point to lower oil prices for the intermediate future.

But the picture is not entirely rosy, it never is. While the U.S. is doing well, Europe and Japan are not. Countries using the Euro have not yet surpassed their pre-recession economic output, as the U.S. has. The Dow Jones World Index, which excludes the U.S., fell 5.5% in 2014. Robust, stable economic growth requires strong economic partners.

CAPE fears

Higher stock prices are powered by two factors: increased profits and increased investor optimism. Optimism is generally measured by the price/earnings ratio. A high ratio means that investors are willing to pay a high price for future profits, and it suggests that they expect those profits to grow.

Nobel Laureate Robert Shiller has traced a cyclically adjusted price earnings (CAPE) ratio from 1871 to the present. His CAPE ratio includes an inflation adjustment and a ten-year time frame for smoothing annual variability. For the 20th century, the average CAPE ratio was 15.21. At this writing the CAPE ratio stands at 27.34. Speaking historically, that number is in the stratosphere. That’s where it was in 2007, just before the financial meltdown. In 1929, before the Black Friday crash, it stood 32.56. Before the dot-com bubble burst, CAPE reached 43.83.

A high CAPE ratio for the stock market is not necessarily a sell signal, even though it may be suggestive of “irrational exuberance.” High stock prices may also be a reflection of the absence of satisfactory alternatives for investing. However, once the CAPE has reached high levels, future increases in stock prices will have to be fueled primarily by increased profits, not improved investor sentiment.

Housing

Another cloud on the horizon is the housing market. New home sales in November were 1.6% below the year-earlier figure, and existing home sales fell 6.1%. Home price growth has slowed, following the recovery of the recession lows. Historically, the success of the housing industry has closely tracked the ups and downs of the economy generally. An uptick in interest rates in 2015 would not be helpful to home buyers or sellers.

Interest rates

Throughout 2014 investors were concerned about what the Federal Reserve Board would do, and when they would do it. When interest rates go up, the value of existing bonds necessarily goes down, with the longest maturities hit the hardest. As it turned out, investors’ worst fears did not materialize.

The story could be different in 2015, however. In December the Federal Open Market Committee reconfirmed its patience with below-normal interest rates so long as projected inflation remains below a target of 2% annually. Given the drop in oil prices rippling through the economy, that target is not likely to be breached in the near term. On the other hand, another quarter of 5% growth might stimulate the Fed to accelerate a plan of lifting interest rates back to normal levels.

(January 2015)