Seeking Alpha α

2015 Outlook: Pain

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Summary

- Market prediction for 2015: Pain.
- U.S. stock market volatility is likely to increase notably with its relative outperformance over global stocks and other asset classes put to the test.
- A variety of asset classes and strategies provide the opportunity for strong returns in the coming year.

Interviewer*: What's your prediction for the fight?*

Clubber Lang*: My prediction?*

Interviewer*: Yes, your prediction.*

Clubber Lang*: Pain*

--Rocky III, 1982

The U.S. stock market has provided a blissful time for investors over the last several years. It has been almost six years now since the turmoil of the financial crisis dissipated. And with each passing year, U.S. stock market volatility has become less and less as the financial crisis starts to become an increasingly distant memory. But that may all be about to change as we enter into 2015. In fact, the change may already be underway. After so many comfortable years, a new challenge has finally arrived for the U.S. stock market. Thus, my market prediction for 2015: **Pain**.

(click to enlarge)

U.S. Stocks: Waking Up From A Dream?

Source: Gerring Capital Partners, StockCharts.com

The Rise Of A Champion Stock Market

Sure, the U.S. stock market has had to endure several bouts of volatility along the way.

We had the spring and summer of 2010, when only three weeks after the end of the U.S. Federal Reserve's QE1 stimulus program the U.S. stock market as measured by the S&P 500 Index plunged into a -17% correction over the course of several months before the then Fed Chair Ben Bernanke came to the rescue at Jackson Hole with reassurances that QE2 would soon be on its way.

We had the summer and fall of 2011, when only three weeks after the end of the Fed's QE2 stimulus program U.S. stocks cascaded lower into a -20% correction in just two short months before Mr. Bernanke came to the rescue once again with reassurances that the Fed would be back with even more stimulus. What followed were two rounds of Operation Twist that carried the markets through the rest of the year and throughout all of 2012. Along the way, Mario Draghi and the European Central Bank (ECB) got into the stimulus game with their Long-Term Refinancing Operation (LTRO) from December 2011 to February 2012.

By the end of 2012, the U.S. stock market was showing signs of agitation once again. Yes, the market was rising throughout the year, but the S&P 500 Index had a tough spring with an -11% decline in April and May. And after reaching new post crisis highs in September, it dropped by another -9% through mid-November before rallying into the end of the year.

It was at this moment at the very start of 2013 that the then Fed Chair Ben Bernanke unleashed the stimulus haymaker. The Fed began the daily purchases of U.S. Treasuries as part of its latest QE3 stimulus program totaling $45 billion per month. This amounted to $3 billion in fresh liquidity flowing into the financial system each and every trading day. And it was at this very moment that the U.S. stock market descended into what almost seemed like a dream state. Over the next twenty months from January 2013 to August 2014, the S&P 500 Index rose with remarkably low volatility.

But in September 2014, something notable happened. Following many months of current Fed Chair Janet Yellen carefully winding down QE3 to its end, the U.S. stock market seemed to suddenly start to wake up. While modest in comparison to what happens in a normal market environment, the S&P 500 Index experienced a -10% correction in

September and October. In the process, it broke below its 200-day moving average for the first time in several years. Of course, U.S. stocks have since recovered to advance to new highs. But what this fall correction and some of the events that have surrounded it demonstrated is that the dream for the U.S. stock market may finally be ending.

Rocky Balboa*: I said why you doin' this?*

Mickey*: Because you can't win, Rock! This guy will kill you to death inside of three rounds!*

Rocky Balboa*: You're crazy.*

Mickey*: What else is new?*

Rocky Balboa*: He's just another fighter.*

Mickey*: No, he ain't just another fighter! This guy is a wrecking machine! And he's hungry! Hell, you ain't been hungry since you won that belt.*

Rocky Balboa*: What are you talkin' about? I had ten title defenses.*

Mickey*: That was easy.*

Rocky Balboa*: What do you mean, "easy"?*

Mickey*: They was hand-picked!*

Rocky Balboa*: Setups?*

Mickey*: Nah, they wasn't setups. They was good fighters, but they wasn't killers like this guy. He'll knock you to tomorrow, Rock!*

Rocky Balboa*: Geez, Mick why'd you do it?*

Mickey*: Because the beating you got from Apollo shoulda killed you, kid. It didn't. It was my job to keep you winnin', and to keep you healthy.*

--Rocky III, 1982

S&P 500 Index - Paper Champion

The U.S. stock market is a celebrated champion among global investors given its stratospheric rise since the quieting of the financial crisis nearly six years ago. But are all the accolades deserved? Or has this been a market that has been effectively made "easy" and hand-picked for investors through the addition of $7.8 trillion in national debt and the $3.6 trillion expansion of the Fed's balance sheet, a combined total that amounts to more than 50% of the total market capitalization of the U.S. stock market?

Putting the U.S. market in a global context certainly raises questions. According to the Conference Board, during the period from 2010 to 2013, the U.S. economy has posted a solid but far from extraordinary annualized GDP growth rate of 2.2%. And the U.S. is on track to post another year of 2.2% annualized GDP growth in 2014. Over the same time period, the world as a whole generated annualized GDP growth of 3.7% from 2010 to 2013 and is projected to post growth of 3.2% in 2014. In short, it is not as though the U.S. economy has been the bulwark while the rest of the world has had an economic glass jaw.

But when scrutinizing global stock market performance, one might easily draw a different conclusion that the U.S. economy must be the undisputed champion among a world of dogs. For after traveling in lockstep together for the first few years after the financial crisis died down through mid 2011, the U.S. stock market suddenly parted ways with the rest of the world (NASDAQ:ACWX). In the over three years since, the U.S. stock has gone on to more than double, while the rest of the world is effectively unchanged from where it was trading in April 2011.

(click to enlarge)

Source: Gerring Capital Partners, StockCharts.com

Has the U.S. been that much better since mid 2011? Or has the U.S. stock market been on an unworthy victory tour puffed up in part by more than $11 trillion in fiscal debt and monetary liquidity? If the latter is true, exactly how much longer can it continue?

A look within the U.S. stock market reveals troubling signs as we move into 2015.

First, U.S. small cap stocks effectively ground to a halt in 2014. After trending together for the first four months of the year, U.S. large cap stocks (NYSEARCA:SPY) took off once again to the upside and left its U.S. small cap stock (NYSEARCA:IWM) counterpart behind in the dust. Yes, small caps are ending the year on a high note, but this is after being down nearly -10% for the year as recently as mid-October and down roughly -1% for 2014 as recently as two weeks ago in mid-December.

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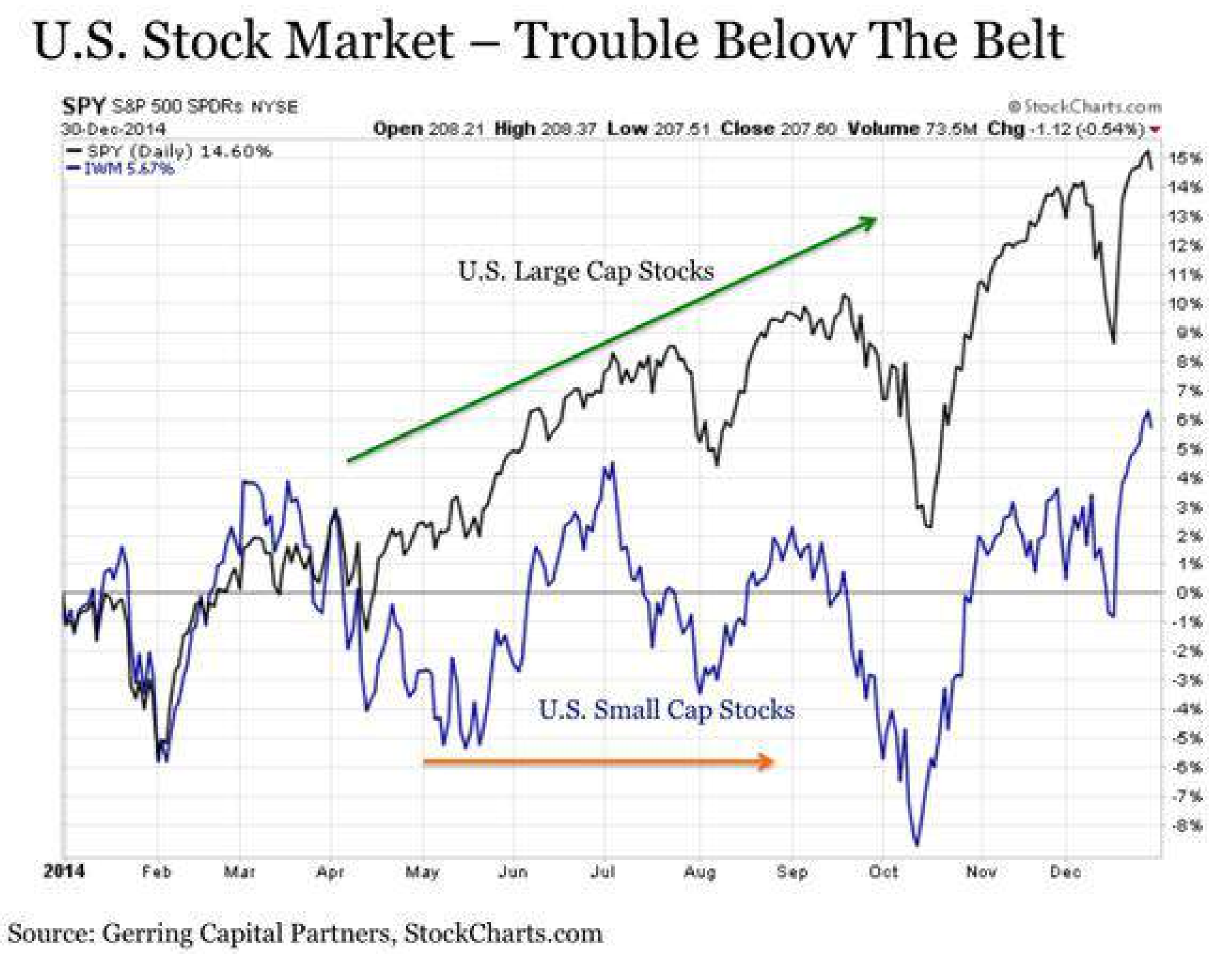

Why does this matter? Because U.S. small cap stocks not only serve as a leading indicator for long-term market shifts, but they are generally more sensitive to the performance of the underlying economy. In short, if the fundamentals that underlie the U.S. stock market were sufficiently strong to support further gains, we would presumably be seeing better performance out of the small cap space.

Second, U.S. stock performance has been led throughout 2014 by the most defensive sectors that tend to perform best either near or after broader market peaks. For example, utilities (NYSEARCA:XLU) have been the uncontested leader for the year having advanced by +30%. Health care (NYSEARCA:XLV) is not far behind at +26%. And consumer staples (NYSEARCA:XLP) are also up a strong +17%.

(click to enlarge)

Defensive Sectors Drive The Market In 2014

Source: Gerring Capital Partners, StockCharts.com

Don't get me wrong. As someone who was heavily overweight utilities through 2014, such performance is thrilling. But if we are operating in a market that is leaning on a +30% gain from utilities to post another solid advance in 2014, it does not necessarily bode well for what is to come.

Lastly, U.S. stocks are expensive. With stocks trading at a price-to-earnings ratio of 19.5 times trailing 12-month as reported earnings, this is high by historical standards. Also, with a 27.3 times 10-year cyclically adjusted price to earnings ratio, stocks are trading at some of the highest readings on this metric in history.

Putting this all together, the performance of the U.S. stock market is being driven by an increasingly narrow group of securities. As 2014 draws to a close, the leaders have been whittled down to U.S. large caps. And even within this group, we have seen major sectors such as energy (NYSEARCA:XLE) drop off definitively to the downside and other cyclical sectors such as materials (NYSEARCA:XLB), industrials (NYSEARCA:XLI) and consumer discretionary (NYSEARCA:XLY) all looking increasingly wobbly, as each were negative for the year as recently as mid-October. And in a world where geopolitical and systemic risks appear to be rising, the U.S. stock market is likely to find its performance leadership narrow even further in 2015.

Will The Fed Still Be In The Stock Market Corner In 2015?

But what about the Fed? Sure, the U.S. stock market could enter into correction in 2015. It could even be pretty sharp and could result in a decline of more than -10%. But won't the Fed simply be there with more monetary stimuli to push the market back higher at the first sign of trouble? The answer here is no. The Fed is gone from the stock market's corner. And it's not coming back unless the market finds itself flattened on the canvas.

The Federal Reserve under new Chair Janet Yellen has spent the last year slowly extracting itself from a QE3 stimulus program that the market effectively had it trapped in for much of 2013. And having the U.S. central bank and overseer of the world's reserve currency stuck in a program for nearly two years that had it increasing its balance sheet by more than 50% through the injection of an additional $1.6 trillion into the financial system is not a healthy circumstance at all.

But now the Fed is out. And unfortunately upon reflection by its current Chair and one of her legendary predecessors in Alan Greenspan, these various Fed stimulus programs over the last several years did not perform as hoped in working to achieve sustained economic growth. They instead helped create what has become one of the widest wealth and income inequality disparities in recent American history. And while many on the Fed would be highly reluctant to admit it, but they also have indicated the recognition that these stimulus programs have helped contribute to artificially inflated and potentially unstable asset prices. As a result, they are not likely to come back with any more monetary stimuli unless absolutely necessary. And even then, any future asset purchase programs would likely be highly targeted and deliberately structured in such a way that the benefits would flow directly to somewhere other than the stock market.

As a result, the stock market is now on its own. But this does not mean that the Fed won't lend a completely hollow hand when needed. Anyone trading on the short side of the U.S. stock market in the coming year should fully expect that a member of the Federal Reserve will come out jawboning about a new QE stimulus program the moment the stock market finds itself down by -7% or more within a two month period. Such has been the pattern of the Fed in the past, and the market has traditionally responded well to such promises. This, after all, is what St. Louis Fed President James Bullard did in mid-October, and the markets absolutely loved it and started to rally sharply off of the bottom. Fully understanding the power of the jawbone having watched ECB President Mario Draghi successfully pull off the trick for years, the Fed is likely to go to this well on any sustained pullbacks in 2015. And it will likely take at least a year before the U.S. stock market starts to get wise to the fact that no stimulus will actually be coming.

Instead, the Fed wants to raise interest rates and is clearly itching to do so no matter how much they talk about "patience" in the process. The first rate increase could come as early as April 30. And if the economy and the stock market continue to perform as they are right now, I would fully expect it to come at that time. However, if the global economy and markets start to wobble, then June 18, July 30 or September 17 are also possibilities. But for now, investors should be prepared for April. Whether the Fed can continue to raise interest rates further off of the zero bound after its first rate hike remains to be seen.

The Fall Of A Champion

What does all of this imply for our paper champion of a U.S. stock market? Pain. But pain does not mean a catastrophic decline. Pain means volatility. Pain means unexpected and sometimes sharp punches in the face to the downside followed by equally swift counter punch rallies to the upside. New highs may be set along the way. And critical upward sloping support lines are also likely to be shredded to the downside in the process. In the end, it is likely to be an environment that will test the nerves of what has largely become a complacent and arguably overconfident U.S. stock investor. It will likely force a number of nervous long stock investors to the sidelines. And it will also likely repeatedly rip the faces off of woebegone short sellers that are sure that *this* correction is the one that is finally going to take the market under to the downside. By the end of the year, we could easily see the S&P 500 Index up +5%. Then again, we could just as easily see it down -10%. It will likely just depend on where the swinging price line happens to be when the calendar flips to the last trading day of the year.

For what I would contend is the most likely representation of what the S&P 500 Index might look like in 2015, I offer up the following chart.

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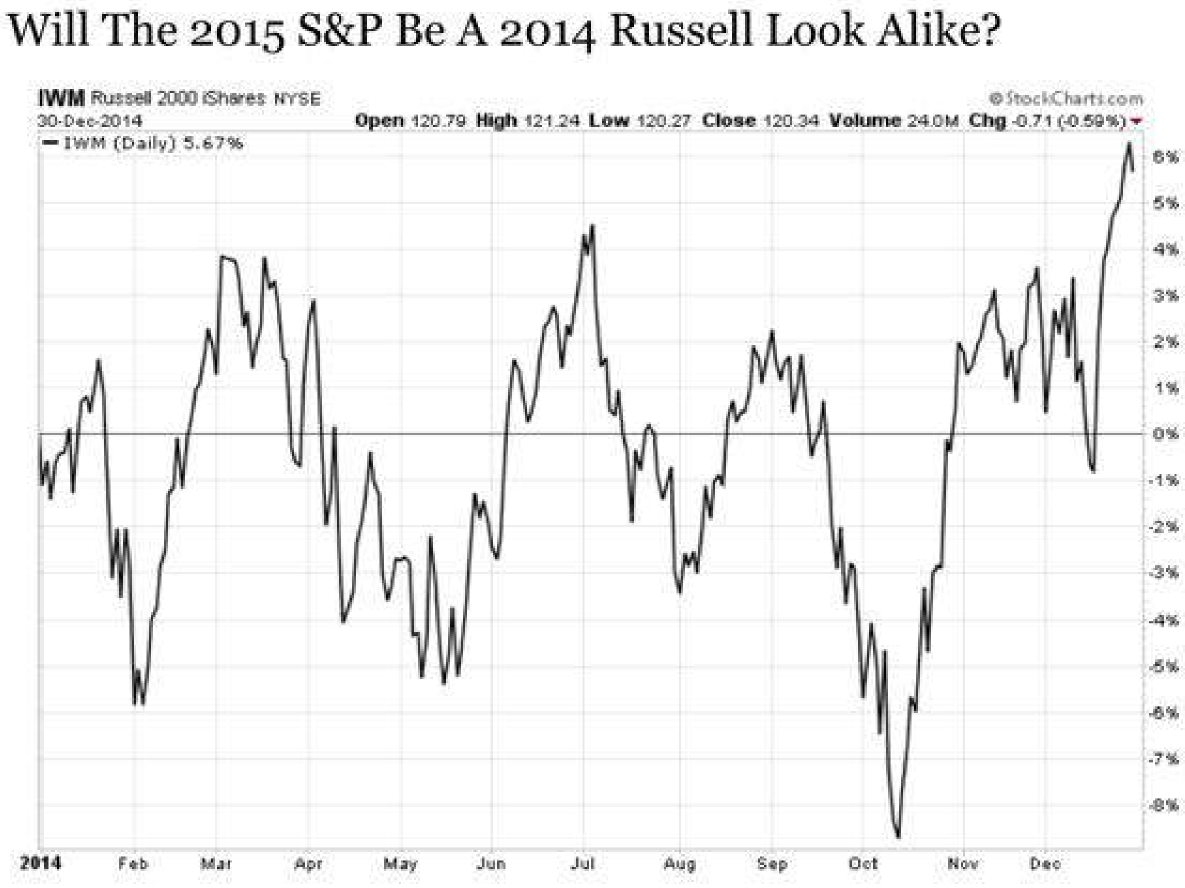

Source: Gerring Capital Partners, StockCharts.com

Put simply, it is very possible that the large cap S&P 500 Index in 2015 could look very much like the small cap Russell 2000 did in 2014. Not a terrible environment to be sure, but one that would certainly keep investors on their toes.

Finding The Eye Of The Tiger For Your 2015 Investment Portfolio

Suppose that it is shaping up to be a choppy sideways year for the S&P 500 Index in 2015. Suppose it's even worse with the six-year bull market finally coming to an end with a sustained downside move getting under way. In a global environment of slowing growth and the specter of geopolitical and market event risk increasingly emanating from places like Russia, the Middle East and China as well as sectors such as energy and materials, where is an investor that wishes to achieve respectable risk-adjusted returns to turn? Fortunately, like always, the global markets offer a wealth of attractive opportunities for investors to capitalize upon.

The following are some themes that may merit consideration in the coming year.

1. U.S. Stocks - Stay Long Until The Trend Finally Breaks

The most important point to remember as we enter the New Year is that the current bull market in U.S. stocks as measured by the S&P 500 Index remains intact. And the past six years of market history is littered with investors that have declared that a market top is in only to see U.S. stocks rip another +10% higher. As a result, investors should maintain long positions in U.S. large cap stocks until the uptrend is finally broken. This does not mean that investors should be 100% long U.S. stocks - I would contend that they never should be for risk management reasons - but it does imply that investors should maintain a reasonable allocation to U.S. large caps within the context of a broader asset allocation strategy for the time being. Maintaining a selectively defensive bent would also likely be well served, although specialized themes in the technology sector (NYSEARCA:XLK) should not be ruled out.

The topping process of the third longest bull market in history is something that will likely take several months at least to play out - one could reasonably argue that the topping process may have already started - and it will include *multiple* quick breaks of the 200-day moving average (red line on chart below) along with at least one decisive slash below the 400-day moving average (pink on chart below).

(click to enlarge)

Source: Gerring Capital Partners, StockCharts.com

When the S&P 500 Index breaks below the 400-day M.A. and is unable to breakout back above the 200-day M.A. on the subsequent bounce, probability suggests that uptrend will be officially broken and the new bear market will be fully underway. Historically, such inflection points take place not far below market peaks, so it is worthwhile to watch closely for any such set ups in the coming year.

2. Consider Financials

It has been speculated for years since the financial crisis that the Fed would raise interest rates. But this year, it appears that it may finally happen. And at least to this point, the market seems to be vastly underestimating such an outcome. After all, if investors thought a hike in interest rates was imminent, we likely would not see utilities and REITs (NYSEARCA:VNQ) screaming to the upside to close out the year.

Suppose the Fed does actually raise interest rates as they suggested they might, following their April 30 meeting. A sector that stands to benefit from such a move, particularly if underlying economic growth can remain positive, is the financials sector (NYSEARCA:XLF) with the rise in interest rates potentially providing a boost to net interest margins. The benefit could be particularly pronounced among regional banks (NYSEARCA:KRE) that tend to have more traditional banking operations with a large deposit base relative to their overall size. Insurance companies (NYSEARCA:KIE) also stand to benefit from higher interest rates given their need to generate low risk interest income.

This is not to say that the financial sector is not without its continued headwinds including increased regulatory scrutiny and higher capital requirements. Thus, any allocation to the sector should be undertaken with selectivity and an eye toward risk.

(click to enlarge)

Source: Gerring Capital Partners, StockCharts.com

Another factor favoring financials is its still vast underperformance relative to the broader market. For while the S&P 500 Index is now nearly +60% above its pre-crisis highs, the regional banking sector has only now just returned to breakeven while the financials sector is still trading -20% below its pre-crisis highs. Investor apprehension toward the sector is more than understandable given what took place several years ago along with the risks that persist to this day. But they now represent an attractive relative value as a result. And one can be rest assured that between Washington lobbyists and the open hot line with the Federal Reserve than an environment that is highly supportive to the financial sector is likely to remain in place for the foreseeable future.

3. Look Globally To Seek Attractive Stock Values

The increasingly wide performance disparity between U.S. and non-U.S. stocks has opened up some particularly attractive relative value opportunities for those investors looking outside of the U.S.

Given the slowing global growth environment, a risk prudent strategy when venturing outside of the U.S. would be to focus on developed markets (NYSEARCA:EFA) over emerging (NYSEARCA:EEM) and frontier (NYSEARCA:FM) markets. Taking this risk-controlled approach a step further, targeting attractive value opportunities among defensive global sectors such as consumer staples, health care, telecom and utilities should also be well served. This might include focusing specifically on single country markets that have a meaningful weight to these defensive sectors. Representative countries that may warrant consideration in this regard include the United Kingdom (NYSEARCA:EWU), Switzerland (NYSEARCA:EWL), The Netherlands (NYSEARCA:EWN), New Zealand (NYSEARCA:ENZL), Belgium (NYSEARCA:EWK), Denmark (BATS:EDEN) and Israel (NYSEARCA:EIS).

In selected cases, attractive absolute value opportunities now also exist across these non-U.S. markets. The United Kingdom is an example in this regard. For while the U.S. stock market is currently trading with a price-to-earnings ratio close to 20 times, the U.K. market as measured by the iShares MSCI United Kingdom ETF is trading at a far more reasonable 13.7 times earnings. While at least some of this difference in valuation might be explained by the higher weighting to financials and energy stocks in the U.K., this should be at least partially offset by the greater combined weighting in the defensive consumer staples, health care, telecom and utilities sectors. And for those investors willing to take the next step further into the U.K., the opportunity exists to cherry pick the defensive names out of the broader basket. For example, one could easily own U.K. based names such as Unilever (NYSE:UL) and GlaxoSmithKline (NYSE:GSK) with their respective 3.5% and 5.6% dividends that are free from withholding taxes for

U.S. stock investors through the purchase of these ADRs that actively trade on the New York Stock Exchange.

One final point about global stock opportunities that is important to mention is the currency effects. A contributor to the poor performance of non-U.S. stocks in 2014 has been the strong ascent of the U.S. dollar (NYSEARCA:UUP) since July. And while the relative weakness of the euro (NYSEARCA:FXE) and Japanese yen (NYSEARCA:FXY) are understandable given the direction of monetary policy in these regions, the weakness of the British pound (NYSEARCA:FXB) relative to the U.S. dollar may be less sustainable given that the Bank of England's Monetary Policy Committee has the same stated intent as the Fed of working toward raising interest rates. Thus, the potential exists for the current currency headwind to either neutralize or even become a currency tailwind for U.S.-based investors in the U.K.

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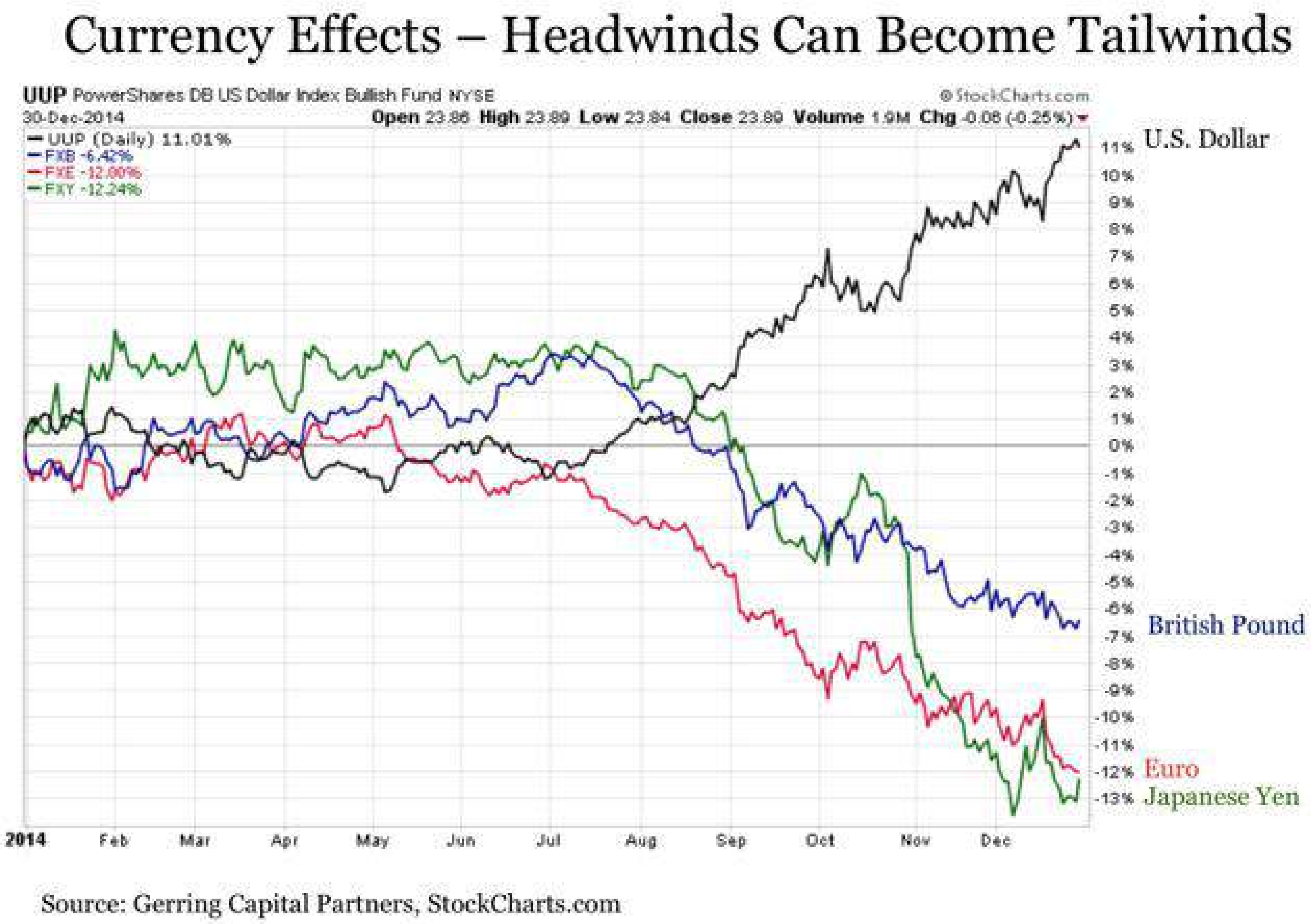

4. Gold

Gold may finally find a bottom in 2015. The bear market in gold (NYSEARCA:GLD) has been relentless over the last three years with a decline of roughly -40% since the September 2011 highs. But while the trend line remains definitively down and sentiment remains generally poor, the fact that gold continues to trade above lows first established in June 2013 suggests at least some degree of stabilization in the price. While another leg lower in the gold price should not be ruled out in the first half of 2015, we are likely drawing increasingly close to the end of the gold bear market.

(click to enlarge)

Gold: Will 2015 Bring An End To The Bear Market?

Source: Gerring Capital Partners, StockCharts.com

If this is indeed the case, the potential upside in gold remains considerable. This is due to the fact that the strength of underlying physical demand has never really been in question through the entire gold bear market. And physical supplies have also been on the decline in recent years. Thus, the fundamentals behind gold remain very constructive. And while last I checked, an increase in demand coupled with a decrease in supply is supposed to lead to higher prices, such traditional laws have been broken thanks to extraordinarily aggressive liquidation activity in the paper markets in recent years. Such forces remain a major wild card for gold going forward. Thus, other than those investors that hold a high conviction in the long-term outlook for the metal, allocations to gold as a percentage of an overall portfolio strategy should be measured at around 5% and entered into gradually if possible. Also, investors may be well served to exercise patience before establishing a position until at least some of the various long-term downtrends have been definitively broken.

5. U.S. Treasuries

The U.S. Treasury market remains among the best ways to hedge against a sharp stock market decline. This is due to the fact that the category enjoys a negative correlation to stocks during periods when the stock market is falling, but has demonstrated the ability to rise during extended periods when the stock market is rising. Following a tremendous year for long-term U.S. Treasuries (NYSEARCA:TLT), further price gains may be harder to come by in 2015 as yields have fallen to post crisis low levels, but intermediate-term U.S. Treasuries (NYSEARCA:IEF) continue to offer current appeal as a portfolio hedge against a weakening economy or the outbreak of a destabilizing market event.

6. Tactical Market Timing

If 2015 indeed evolves into a year where we see more violent stock market swings either sideways or to the downside, the implementation of a disciplined market timing strategy with a limited segment of an overall asset allocation strategy may have merit. Any such approach undertaken should be mostly if not exclusively quantitatively oriented so as to remove any behavioral biases. It should also be rigorously back tested with a proven historical track record while also demonstrating continued efficacy in the current policy distorted environment. Moreover, the undertaking of any such approach should be limited to only a small portion of an overall portfolio in order to manage against any risks associated with the model misfiring. But for those strategies that are implemented properly based on sound indicators and modeling, it provides the opportunity to generate positive upside results even in sideways to downward trending markets. Lastly, the preferred instrument of choice for executing such a strategy would be a highly liquid and market representative exchange traded fund such as the S&P 500 SPDRs or the S&P 500 iShares (NYSEARCA:IVV).

7. Hedges

The final strategy for consideration is only for the most battle tested of market pugilists. The one characteristic that the market has lacked for several years now is any sense of fear. This is demonstrated by the fact that the CBOE Volatility Index is hovering at lows last seen in 2007. And as we move forward over the next few years, a significant total return opportunity in the stock market exists to the downside, with the magnitude of this downside opportunity increasingly expanding the further the market continues to rise today. As a result, and only when the time is right and potentially sometime in 2015, investors may wish to consider a variety of strategies to directly capitalize once the next cyclical bear market gets underway. This may include non-leveraged inverse strategies (NYSEARCA:SH), VIX futures ETNs (NYSEARCA:VXX) or deep-out-of-the-money put options to name a few. Such strategies are highly specialized, however, and should be carefully researched before implementation. In addition, investors should manage such positions closely and they should make up a relatively small percentage of an overall portfolio strategy - 5% to 10% at most - for risk control purposes.

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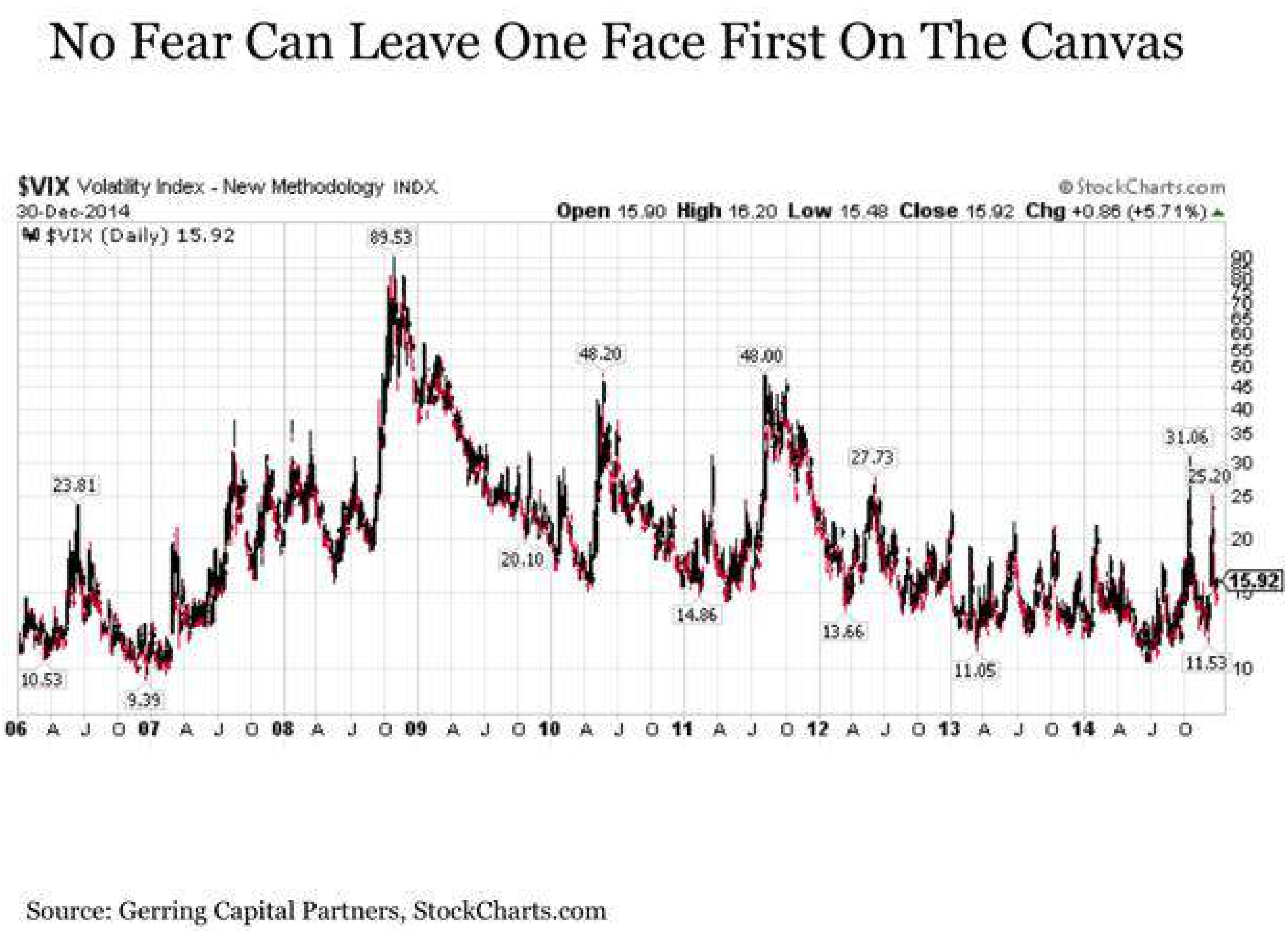

Bottom Line

The bell is about to ring and the market fight is about to get underway for the 2015 calendar year. And unlike in recent years, 2015 has the potential to bring pain to investors. But if increased volatility does indeed present itself in the U.S. stock market in 2015, it is important for investors to remember that this would represent a return to more normal market conditions. Also, it is critical to note that in the end pain is good. After all, there is a reason the expression "no pain, no gain" exists. What policymakers across the world have forgotten in their persistently desperate attempt to rescue the global economy from the brink so many years ago is that allowing the markets to feel pain serves a purpose. For a period of suffering and rationalization more often than not forms the foundation of the next great advance to new heights. And such is the juncture that the U.S. economy and its financial markets are now ready to endure. It may not feel good in the short run, but we will all be better for it in the long run.

For it was not the protagonist at the start of Rocky III that was loved - on the contrary, he was having fun but had become disrespected and soft. Instead, it was the gritty and battle test warrior that returned at the end of the movie that garnered the audience cheers. And this is the final redemption after the fall that the U.S. stock market must undergo to return to true greatness. Hopefully this is a process that gets underway in earnest in 2015.

Disclosure: This article is for information purposes only. There are risks involved with investing including loss of principal. Gerring Capital Partners makes no explicit or implicit guarantee with respect to performance or the outcome of any investment or projections made. There is no guarantee that the goals of the strategies discussed by Gerring Capital Partners will be met.

Additional disclosure: I am long stocks via the SPLV as well as selected individual names. I also hold a meaningful allocation to cash at the present time.