BARRON'S COVER

Stock Market Could Take a Breather After China's Selloff

The S&P 500, down 6% on the week, is off to its worst January ever. Tossed aside with the rubble were auto shares, off more than 10%, financials, and Apple. All could move higher in the year ahead.

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January 9, 2016

Photo: Barron's Graphics

The stock market got off to its worst January ever as major market indexes fell 6% to 7% last week. Friday was marked by a dispiriting reversal when early gains of 1%, spurred by a stronger-than-expected U.S. employment report, turned into a loss of about 1% by the session's end.

The Dow Jones Industrial Average finished the week at 16,346, down 1,079 points, or 6.2%, in the five sessions, while the Standard & Poor's 500 index fell 6%, to 1,922, putting it within striking distance of its Aug. 25 low of 1,867. The S&P 500's showing easily eclipsed the prior first-week record loss of 5.3% set in 2008. While the 2008 decline augured a poor full year when the S&P fell 38.5%, most negative starts since 1950—there have been 24—were followed by positive full-year performance, according to the Stock Trader's Almanac.

The brutal beginning to 2016—reflecting concerns about the health of the Chinese economy and the outlook for U.S. corporate profits—has been a blow to most prognosticators, who predicted a good year for stocks. Likewise, it has left battered investors wondering if the long bull market dating back to March 2009 is over.

It's probably too early to call an end to the bull run. The S&P 500 now trades for less than 16 times estimated consensus 2016 earnings of $123. That's not cheap by historical standards, but stocks still look good relative to Treasuries, high-grade bonds, and cash. The earnings yield—the inverse of the price/earnings ratio—of 6% is comfortably above bond yields and inflation. The U.S. economy still looks healthy, although real growth might not average much more than 2% this year.

Sizing Up the S&P 500

Goldman Sachs strategist David Kostin cut his earnings projections on Friday for the S&P 500 by $3 for 2015, 2016, and 2017. He sees 11% earnings growth this year off a lower base in 2015. The S&P trades for about 16 times his 2016 estimate.

	Sales Growth	Profit Margin	EARNINGS PER SHARE Level	EARNINGS PER SHARE Growth	DIVIDENDS Level	DIVIDENDS Growth	Payout Ratio	Valuation P/E (NTM)	Dividend Yield
2014	4.0%	9.0%	$113	5%	$39.44	13%	35%	19.5	2.1%
2015E	-2.8	8.2	106	-7	43.39	10	41	17.5	2.1
2016E	4.3	8.8	117	11	45.06	4	39	16.6	2.2
2017E	6.5	8.9	126	8	47.81	6	38	16.5	2.3

E=Estimate.
Source: Goldman Sachs Global Investment Research

The current S&P 500 earnings estimate could prove too high, but that expectation arguably is reflected in the market. On Friday, Goldman Sachs strategist David Kostin cut his 2015, 2016, and 2017 S&P earnings estimates by $3 apiece, with his 2016 projection falling to $117 from $120. He sees an outright decline in S&P earnings for 2015, driven by the first annual loss in the energy sector in at least 48 years. That reflects the collapse in oil prices, which declined 31% last year to $37 a barrel. Crude was down another 11% last week, to $33.

"This reminds me of August, when people were worried that China would sink the world," says Robert Doll, chief investment strategist at Nuveen. "Why did the market come back? China stabilized, and the U.S. economy did OK. That's what we need to happen again."

Back in August, the S&P 500 fell 11% in a little over a week, to a low of 1867, before quickly rebounding to almost 2000.

Doll remains upbeat on 2016, although he's less confident in his year-end 2016 S&P target of 2150, which is more than 10% above current levels. He isn't alone. All 10 strategists surveyed by *Barron's* in our Year-End Outlook for this year (Dec. 14, 2015) were bullish, and their average S&P 500 year-end target was 2200.

The U.S., Doll argues, is the most insulated from overseas shocks of any major economy, with exports accounting for just 13% of gross domestic product, versus almost 50% in Germany. The stock market admittedly has more international exposure, with companies in the S&P 500 getting almost 40% of profits from outside the U.S.

THE S&P 500 DIVIDEND yield is 2.3%; rarely in the past 60 years has it yielded more than the 10-year Treasury note, now at 2.12%. Tom Lee of Fundstrat Global Advisors stated in a client presentation on Friday that this relationship is a strong argument for stocks. He noted that the last time this occurred was in late 2011. That turned out to be a great buying opportunity for stocks.

"With inflation and interest rates potentially rising in 2016, we see this valuation argument for equities as compelling," he wrote, citing likely dividend increases over time. He also noted other bullish factors, including latent U.S. housing demand and the reduced "head winds" for U.S. companies from the stronger dollar as 2016 progresses.

This could be a year when value-oriented stocks beat their growth counterparts, after one of the worst years of relative performance for value. Growth stocks in the S&P 500 bested the index's value components in 2015 by nine percentage points.

Winners this year could include Apple (ticker: AAPL) and Intel (INTC), Merck (MRK) and Pfizer (PFE), Ford Motor (F) and General Motors (GM), Dow Chemical (DOW), and major financials like JPMorgan Chase (JPM), Citigroup (C), Bank of America (BAC), and Goldman Sachs (GS). Some battered retailers already are getting a lift, including Wal-Mart Stores (WMT) and Macy's (M).

MARKET LEADER APPLE remained under pressure last week, falling 8%, to $97, leaving the stock 28% below its 52-week high of $134, set in April. The decline has come as analysts scale back iPhone sales estimates and earnings projections for the current fiscal year ending in September. A lot of bad news seems reflected in Apple shares, which now trade for 10 times estimated fiscal-2016 earnings. Apple's effective P/E falls to about eight after reflecting its huge net cash position of about $25 per share, or $140 billion.

Major financial stocks have fallen so far this year after a subpar 2015, with many trading in lockstep and finishing with losses of about 10% for the week. This reflects fears about the impact of weak markets, falling commodity prices, and a weaker global economy.

Tough Start to 2016

Globally, stocks got off to a rocky start in 2016, and oil continued to slide. Gold has perked up, however.

	2015*	YTD 2016*
90-Day Treasury Bill	0.1%	0.0%
10-Year U.S. Treasury	1.5	1.2
iShares iBoxx $ High Yield Corp. Bond ETF (HYG)	-5.0	-1.3
S&P 500 Index	1.4	-5.9
iShares MSCI EAFE ETF (EFA)	-1.0	-6.5
iShares MSCI Emerging Markets ETF (EEM)	-16.2	-8.3
Gold (spot price)	-10.4	4.0
Crude Oil (WTI)	-30.5	-11.2

*Total return. Sources: Bloomberg; Nuveen Asset Management

As a result, some stocks trade at or below tangible book value, which theoretically amounts to a conservative liquidation value. This could mark a good entry point for the stocks, since industry balance sheets have strengthened markedly since the financial crisis amid reduced risk-taking activities.

Goldman Sachs, at $164, trades just above its third-quarter tangible book value of $162 and in line with its projected year-end 2015 tangible book. It is uncommon for Goldman to trade at that level. The stock also trades at nine times the current 2016 consensus estimate of $18 a share.

Morgan Stanley, which has lagged behind its peers in the stock market during the past year, finished on Friday at $28, below its third-quarter tangible book value of almost $30, and at nine times estimated 2016 earnings. Citigroup, at $46, trades at 80% of its tangible book of $60, and Bank of America, at about $15, ended just below its tangible book of $15.50 a share. JPMorgan, at $59, is the only big bank trading at a premium to its tangible book, which was $47 a share in the third quarter. JPMorgan's premium valuation reflects higher returns and the most diversified earnings base among its peers.

Ford and GM illustrate why value investing has been so frustrating lately, as their inexpensive valuations and high dividend yields haven't put a floor under the stocks. GM, at $29.65, trades for five times estimated 2016 earnings and yields 4.9%, while Ford, at $12.63, fetches six times projected 2016 profits and yields 4.8%. Both stocks fell more than 10% last week.

There have been few asset classes with strong results in the past year. Overseas markets—as measured in dollars—did even worse than the S&P 500 and got off to a poor start this year. It's amazing that emerging market equities, as measured by the iShares MSCI Emerging Markets ETF (EEM), are back where they traded in 2009, having declined 25% in the past year.

Despite a tough backdrop, global stocks still look like the best major asset class.