Predicting a bear or bull market for 2015? By Vern Gowdie, Daily Reckoning, 5 January 2015

Making predictions is a dangerous business.

The lacklustre performance of the Australian share market in 2014 has most likely influenced fund managers' rather downbeat outlook for 2015.

Whereas across the sea, Wall Street analysts are unanimously predicting the US market to continue its six-year bull run. Confidence begets even greater confidence.

According to *Business Insider*, the 2015 consensus from Wall Street's top 13 analysts is: '*The average year-end target on the S&P 500 is 2,225 on earnings of $US125.35.*'

Currently the S&P 500 index is 2,058 and operating earnings are US$116.

On average, the analysts are predicting an 8% increase in the index and earnings.

When you're in the business of selling positive performance, it's easy to understand why analysts pick a relatively high level of return (compared to zero bound interest rates) for the coming year.

The fact analysts are notoriously overly-optimistic in their forecasting abilities seems to matter little to mainstream financial media...especially when US markets have been so strong for so long.

In April 2010, McKinsey & Co produced a study titled: 'Equity analysts: Still too bullish'.

The following is an extract from the McKinsey report:

'*Moreover, analysts have been persistently overoptimistic for the past 25 years, with estimates ranging from 10 to 12 percent a year, compared with actual earnings growth of 6 percent. Over this time frame, actual earnings growth surpassed forecasts in only two instances, both during the earnings recovery following a recession. On average, analysts' forecasts have been almost 100 percent too high.*'

The only times analysts have under-estimated earnings growth is the year immediately following recessions. This is entirely consistent with the psychological pattern of extrapolating the past into the future...forecasting based on the rear view mirror.

After six years of positive gains, it's a no-brainer US analysts believe 2015 is destined to be a continuation of the past trend.

Based on the McKinsey study, analysts have a proven track record of over-estimating earnings by *almost 100 percent.*

Over the 25-year period earnings grew on average at an annual rate of 6% (compared to forecasts ranging from 10–12%). The 6% earnings growth rate mirrored the growth rate of the

US economy over the same period. Put simply, the reason for this is earnings cannot grow faster than the economy. It's not possible.

Based on this premise, a consensus of 8% earnings growth in 2015 suggests the US economy is also likely to produce a growth number of this magnitude. Short of some global economic miracle, the US economy is going to fall well short of 8% growth... somewhere around 3% to 4% is at the upper end of economic growth projections.

The other headwind to optimistic US earnings forecasts is the slowdown in share buyback schemes. Rising corporate bond interest rates have curtailed the ability of companies to access cheap financing to artificially boost earnings per share.

According to data compiled by Bloomberg and the S&P Dow Jones Indices it '*shows S&P 500 companies have been ploughing 95 percent of their profits into stock buybacks – and that stocks with the most repurchases gained more than 300 percent since March 2009.*'

Minus the tailwind of creative accounting, US companies (on average) are going to be assessed on their real performance. This is exactly what happened to IBM in October 2014, prompting this headline from CBC News:

IBM stock falls 7% after it downgrades earnings forecast

IBM had been a serial abuser of the stock buyback trick and had failed to reinvest sufficient capital into the business for future growth. This little bit of account skulduggery rewarded IBM shareholders with a165% gain from late 2008 to early 2013. Since then, IBM's share price has fallen 25%. The moral of the IBM story is that eventually the truth wins out. This moral will be learnt by investors in the broader market in due course.

My prediction for 2015 is that Wall Street analysts are going to continue the not-so-proud tradition of over-egging the earnings numbers.

However, in spite of my projected sluggish US earnings growth, the analysts prediction of the S&P 500 index hitting 2,225 points is a very real possibility. Momentum buying based on nothing but optimism and hubris is not uncommon in the late stages of an ageing bull market.

Those (like myself) waiting for a significant market correction (a decline of 50+%) may just have to wait a little longer.

In his latest quarterly newsletter, Jeremy Grantham of Boston-based GMO (and one of the smartest investment brains in the business) said:

'*Nevertheless, despite my nervousness [in current market values] I am still a believer that the Fed will engineer a fully-fledged bubble (S&P 500 over 2250) before a very serious decline.*'

The difference between Grantham and the Wall Street analysts (besides the fact he has an impressive 40+ year track record) is that he sees the S&P 500 at 2250 points as a *fully-fledged bubble,* whereas the analysts see it as marker on an ever northward heading chart.

Grantham and his firm, GMO have an impressive track-record in identifying bubbles. However, in a market boom the most under-appreciated quality is experience. No one wants to listen to the words of caution from those who have been there and done that. People want the hot-tip. They don't want to be told to take a cold shower and be patient.

Therefore Grantham's prescient warning will go largely unnoticed.

Since the GFC, the Fed has done everything within its power to levitate the US share market. In their single-minded determination to create the pre-determined wealth-effect objective, the fact that market values have been grossly distorted has counted for nought.

Based on past actions, Grantham's belief that '*the Fed will engineer a fully-fledged bubble*'is an accurate call. If the US share market begins to seriously wobble in 2015, it's a fair bet the Fed will delay increasing interest rates and/or begin another round of QE...setting up the 'last hurrah' phase for markets.

Against this backdrop the Australian share market is likely to play 'follow the leader' and could well rise another 5% to 10% in 2015.

However, when the *last hurrah* is over and the *serious decline* phase hits the US share market, there's no doubt we'll be caught in the downdraft emanating from Wall Street.

Prudent investors who value the wisdom borne from experience, need to ask themselves whether a possible 10% gain is worth a probable 50+% decline.

The US share market has been subjected to 38 severe bear markets since 1870...an average of one in four years.

Over one-third of the 38 bear markets have inflicted losses in excess of 40%.

The last severe bear market was from 11 Oct 2007 to 6 Mar 2009...a loss of 57.7% over a 17 month period. NOTE — this 17 month bear market wiped out the entire gains of the preceding five-year period. That's how swift and vicious bear markets can be.

The law of averages (and common sense) tells us the next severe bear market is much closer than the Wall Street analysts would have you believe.

The US share market on every long term valuation and sentiment metric is overvalued, overbought and over bullish. The Fed (as Grantham suspects) may well continue to play to the cheering crowd, and 2015 could be another positive one.

However, in my opinion, average investors are playing with fire if they try to milk the last drop out of this market. The last 10% to 20% of a bull market run disappears very quickly when the bear awakens from its hibernation.

While on the topic of unpredictable predictions, who would have thought in January 2007 (when the All Ords index was around 5700 points) that eight years later the market would be trading below that level.

Experience has taught me to expect the unexpected with markets. There is no pre-ordained rule that says markets must go up. Markets can and have been manipulated to achieve short term objectives. However, as in the case of IBM, the truth eventually wins out.

The longer the US market continues to move away from its historical valuation averages, the harder the fall that awaits us.

When it does, severe bear market number 39 is assured a place near the very top of the table.

Regards,

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For *The Daily Reckoning*