Quarter-End Insights

# Stock Market Outlook: Proceed With Caution

By Matthew Coffina, CFA | 03-30-15 | 06:00 AM | Email Article

- All eyes remain on the Federal Reserve as it moves closer to raising short-term interest rates. However, we think investors are paying too much attention to the exact timing of a rate increase, while ignoring the far more important question of where rates will ultimately settle.
- We've adjusted our cost of capital methodology to better reflect realistic long-term inflation and total return expectations. Our fair value estimates assume a long-term Treasury yield of 4.5%--well above current interest rates.
- A comprehensive review of our energy sector coverage revealed that we were too optimistic about long-run oil and gas prices. The energy sector still seems relatively undervalued, but fair value estimates have been coming down.
- The broader market looks moderately overvalued, and opportunities are few and far between. Investors in common stocks must have a long time horizon and the patience and discipline to ride out volatility.

**Interest Rates: Gravity for Asset Prices**

Investors always hang on the Federal Reserve's every word, but the obsession with monetary policy is reaching new heights as we approach the first short-term rate hike in almost a decade. The target federal funds rate has been around zero since late 2008, and the last time the United States was in an environment of tightening monetary policy was mid-2006. Throw in the Fed's quantitative easing program and other unconventional policy actions around the world, and it's clear that we're in uncharted territory. It's no wonder investors are on edge.

Warren Buffett has compared interest rates to gravity for asset prices. The intrinsic value of any financial asset is equal to the discounted present value of the cash flows it will produce. Higher interest rates mean higher discount rates, and thus lower present value. In other words, $1 received 10 years from now will be worth less today if we could have invested it at 4% in the meantime as opposed to 2%. The discount rate for bonds is observable in the market as the yield to maturity. The discount rate for stocks can't be observed directly, but that doesn't mean it's any less real.

The complication with stocks--as opposed to bonds--is that future cash flows are also unknown. To the extent that higher interest rates are correlated with strong economic growth or higher inflation, it's reasonable to expect that companies' cash flows will also be higher. For investors with a sufficiently long time horizon (at least five years, and preferably decades), we still think stocks are far superior to bonds in terms of their ability to protect and grow purchasing power.

Considering that most investors are focused on the threat of rising interest rates, it may be surprising that Morningstar has recently been reducing our cost of equity

assumptions (a key input to discount rates). The timing here is purely coincidental. In examining market history, we concluded that real (inflation-adjusted) returns from stocks have averaged around 6.5%-7.0% per year. We expect long-run inflation in the range of 2.0%-2.5%.

The midpoint of both ranges leads us to a nominal return expectation for the overall stock market of 9%--down from our previous assumption of 10%. We use this 9% cost of equity to discount free cash flows to shareholders of developed-markets companies with average economic sensitivity. We use a cost of equity of 7.5% (down from 8%) for companies with below-average economic sensitivity, and costs of equity of 11% (down from 12%) or 13.5% (down from 14%) for companies with above-average economic sensitivity. We make adjustments for firms operating in foreign jurisdictions with different inflation rates.

Our new cost of equity methodology has resulted in modest fair value increases for a wide variety of stocks. However, this does not mean that we expect the current low interest-rate environment to last indefinitely. Quite the contrary: Our assumptions imply a long-term Treasury yield of 4.5%--well above current interest rates. The 4.5% nominal risk-free rate includes 2.0%-2.5% inflation plus a 2.0%-2.5% real return expectation. We think this is a reasonable base case, and long-term interest rates would need to climb meaningfully above 4.5% before they would be a drag on our fair value estimates (assuming our cash flow forecasts are correct).

**Lowering Our Oil and Gas Price Forecasts**

Aside from cost of capital changes, the biggest adjustments we've been making to our fair value estimates are in the energy sector. Morningstar's energy team conducted a comprehensive review of the supply and demand outlook for energy over the next five years and concluded that our previous oil and gas price assumptions were too optimistic. We now use a long-term Brent crude oil price of $75 per barrel (down from $100) and a Henry Hub natural gas price of $4 per thousand cubic feet (down from $5.40). This has resulted in fair value reductions for a broad selection of energy companies, with a few moat downgrades to boot.

Since peaking last summer, oil and gas prices have experienced dramatic declines. Unfortunately, it took us much too long to recognize the fundamental deterioration in the balance between supply and demand underlying the collapse in prices. We've implemented a new modeling framework that we hope will enable us to be more proactive in the future. Our latest analysis led to three important revelations:

1. Growth in U.S. shale oil production has pushed the highest-cost resources off the global oil supply curve. If oil sands mining and marginal deep-water projects aren't needed to meet incremental oil demand over the next five years, they lose their relevance to setting oil prices. We expect higher-quality deep-water projects to provide the marginal barrel in the near term, leading to a Brent midcycle price of $75/barrel.
2. Our new forecasts also account for falling oilfield-services pricing due to overcapacity. Energy companies are aggressively cutting their capital spending budgets, creating an excess supply of rigs, equipment, and labor. Far from being static, marginal costs fluctuate with changing input costs.

3. The domestic natural gas market remains well-supplied with low-cost shale gas, especially from the Marcellus Shale. Improvements in drilling efficiency and abundant resources should enable producers to easily meet growing demand, even at a midcycle natural gas price of $4/mcf.

Smaller, less diversified, and more leveraged exploration and production companies have seen the biggest fair value reductions as a result of our new commodity price forecasts. Oilfield services and integrated oil companies have also been hit. In contrast, our fair value estimates for midstream energy companies have proven resilient: These firms are more exposed to volumes than prices, and benefit from an environment of plentiful supply. Our analysts still view energy as the most undervalued sector, but the gap has narrowed significantly as our fair value estimates have come down.

**Market's Rise Leaves Few Opportunities**
As for the valuation of the broader stock market, the median stock in Morningstar's coverage was trading 4% above our fair value estimate as of the close on March 20, 2015. Cyclical and defensive sectors have been taking turns leading the market higher, which has left both overvalued. In our view, industrials, technology, health care, consumer defensive, and utilities are the most overvalued sectors, with the median stock in each trading between 7% and 11% above our fair value estimates. Only energy looks like a relative bargain, with the median stock trading 9% below our fair value estimate.

Things don't look much better at the level of individual stocks. Only 25 stocks under Morningstar's coverage carry our 5-star rating, and many of these are high-risk mining, energy, and emerging-markets companies. Only 14 are traded on U.S. exchanges. Only one 5-star stock (Spectra Energy (SE)) has a wide economic moat.

The S&P 500--at a level of 2,108--carries a Shiller price/earnings ratio of 27.7--higher than 79% of monthly readings since 1989. The Shiller P/E uses a 10-year average of inflation-adjusted earnings in the denominator. Alternatively, the S&P 500 is trading at 18.4 times trailing peak operating earnings, which is higher than 77% of monthly readings since 1989. In both cases, such high valuation levels have historically been associated with poor subsequent five-year total returns and an elevated risk of a material drawdown. Proceed with caution.

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