Goldman SMALL CAP RESEARCH

# The Goldman Guide

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**INSIDE THIS ISSUE:**



### *KEY TAKEAWAYS*

- ⇒ *3 reasons why stocks will go up*
- ⇒ *Wild indicator related to sports could portend happy days ahead*
- ⇒ *It's all about the earnings growth and valuation and multiples are in good shape*
- ⇒ *Certain sectors are very attractive and these stocks look great*
- ⇒ *Back of the envelope, worst case scenario is noted*
- ⇒ *Hard to believe the Russell 2000 hit a 52 week low and is down 19% from 52-week high*

### *THE MAJOR INDICES*

| Index | Close | 2015 |
|---|---|---|
| DJIA | 16346 | -6.2% |
| S&P 500 | 1922 | -6.0% |
| NASDAQ | 4644 | -7.2% |
| Russell 2000 | 1046 | -7.9% |

(figures are rounded)

## Three Reasons Why Stocks Will Go Up

I am not going to sugarcoat it. Last week was scary as hell. Who expected that?

With the major indices down 6-8% and indications of another 1% or more, this China debacle and continued drops in oil do not seem to abate anytime soon. We alluded to this problem as something that would weigh on stocks, but we never envisioned anything like this. Nonetheless, here are 3 reasons why we will weather the storm and you will see stocks will go up, and likely sooner than you think.

**Reason #1: China, China, China**

Stocks have been whipsawed because of foreign economic issues and are not directly related to domestic earnings performance or material changes to forecasts.  Earnings season, which will truly begin in earnest next week, could be the trigger we need to get stocks back in the right direction, or at the least, stem the bleeding.

**Reason #2: Déjà Vu & Val-U**

Didn't we just experience this in August 2015? On August 24th, the S&P 500 Index dropped by 10.2% from its close 5 days earlier, when the collapse started. Four days later, it rose more than 6% from the lows. I am not predicting the same action. However, it is a reminder that when the move occurs, it could be more than a dead-cat bounce.

Plus, stocks are pretty attractive on a P/E basis. At current levels, the 12-month forward P/E on the S&P 500 is 15.1x, versus over 19x a year ago—and the 14.2x 10-year average.

# Three Reasons Why Stocks Will Go Up (cont'd)

**Reason #3: The NFL Playoffs**

I may be jumping the gun here a bit as we talk about the Super Bowl Indicator each year. However, for you sports fans out there, here is some really cool data:

There have been 47 Super Bowls and teams with connections to the "old NFL" (excludes AFL teams and post-NFL-AFL merger expansion teams but includes the Ravens which traces its roots to the Cleveland Browns) have dominated. When an NFL team has won, the market has risen by an average of 11.9% while during years AFL teams have won, the market has dropped by an average of (-3.4%).

Right now, there are 8 teams in play for the Super Bowl. They include 3 NFL teams (Steelers, Packers, Cardinals), 3 AFL teams (Patriots, Broncos, Chiefs), and two expansion teams (Seahawks and Panthers.) After crunching the numbers, I can say that I am strongly cheering for four teams, am ambivalent about two and definitely rooting against the Patriots and Chiefs. Here's why:

In the Patriots four victories, the market has dropped an average of (3%), even though stocks rose incrementally two of the four years. FYI, stocks did basically nothing when the Chiefs won so I am not keen on them either.

In contrast, the market has never declined when the Steelers, with 6 rings, have won the Super Bowl—and stocks rose an average of 21% during those years!!

Stocks have actually never declined during the AFL-tied Broncos' two wins (average return of 23%) or the Packers' four wins (up an average 14.8%). When Seattle won, the market jumped 11.4% and when both expansion teams won (Seahawks and Bucs), the return was 18.9%, on average.

The bottom line? I am rooting for the Steelers, Broncos, and Packers for their track record, and am okay with the Seahawks as well. The Panthers might be shaky for stocks, and the Cardinals only have the NFL link behind it so that may be shaky too. And I definitely don't want the Pats. All in all, thanks to this useless but pleasantly distracting data, I like our odds of a higher market, despite the current malaise.

## *The Stock Market Today*

**AAII Sentiment Survey (figures rounded)**

| | Current | Last Week | *Long Term Avg* |
|---|---|---|---|
| Bullish | 25% | 22% | *39%* |
| Neutral | 51% | 40% | *31%* |
| Bearish | 24% | 38% | *30%* |

Clearly investors are getting more Bearish, and understandably so. However, according to data produced by Birinyi Associates, in the past 20 years, there is no correlation between the performance of stocks for the first week of the year and the full-year returns. In fact, only half of the time was the direction for the first week and the full year even the in the same direction!

The table below is a little scary. As much attention as the big stocks are getting, a new 52-week low was reached by the Russell 2000 Index, and this small stock index is now down nearly 20% from its 52-week high. Regardless, sure feels like a bear market for all the indices right now. I am not calling a low here, but tice in the past 6+ years, the 12-month forward P/E on the S&P 500 dropped below 11x for a blip and then roared back. Barring a real crisis, which I think is unlikely, I think ultimate downside is to the 13x level, which means we could drop another 7-8% before a big uptick occurs, in the worst case.

U.S. Stock Market Index Performance
1/8/2016

| Index | Close | 52-Wk Hi | 52-Wk Low | Hi Date | Low Date | % off High | % from Low | % Below 200-DMA |
|---|---|---|---|---|---|---|---|---|
| DJIA | 16,346 | 18,351 | 15,370 | 5/19/15 | 8/24/15 | 10.9% | 6.4% | -6.6% |
| S&P 500 | 1,922 | 2,135 | 1,867 | 5/20/15 | 8/24/15 | 10.0% | 2.9% | -6.6% |
| NASDAQ | 4,644 | 5,232 | 4,242 | 7/20/15 | 8/24/15 | 11.2% | 9.5% | -6.7% |
| Russell 2000 | 1,046 | 1,296 | 1,045 | 6/23/15 | 1/8/16 | 19.3% | 0.1% | -12.9% |
| Average | | | | | | 12.9% | 4.7% | -6.6% |

Source: www.BarChart.com, Goldman Small Cap Research

## *Say What?*

Great info, insights, and hard-hitting stories make up this week's *Say What?* feature...

*Investor's Business Daily*

http://news.investors.com/politics-obamacare/010916-789062-obamacare-signups-show-law-failing-near-poor.htm?ref=HPLNews

Nice insights and another reason to avoid health insurers.

*The Wall Street Journal*

http://www.wsj.com/articles/at-nearly-90-super-bowl-stock-analyst-has-a-streak-going-1452482753

I didn't catch this until after I wrote our Super Bowl piece, but you should read this too.

*USA Today*

http://www.usatoday.com/story/money/personalfinance/2016/01/08/what-to-do-when-you-win-the-lottery/78508764/

Since we are all trying to win that Powerball on Wednesday...

*Marketwatch*

http://www.marketwatch.com/story/heres-how-the-stock-market-has-reacted-to-state-of-the-union-speeches-2016-01-06

Could be valuable for you day-traders out there...

*ZeroHedge*

http://www.zerohedge.com/news/2016-01-10/feds-williams-we-got-it-wrong

An a-ha moment.

## *Sectors and Stocks to Own Now*

Admittedly, our **Hovnanian (NYSE—HOV)** bottom fishing pick for the year isn't look too good, nor is the Dogs of the Dow. However, our short term must-own pick **Smith & Wesson (NASDAQ—SWHC)** and pick of the year **Rovi Corp. (NASDAQ—ROVI)** all held their own, which is a miracle, all things considered. We still like all three, in case you were wondering…

I know we have stressed P/E multiples a great deal in this issue. That is because ultimately this is the measure on which stocks and sentiment will be judged: valuation. We have seen a lot of downward revisions in guidance and reports for 4Q15 and earnings will probably be down a tad in 1Q16 before a material change in 2Q16, which will be a boost to many stocks. Still, for those late to the party, if earnings are not up to snuff for Q4 or even 1Q16, it is definitely not indicative of the earnings growth expectations for the market or sectors in general.

For example, the key sectors we are focused on in terms of earnings growth in 2016 and their valuations (according to Factset) are outlined in the table. From our view, financials look cheap, especially when compared to historical multiples, as does tech and health care. Consumer discretionary appear to be okay, but not great, unless you can find a stock growing at a very fast pace. Interestingly, the P/E on the S&P 500 of 15.1x is higher than the average of these four leading sectors. That is because the P/E on energy is a scary 27x, versus its 15% 5-year average. Stay away from that segment!

Select U.S. Stock Market Sector Forecasts: 12 Month Forward P/E as of 1/8/2016

| Sector | Rev Growth | Earn Growth | 12-Mo P/E* | PEG Ratio | 5 Year Avg P/E |
|---|---|---|---|---|---|
| Cons Disc | 6.0% | 14.7% | 17 | 1.16 | 16.6 |
| Financials | 2.7% | 8.6% | 12 | 1.40 | 11.9 |
| Health Care | 7.7% | 10.0% | 15 | 1.50 | 14.7 |
| Technology | 4.4% | 7.3% | 15 | 2.05 | 14.3 |
| Average | | | 14.8 | | 14.4 |

* denotes rounding

Source: www.FactSet, Goldman Small Cap Research

## *Sectors and Stocks to Own Now (cont'd)*

As we noted earlier, last week was not a total loss when it comes to our small cap companies we follow. Right on cue, fitness equipment manufacturer **Nautilus, Inc. (NYSE – NLS - $19.36)** jumped 17% to coincide with all of our New Year's resolutions to finally get in shape. We first featured **NLS** in our *30-30* report in May of 2013 at $7.58 and the stock has performed admirably up 155% since then. The question is will the stock be 'fit' for 2016 in what appears to be a tough market from the get go.

Nautilus is expanding the revenue stream with both organic growth and M&A activity. The Company bought elliptical trainer Octane Fitness early last week for $115 million, clearly an effort to boost its technology along this product segment. Late last month the Company announced its partnership with Rogue Fitness as a distributor.

From an analysis standpoint the first item that jumps out is the $0 debt as of the end of 3Q15. The margin story is also impressive with the gross margin of 53% and an operating margin 13% versus industry averages of 40% and 5% respectively. Plus, a short float of 2.3% is a real positive on the technical side.

The best part? This small cap consumer discretionary stock is expected to grow EPS from $0.64 in 2014 to $0.86 in 2015 to $1.12 in 2016. With a 2-year EPS growth rate of 30%, the current 16x P/E multiple on 2016 projected EPS, **NLS** is just plain cheap. We think holding onto **NLS** is worth what will probably be a bumpy ride at the start of this year resulting in a $24 price target (22x multiple) later on this year.

# The Goldman Guide

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