Review & Outlook

FOURTH QUARTER 2014

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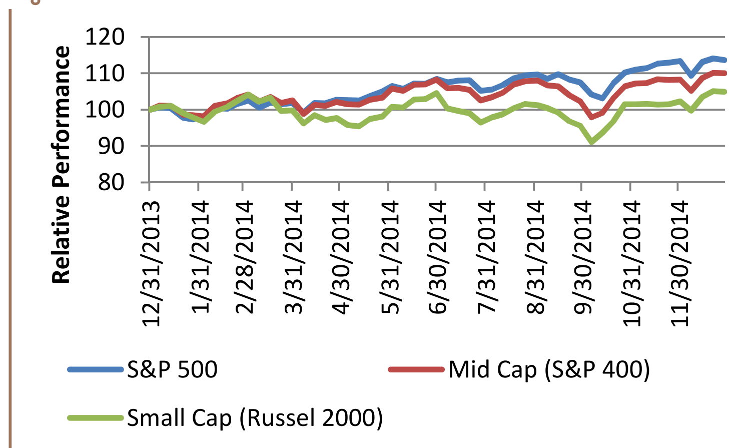
Review

In 2014, interest rates remained surprisingly low, and stock prices increased more than expected. Facilitated by continued low interest rates, the S&P 500 index achieved a total return of 13.7% for the year (including dividends). However, we also saw an increase in volatility. The S&P 500 dropped almost 6% in late January/early February. It swooned again in September and October, dropping 7% (partly a reaction to the Ebola panic); then dropped 5% in early December in response to the sharp drop in oil prices. Despite these dips, the market more than recovered each time, ending with a nice return for the year.

Large cap, mid-cap, and small cap stocks performed about the same through the middle of the year. Then small and mid-cap stocks lagged well behind large cap stocks for the balance of the year. The S&P 600 Small Cap Index achieved a return of only 5.8%, around a third of the S&P 500's return. Returns for high quality short and intermediate term bonds were hampered in 2014 by continued low interest rates.

The dominant economic story at the end of 2014 and beginning of 2015 is the plunging price of oil. The fall in the price of oil would appear to be unequivocally good news for consumers in the United States and around the globe.

Figure 1: Relative Performance of Indices[1]



It may be important to remember that the S&P's 13.7% return this past year was well above the long term average. Historically, the return has been 8-9%. Demographics and other factors suggest slower growth in the near-term, so 13.7% is a good year, especially when you reflect on the headlines. News about miserable winter weather, Ebola, general Federal Government dysfunction, ISIS, Malaysia Airlines flights disappearing and falling victim to Russia-Ukraine hostilities, all tended to obscure a very good year in the stock market.

Outlook

As the year drew to a close, we heard mostly good news about the US economy in 2015. Job growth was strong and widespread in November, with unemployment holding steady at 5.8%[2]. The Bureau of Economic Analysis also revised the most recent estimates of GDP growth to 5.0% for the third quarter (after two previous upward revisions), well above expectations[3]. GDP growth for 2014 could easily exceed our forecast of 2.5%. Moreover, most forecasts call for stronger growth in 2015, continued low inflation, and better prospects for wage growth.

The optimism heading into 2015 stems from a variety of factors, dominated largely by continued strength in the U.S. economy. However, there are definitely risks. China's growth continues to slow, while Japan and Europe continue to face stagnant economies with deflationary pressures. The strength of the U.S. economy will also likely result in the Federal Reserve Bank finally starting to push interest rates upwards.

Research notes from national financial firms see these relatively strong economic factors translating into another positive year in the stock market, though concerns are creeping in with the market already up more than 200% off the lows. Oppenheimer sees another year like 2014. Goldman Sachs sees a positive year, but much weaker than 2014[4]. We think the positives outweigh the negatives going into 2015, but our optimism is guarded. We also feel two themes will likely dominate the equity markets in 2015: the price of oil; and the Federal Reserve Bank starting to raise the funds rate. As noted below, we believe that the fall in the price of oil should

provide a tailwind and net benefit for the outlook for stock prices. Even if the Federal Funds Rate is raised only a quarter point, it will be significant following such a long run at almost zero. An increase in the Fed Funds Rate will likely lead to volatility in the equity markets. If the underlying motivation of an interest rate hike is an improving economy, any negative impact on stock prices should be short term.

In Focus

The dominant economic story at the end of 2014 and beginning of 2015 is the plunging price of oil. The fall in the price of oil would appear to be unequivocally good news for consumers in the United States and around the globe. It is like a tax cut, or a "real" gain in income. The same is true for any company that uses oil or natural gas as an input.

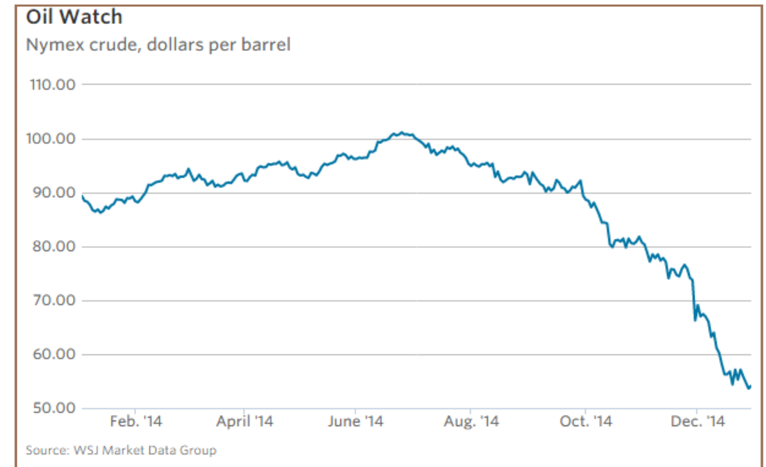
An important topic for investors relates to the underlying reasons for the decrease in the price of oil. Lower aggregate worldwide demand may drive down demand for, and price of, oil. This is a good part of what happened from July 2008 to March 2009 when oil prices went from roughly $133 per barrel to $39 a barrel. We all remember what happened to the value of stocks in this period leading up to what is now known as "The Great Recession."

However; if a significant increase in the supply of oil is exerting downward pressure on oil price the economic news may be largely good (ignoring long term impacts on the environment). The market price of oil will keep decreasing until the producers become financially stressed and stop increasing supply; the high cost producers are forced out. In this case you have more oil in the economy at a lower price leading to a new lower "equilibrium" price. This scenario should be a net positive tail-wind for the world's economies including the US stock market.

We are of the view that lower oil prices are being driven largely by increasing supply, with much of the increased oil production being domestic. The supply driven lower cost of oil should be a boost to major economies, especially economies that consume a lot of energy, but produce relatively little. Europe, Japan and South Korea might be good examples of such economies.

Even for the United States, the new leader in global oil production, the net benefit of a supply driven lower price of oil should be significant and positive[4]. Clearly, there will be some losers, but, for an investor with a well-diversified investment portfolio, we see the positives of lower oil prices outweighing the negatives in the majority of economic sectors.

Figure 2: Oil Watch[5]



One reason we see lower oil prices as a net benefit for investors with a well-diversified portfolio is that we think the increases in supply, and lower prices, will persist. The dynamics in the oil market right now flow from technology on the supply side more than weak demand. That technology is not going away, so there is very limited opportunity for OPEC and others to reduced supply to control price, as they have in the past. Further, it seems clear from both statements and actions that Saudi Arabia is prepared to keep output high in order to maintain market share. Market forces will eventually push prices back up above the early 2015 lows, as production curtails somewhat and consumption increases with lower price, but we don't see prices going back to $100 per barrel for at least a couple of years.

1. Figure 1: Yahoo! Finance Historical Indices Data.
2. Bureau of Labor Statistics: www.bls.gov
3. Bureau of Economic Analysis: www.bea.gov
4. Business Insider: "Wall Street Bull Expects 2015 to be Another Year of Double-Digit Stock Market Gains. 11/24/2014. Ro, Sam.
5. Figure 2: Wall Street Journal: Market Data Group.

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