January 20, 2015

Q4 2014 Commentary: Moving on.

Another year removed from the great recession of 2008-09 and another good year for US financial markets is in the books. The memory and pain of the 38% decline in the S&P 500 in 2008 still lingers in investors' minds, but the markets have moved on. The 13.7% gain in 2014 marked the sixth consecutive year in which the stock market advanced. Volatility, as a proxy for investor angst, has been at historically very low levels over the past two years. Distressed property transactions have returned to pre-crisis levels. It is time to turn the page on that chapter in the markets.

The equity market finished the year strongly with the S&P 500 rising 4.9% in the quarter. Interest rates continued to fall, which pushed bond prices higher. The US aggregate bond index rose 1.8% in the fourth quarter and 6.0% for the full year. Frankly, there is not much mystery why results were very good for stocks and bonds this year:

- Economic growth rebounded to 5.0% in the 3rd quarter after weather related problems slowed growth early in the year.
- Unemployment fell from 6.6% in January to 5.6% in December.
- Jobs created averaged 246,000 per month vs 194,000 in 2013.
- The ten year US Treasury yield fell from 3.03% to 2.17%.
- Inflation was less than 1.0%
- Operating earnings for the S&P 500 are on track to rise 8%.

Let's see…good economic growth, check…low unemployment, check…falling interest rates, check…gas prices below two dollars per gallon, check. It really doesn't get much better and, fortunately, it appears that these conditions will persist. Mario Draghi's recent announcement that the European Central Bank would commence its own massive, US style, quantitative easing program will support a strong dollar and attract foreign investment. Relative to the rest of the world's economic problems, the US represents the proverbial best house in the neighborhood. International demand for US stocks and bonds will support prices going forward. It remains to be seen whether the US economic engine can keep chugging along when much of the rest of the world is teetering toward recession. However, with quantitative easing in full swing in Japan and Europe, we are inclined to believe that the US economy will be fine. The decline in the price of oil, while detrimental to oil industry employment and earnings, will benefit all US consumers as they pay less for gas and energy.

Despite the economic travails in Europe and Japan and the slowing growth in China, the 800 lb. gorilla in the investment room is still the price of oil. Since last summer, the price of a barrel of oil has collapsed by more than 50%. As a contrarian investor, we are naturally interested in the investment opportunity this kind of price decline can create. At $46 per barrel, many oil wells are not profitable. Drilling rigs are being shut down and exploration budgets are being slashed. As we have often heard recently, the cure for lower oil prices is lower oil prices. Lower prices bring reduced exploration and well closures that will bring supply into balance with demand. However, reducing supply is a slow process and it makes sense to bide our time for now. At some point in 2015 we expect investment in energy companies will make sense and produce exceptional returns for years to come. We are not at that point…yet.