OVERVIEW

Economic Analysis and Market Review

Q4—2014

BRIEFLY...

- US economy rolls on
- Interest rates: where to next?
- Inflation: what's ahead?

"Roll on you Tide", the Alabama Crimson Tide's cheer heard throughout their football games would be an apt cheer for the U.S. economy. Following on the second quarter's 4.6% gain, the third quarter produced an even better result of 5%. This was much better than forecast and validated the Fed's optimism that the economy could stand on its own without pumping money into financial markets. They ended their "quantitative easing" program (QE3) in October. When the results are in for the fourth quarter, I'm sure it will prove to be another stellar one. It's been a long time coming. If the Great Recession ended officially in 2009, we would normally have seen these kinds of results in 2010, but this was no ordinary post-war recession as everyone now knows. 2014 produced over 3 million jobs to bring the unemployment rate down to 5.6%, close to the 5.5% level where the Federal Reserve would call it full employment.

With full employment close at hand, the Fed can now focus on their second responsibility — inflation. Their stated target rate is 2% and at last count, U.S. inflation is running around 1.2%. It would appear their work is done—except for one thing. Interest rates. Since the Great Recession began in 2008, the Fed has kept short-term interest rates at zero. They did this in the belief that low interest rates would add liquidity to the system by encouraging businesses to borrow and expand and create jobs as well as give the housing market a needed boost. This didn't work as anticipated hence the quantitative easing program of buying bonds and injecting billions into the financial markets. Now, however, many economists believe that with so much liquidity in the system and the economy at or near full employment, inflation will surely come roaring back with a vengeance. The tool the Fed relies on primarily to fight inflation is interest rates, as inflation rises, so do interest rates to rein it in.

The key question now is when will the Fed raise interest rates? To know this is to know how to invest accordingly as a hike in interest rates will surely disrupt the markets, bonds especially. The Fed will have to take into consideration a number of factors in their decision and most wouldn't warrant an increase:

BRIEFLY...

- Oil price decline: positives negatives
- Market volatility 2015: more of the same

1. Wage Inflation: We are close to full employment which usually leads to higher wages putting pressure on prices but there is still plenty of slack in the labor market so wage increases haven't kept up with what little inflation we do have.
2. Capacity Utilization: This refers to the amount of manufacturing activity in play and what percent of plant and equipment is being utilized. Currently that number is around 86% leaving plenty of room to expand without having to invest in more equipment. And then there's one final thing—oil. Our economy and the economies of the developed world are driven by oil and the price of oil has plummeted. In the last half of 2014, the price oil declined 50% from a high of $100/barrel to its current level of $45/bbl. This monumental decline is not new in the oil business. In 2008, oil dropped dramatically from $140/bbl. to less than $40.

Three factors have come together to produce this big drop. The first is the slowdown in the world economies, led by China, but supplemented by the sluggishness of the Eurozone. The second is the increased supply, principally due to the shale fracking revolution in the US. The third is the collapse of cohesion in OPEC. Perhaps the collapse wouldn't have been so severe if OPEC had cut production but Saudi Arabia is intent on holding market share and has the wherewithal to hold out until many of the smaller drillers whose drilling costs are high are out of business. Already some of the larger oil companies like Shell and Conoco Phillips have put a hold on some of their new projects and many of the oil service companies have a lot more oil rigs sitting idle.

Obviously, there are net benefits to our economy with prices this low. Consumers are spending much less on gasoline which means more income available for other items and certain businesses will be big beneficiaries of cheap oil – airlines will pay much less for jet fuel, their biggest expense, FedEx and UPS and truckers will be paying a fraction of past fuel charges and car manufacturers, as customers are still buying gas guzzling SUVs, their most profitable model.

What is not so obvious are the companies that will not benefit from current low oil prices. Some are not in the energy sector like capital goods and materials sectors where suppliers of drilling equipment, pipes, storage containers, machinery, cement, water, and chemicals used in shale production are all likely to experience a negative impact. And then there is the financial sector where banks have lent to drillers and mutual funds that own the non-investment grade bonds of many of these small drillers. If these drillers go out of business, there will be defaults.

While all of these developments were unfolding in 2014, the markets, as you might expect, experienced much greater volatility than in recent past. This was partly due to the collapse of oil prices but also due to a strengthening dollar, Vladimir Putin's adventure into Ukraine with the subsequent sanctions imposed by the West and the breakout of EBOLA in west Africa that killed thousands and threatened to migrate to the US. All of these events were responsible for corrections in the stock market but failed to de-rail the bull market trend. It was a very confusing year as roughly 80% of active money managers missed their benchmark and over 400 hedge funds fell by the wayside. Experts said small cap stocks would outperform large caps as large cap stocks gathered a bigger percentage of their revenues and profits from overseas where economies were stagnating. That proved to be false as large cap stocks outperformed small cap stocks by a factor of 2:1. Bond experts said to get out of bonds, or at least shorten the maturities, as interest rates were going to rise. That proved to be false as interest rates actually declined causing long-term Treasuries to perform very well.

Now as we begin 2015, the guesswork begins anew. Since it's the third term of the "presidential cycle" I believe stocks will again do well and interest rates should remain at low levels as I don't expect the Fed to raise interest rates, so investors will get their interest payments from their bonds but little in the way of appreciation and, finally, international stock markets should rebound as stimulus programs begin in the Eurozone and Japan.

Market Indexes
Fourth Quarter, 2014

INDEX	Q2'14	YTD	3 YEARS	10 YEARS
S&P 500	4.9%	11.2%	20.4%	7.7%
Russell 2000	9.7%	4.9%	19.2%	7.8%
Europe, Aust., Far East	-3.6%	-4.9%	11.1%	4.4%
Barclays Agg. Bond	1.8%	5.9%	2.7%	4.7%
Dow Jones Real Estate	15.1%	32.0%	16.1%	8.1%
Treasury Bills	0.00%	0.03%	0.07%	1.5%

- The S&P 500 is an index of 500 large, well-established companies
- The Russell 2000 is an index of 2000 small companies
- The Europe, Australasia, Far East Index (EAFE) is an index of developed countries around the world
- Barclays Aggregate Bond Index is an index composed of investment grade bonds
- Dow Jones Real Estate Index is an index of commercial real estate properties
- Treasury Bills are 3-month securities issued by the U.S.Treasury

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