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Outlook for the New Year

Mark Burkhardt, Portfolio Manager January 15th, 2015

As we begin a new year and contemplate how it will unfold, I have become increasingly concerned that certain geo-political and valuation risks are growing and could make the investment landscape of 2015 a more difficult one to navigate. We would be wise to remember that while the markets ended last year near all-time highs, the volatility we saw in the final three months of the year portend of wider market swings in the near future. As an example, the Dow Industrials has seen over 3,400 points of movement just in the first 10 trading days of this New Year. Historically, market volatility, whether they are large percentage moves to the upside or to the downside are symptoms of a market that is entering the late stages of a longer term trend. These types of wide market price swings are often seen either near the end of a protracted decline or advance and are very confusing for investors as they try to determine what the real underlying direction is.

Last year our markets had given up all of its accumulated gains for the year by mid-October with the all of the final gains coming in a flurry of buying in the last two months. This year-end rally had all the markings of a professional buying panic as many portfolio managers wanted to make sure that they could show their clients that they own all of the year’s winners, even if they had only owned them for just a couple of weeks. Believe it or not, this is actually typical behavior as mutual fund and hedge fund managers are under enormous pressure to try and close performance gaps with the benchmarks they are judged by. The economic landscape as it stands today still appears to be a net positive for investors. Recessionary fears in Europe and slowing growth in China will have negative implications on our economy but should be more than offset by lower energy and interest rate costs. The decline in long term interest rates will continue to help households and businesses as their borrowing costs decline further and the ability to refinance more expensive debt remains compelling. Lower fuel costs and cheaper imports will have a major positive effect on consumer confidence and spending. The impact of a slowing global economy and a rising dollar will negatively impact the profitability of many US based multinationals and make our nation’s exporters less competitive than their foreign rivals. Therefore we will continue to pare back on those positions that have substantial export exposure and overweight those sectors that have a stronger domestic exposure.

One of the biggest economic stories last year continues into this year, and that is the remarkable collapse in oil prices. In my last letter I discussed the geopolitical risks that falling oil prices could instigate. While those still remain, the investment risks are becoming equally consequential. The damage to energy stocks has been widespread, whether they are the large global integrated oil companies like an Exxon or Chevron, or smaller domestic drillers that rely on new fracking technologies, all have been hurt. What we are seeing in the oil markets is the return to true supply and demand pricing without OPEC manipulating production quotas to achieve predetermined pricing goals. This ongoing search for price discovery creates wide swings both on the upside and downside as energy traders look to exploit near term oversold and overbought conditions. Using the latest figures from the International Energy Agency, the world currently produces 93.7 million barrels of crude oil per day and uses only 91.5 million barrels per day. Therein lies the problem from the perspective of an oil company. Demand, for whatever reason is not equal to or exceeding the current supply. While approximately 2 million barrels per day in excess production may not sound like a big problem, it eventually becomes one.

Let's suppose you have an oil well in your back yard. It's a wonderful thing, assuming you're not an environmentalist, and let's say your well produces 10 barrels of oil a day. The problem is that you have only been able to sell 9 barrels a day. Not a big deal? Well after a year of this your back yard is stacked with 365 barrels of oil and you're running out of places to put it. That's what is happening right now, the world is awash in excess oil. So much so that oil traders are leasing supertankers not to transport oil to market but rather just to store it offshore. These oversupply problems will take a much longer time to resolve than many investors may think. Here in the US, existing fields will be producing an additional 500,000 barrels per day by mid-year without any additional new drilling. Just to put this supply glut in perspective, at the end of 2014, the US had a record of 1.14 billion barrels of crude oil in commercial storage.

Ultimately, markets including crude oil are inherently self-correcting entities where a collapse in prices eventually creates the desire for greater demand. The benefits for consumers are substantial with estimates that the current decline in gasoline will result in US households saving anywhere from $65 to $75 billion just this year. Those savings are in many ways like a large tax cut for Americans and most of that excess cash will easily find its way into increased consumer spending. These energy savings will also a have substantial global impact as well with many oil dependent economies like Europe, China and Japan benefiting the most. The emerging market economies will also be helped as they, unlike more developed nations, tend to be the least efficient users of energy. Worldwide, the overall economic stimulus from energy cost savings alone could add as much as 0.5% to global GDP growth in 2015. The bottom line is that what it a negative for the oil and gas industry, is ultimately a powerful stimulus for near term growth both here at home and abroad.

A year ago, there was overwhelming consensus among economists that inflationary pressures would rise and that our Federal Reserve would be forced to start raising short term interest rates, as long term rates increased. They could not have been more wrong, as just the opposite has happened, since inflation is dropping and long term rates keep moving lower. Since the beginning of the financial crisis, central banks throughout the world have printed over 9.2 trillion dollars in a global effort to stimulate growth and repair damage from the financial crisis. Unfortunately they have little in the way of economic growth to show for what has amounted to a massive global currency devaluation. Central bankers are by their very nature a fearful and overly cautious group of folks, and they would rather hesitate then run the risk of taking any action that could threaten a slowly recovering economy. With the current inflation data coming in well below the Federal Reserve's target of 2%, it is becoming readily apparent to me that they will have no justification to raise interest rates anytime this year.

This flies in the face of conventional wisdom and even the latest talking points from both Fed officials and leading economists who still believe that rate hikes will begin around mid-year. If the Fed were to raise interest rates, basically making the US dollar more attractive to investors, that strength only further weakens the prices of all commodities (which are priced in US dollars) even further, leading to even less inflation and possible deflation. As I alluded to earlier, a rising US dollar also has negative connotations in that it makes our exports more expensive and therefore less competitive versus foreign made products. I believe that the Fed not raise rates this year, and if the dollar continues to rise in value versus other currencies, then the Fed will once again feel compelled to employ some new version of quantitative easing to push the dollar's value down. The world's central banks are all using the same flawed playbook of competitive currency devaluation in order to prop up economic growth while at the same time trying to generate an inflation rate of at least 2% or more. Let's be clear too that there is a fine line between "competitive currency devaluation" and an escalation into a "currency war".

They have failed in both of those goals, while succeeding in generating large gains for investment portfolios as investors are forced into ever riskier assets as they seek returns. What central bankers are either unable to grasp or too arrogant to comprehend, is that even though they have the power to print unlimited amounts of money, they have no ability to impose the fundamental structural reforms that are needed to allow the world's economies to achieve a truly sustainable path of growth. There are always two sides to every coin, by keeping interest rates artificially low, the Federal Reserve is in effect punishing savers who used to rely on their savings for income, but who benefits? Debtors do and the biggest debtor of them all, the US government, benefits the most. By keeping short term rates near zero, the Fed has enabled the government to take on enormous amounts of new debt and pay next to nothing to do it. How much? Well of the $18 trillion in outstanding debt, 68% of it matures in 5 years or less and 27% comes due in 1 year or less. A good analogy would be why would an alcoholic want to stop drinking when the bartender tells him that the next drink is always free? Our central bank is unfortunately falling into a trap of its own making. If the Federal Reserve were to raise rates by even 1%, the interest costs for our government would increase by at least $180 billion over a very short period of time. That is a dramatic budget expenditure increase that no one in government either expects or is prepared to deal with.

Inflation risk, while low now remains one of the most important risks for any investor to deal with, especially for those of you who have already retired. If you want to keep up with inflation, even the modest 1.6% year over year rate we have today, you will need your income stream to consistently rise over time. While historically low, even a 2% inflation rate erodes your dollar's purchasing power by 22% every ten years. Investing in taxable ten year US Treasury Bonds yielding 1.85% is a break-even endeavor at best, so what viable alternatives do investors have? This is very frustrating for investors that are either retired or who are by nature conservative and risk adverse. At this point, there is very little value in the Treasury bond market, even less when you adjust for inflation or look at your return on an after tax basis. Financial planners will tell you that the solution is to pursue a growth strategy by maintaining a sizable allocation to equities, assuming that when you retire, you will sell off about 4% of your portfolio per year. At a 4% withdrawal rate, you can optimistically assume that you won't outlive your assets.

Unfortunately, the market is not as undervalued as it was just a few years ago, rather it could be called either expensive or at the very least fairly valued. Today the S&P 500 trades at 19.1 times trailing reported earnings versus the average going back to the 1920's of around 15 times earnings. With stock prices and corporate profits at historic all-time record highs, and interest rates still very near all-time historic lows one has to wonder if these economic indicators are priced to unsustainable perfection. In this environment I can't assume that your retirement can solely depend on long term capital gains that may become ever harder to generate nor can I expose you to the risks in the bond market which Warren Buffet calls the "next great bubble to burst".

The only clear and prudent path is the Growth & Dividend Income approach we are currently employing. This is the strategy that is at the core of all of our portfolios. Ideally we assemble a portfolio of stocks that offer a current yield that is equal to or higher than competing income instruments such as bonds and just as importantly offer a strong probability of increasing their dividends over time. Dividend paying stocks not only pay a sustainable stream of income, they also give you, the investor, the potential for substantial multiyear capital appreciation. They are also very efficient from a tax perspective as the dividends and long term gains are taxed at much lower preferential rates than ordinary income. Lastly, I have found that these dividend paying companies are inherently more stable as they have greater capital discipline than many newer growth companies. As always, our vigilance of an ever changing world is essential in safeguarding your investments.