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Update on Current Market Conditions

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Over the last four weeks, many of the world's problems which for most of the year we have managed to avoid, have crossed the oceans and are now impacting our markets. Unfortunately, the list of economic and political ills, as well as even fears of a global pandemic has been getting longer, not shorter. Whether it is the dramatic increase in the value of the dollar, the decline in growth forecasts or the fears of global deflation, investors have had to navigate an ever growing set of risks. Markets crave clarity and when it feels that it is lacking, the market tends to assume and embrace the worst case scenario. The recent Ebola scare is a perfect example of this mindset in action. When several western governments were slow to respond to this well known risk and when they finally did, their actions lacked credibility and were perceived by their citizens to border on incompetence. This becomes a common theme, when markets are faced with a risk that appears to be unquantifiable, they will always price in the most negative possible outcome.

The greatest question now facing portfolio managers will be determining whether our own growing economic strength will be enough to offset the lowered growth now being forecasted for much of the rest of the world. This is significant as just over 45% of the S&P 500's revenues are derived from international sales. As a percentage of global GDP the US accounts for 22.4% of total output so unlike in decades past, we are increasingly impacted by the cumulative fortunes of others. While many of the more economically mature nations are still experiencing very sluggish growth, the real driver of the global economy been in the rapidly developing countries. They now account for nearly 40% of the world's economy, up from only 21% just ten years ago. With our stock market carrying valuations that have fully priced in a sustainable economic recovery, any shortfall in those expectations could make companies that depend upon those international sales, look richly valued in the near term. This latest selloff in our markets also reveals that these recent concerns will not quickly dissipate but could well linger on for a while as companies report their earnings and reveal to investors what they foresee in coming months. International companies often hedge their foreign exchange risk but if they start to see a real slowdown in organic growth due to slowing demand overseas, then their market valuation and earnings estimates will have to be revised lower.

One of the other areas which I'm watching closely is the increasing likelihood of the Eurozone falling back into a recession and with it comes the fears of a possible deflationary environment. It is this prospect that has caused the Euro to dramatically fall in value and the dollar to gain. Since most global commodities are priced in dollars, the increase in the dollar's purchasing power has led to widespread declines in many raw materials such as iron ore, crude oil, fertilizers and industrial metals. The stronger dollar is a double edged sword, in that on one side it benefits US consumers since many of the items we import become more affordable. On the other side, there are negative consequences that we need to take into consideration in that our nation's exports become more expensive and therefore less competitive internationally. It also puts enormous pressure on the profitability of the export manufacturers in the emerging markets which these nations depend upon to lift their citizen's standard of living.

The price for the US benchmark crude oil price has fallen 22 percent just since June 20th. This dramatic decline in oil prices is a result of three convergent forces impacting the energy markets at the same time. Since oil is priced globally in dollars, the rising value of the dollar simply means that we can buy a lot more oil per dollar than our foreign competitors. The slowing of economic growth in Europe, South America and parts of Asia creates a situation that year over year global demand for oil is not only slowing but flattening. And finally the biggest reason for the selloff in energy companies and their share prices over the past several weeks is the realization that the world is now awash in excess oil stockpiles. So much so that large seagoing tankers are now being leased not to ship the commodity but rather are used as floating warehouses to store the oil that refineries simply can't use. This could have major implications for what has been in recent years an oil boom in this country. The high price of crude oil during the last decade has made it very profitable to use new and expensive drilling and well technologies to discover and pump oil and natural gas from reservoirs and formations that would not have been feasible years earlier. The longer lower oil prices remain, the less profitable and the more cost prohibitive drilling these new domestic wells will become.

For many years we have been dependent on securing a steady and reliable flow of imported oil with all the geopolitical costs and entanglements that this addiction entails. Many people are not aware that during the 1920's through the 1940's the US, with its huge Midwest oil reserves made us the world's biggest oil exporter. It was that geologic birthright that gave the US and the Allied powers an enormous advantage during the Second World War that the energy impoverished nations of Germany and Japan could never match. Those days of energy independence and the economic strength that we derive from it are nearly at hand once again. While by law we are not allowed to export our crude oil, the dramatic increase in domestic production has had a profound impact on the global oil markets. Oil and gas production here at home has increased by more than 200% in just the last seven years, from under 4 million barrels per day to now over 12 million. Next year the US will pass Saudi Arabia as the world's largest oil and gas producer but this Arab nation will still remain the world's lowest cost producer at around $4 per barrel. Why so cheap? It's because their oil fields are located very near the surface of the desert and the size and depth of these vast reservoirs allow enormous economies of scale. Many countries that have offshore and deep water wells tend to have production costs substantially higher in the $30 to $40 range as the capital expenditures are significantly higher. Here at home, new technologies such as fracking and horizontal drilling in oil shale formations come at a price with the cost of production of this land based crude averaging $47 per barrel.

While these events have negatively impacted several of our energy holdings, I believe the fundamentals remain compelling as many of these positions pay substantial dividends which will help us to weather this recent downturn. What is bad news for the oil companies is in fact good news for our household budgets and the global economy. According to economists, every $10 drop in the price of a barrel of oil boosts world economic output by almost half a percentage point. Prices we pay at the pump have already dropped about 50 cents a gallon which saves about $600 for the average US household and boosts discretionary spending.

Looking ahead the markets have two major events taking place in the coming weeks that could have a significant longer term impact on our investments. At the end of this month, the Federal Reserve will finally wind down its third iteration of its policy of printing money and buying government debt called "Quantitative Easing". The concern for us is that each time the previous versions of this policy were ended, the stock market experienced a notable pullback even though these policy changes were expected and well understood. I many ways our markets are like an alcoholic that can no longer remember what it was like to be sober. Over the last five years the stock market has become so accustomed to the enormous monetary support, now over $4 trillion, that the Federal Reserve has been willing to provide that it can hardly imagine being left to stand on its own.

The second event that could impact our investment allocations is political but with very real economic implications. There is a very real probability that the Republicans will gain control of the Senate and thereby control both houses of Congress. In the near term, the markets will assume and jump to the conclusion that government spending will be substantially cut back and will negatively impact the economy. In the long term, corporate America will focus on the very real chances of major revisions of the tax code, a more business friendly regulatory environment and major changes to the Dodd-Frank banking regulations that many businesses feel is actually impairing economic growth. Many voters tend to think erroneously that a divided government can't get anything accomplished but a quick study of recent history will prove that assumption to be wrong. Success in governing has more to do with the personality and leadership characteristics of the President more than anything else. Ronald Reagan had a very productive presidency all the while working with Speaker Tip O'Neil and a Democratic controlled Congress. Jimmy Carter unfortunately enjoyed Democratic control of both houses but even so his legislative successes were few and far between. Another great example of divided government being very productive is when Bill Clinton lost Democratic control of the House in the 1994 mid-terms and went on to great legislative success working across the aisle with the Republican majority.

Moving through the fourth quarter, I believe that our growing economic strength will provide a substantial counterweight to offset this recent global weakness. I believe that a number of foreign based multinational companies, especially those in Europe, are trading at a significant valuation discount to their American rivals. Several of them pay substantial dividends and their international sales will benefit greatly from a weakened Eurozone currency. While I intend to add several of these positions in the coming weeks, our portfolios will retain their predominately American centric weighting. It is equally important that in our search for value and growth, that all of the world's great companies are given a chance to be one of our portfolio's many long term holdings. As always, our vigilance of an ever changing world is essential in safeguarding your investments.