INVESTMENT ASSESSMENT
JANUARY 2015

The stock market was a wild ride in the 4th quarter of 2014. Stock prices fell at the beginning of October on concerns that global growth was slowing. Then a pledge from the Federal Reserve in December to remain "patient" in raising interest rates gave the market its biggest short-term gain in more than a year. Both the stock and bond markets experienced periodic selling pressure throughout 2014. These market pull backs were all short-lived. Five times this year the S&P500 was hit by short term sell offs, only to quickly come roaring back. The largest drop - 10% in the S&P500 Index - occurred in October when the market plunged on concerns that global growth was slowing. The market then rebounded and surged to record levels in December. Recent market weakness has been fueled by concerns that the Federal Reserve would begin to increase short-term interest rates and by global deflationary trends. While the US economy has continued a recovery, the rest of the world has struggled. Europe is close to recession and Japan's economy shrank again in the fourth quarter of 2014, leaving that country in recession. Russia's economy is crumbling, and power-house China is growing at 7% but that growth rate is slowing.

Federal Reserve Policy and Interest Rates

2014 began much like the year that preceded it with the expectation that interest rates would rise and bond prices would fall. Instead, long-term bond yields dropped. The yield on the US 10-year Treasury note is now at an unbelievably low 1.975%* down from 3.0% just one year ago. In Europe and Japan interest rates hit record lows with government bond yields below 1%. US interest rates were expected to rise but, in fact, went in the opposite direction as investors in Europe and Japan chose the relative safety of US government bonds.

Of course, there is a cost to the government policy of holding interest rates on bonds, mortgages, and consumer loans to arbitrarily low levels. Low rates discourage bankers from lending to businesses that create jobs, because they fear being stuck with low-yielding assets when the rates they must pay to keep deposits could go up a lot in the future. Instead, cheap money encourages Wall street speculators and bankers to invest in stocks and bonds and in foreign exchanges and commodity markets for their own accounts.

Oil Prices

Oil prices are down over 50% from their peak of over $100 a barrel at mid-year. It is all about supply and demand. Global demand has been weak, and supply has surged. There has been a relentless rise in US oil production from shale oil fields, and OPEC, led by Saudi Arabia, has held oil production at relatively high levels. At the same time global energy demand has been weak.

With the short-term collapse in oil prices, there may be more upside than downside in prices going forward. Shale oil producers will delay projects if cheap oil makes them uneconomical. Few of the major oil producing countries can sell oil at $50 to $60 a barrel without running massive budget deficits or slashing spending.

Right now oil prices are volatile and may remain that way over the next few months, but discipline among the major oil producers is likely to cause improvement in the price of oil.

Investment Summary

Over the last five and a half years, the rise in corporate earnings and investor confidence have fueled the recovery in stock prices. Earnings have grown at an annual rate of 14% since 2009**, about three times faster than sales, as companies cut costs. But now there is a potential disconnect. There is a limit as to how much more in earnings can be squeezed out by cost cutting. Growth and earnings isn't going to end, but it will probably slow, and for stock investors the direction is key.

It appears that the underpinnings for stock prices are still in place but there is some loss in momentum. The Federal Reserve will likely begin to raise interest rates sometime this year. At the same time, earnings gains that have been boosted by a remarkable rise in profit margins may not be sustained.

US equities are likely to remain the asset of choice, but we are not in the early stages of a bull market and volatility is likely to increase. A "normal" market correction would see stock prices drop 10%-15%, potentially erasing all of 2014's gains. So we are not calling for an end to the bull market, but we continue to hold an over-weighted position in cash reserves and short-term bonds in the anticipation of a better, low-risk buying opportunity.

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*Wall Street Journal, 1-5-2015
**W.Wang, Bloomberg 10-27-2014