2015 Recap, 2016 Outlook January 2016

2015: A Game of Oil Drilling Chicken, A Rate Hike, and FANG stock distortion

The past year will be remembered by economists and investors as the year that the Federal Reserve achieved "lift-off" from its seven year experiment with zero percent interest rates. While it is mostly agreed upon that the stimulus helped prevent the Great Recession from being worse, only time will tell if it will be viewed as the cause of unintended consequences that created future problems.

The overall U.S. and international economies continued to trudge forward with growth that is encouraging but also slow enough to cause concern that it could fade away if dealt a few speed bumps. The continued fall in the price of oil has surprised most people in its severity and duration, and the resulting damage to the industry has created more of a headwind on the overall economy than expected. However, after being slow to spend their newfound money from gasoline savings, consumers are showing increasing signs of confidence. The clearest sign came from December's car sales data, which led 2015's sales to break the previous record booked in the final go-go era leading up to the tech crash 15 years ago.

The biggest market mover of the year was the news about China's continued economic slowdown and the drama unfolding in its stock market. In an attempt to control its stock market's steep decline, China has enacted one market policy change after another. These have ranged from telling certain institutions to gobble up stocks, to telling big shareholders that they are prohibited from selling anything for six months, to putting a moratorium on new stock offerings to curtail supply. None of it has worked as hoped.

As was the case in 2014, the U.S. large company indices that get the majority of the media coverage masked much weaker stock performance from the other categories such as small and mid-sized companies, international, real estate, etc., that make up a diversified portfolio. If it seems like things haven't been fun for a while, you're right. A stretch of virtually every investment category doing worse than large U.S. companies isn't unheard of, but is fairly rare. Additionally, it's rare for big company stocks to have two calendar years in a row that are relatively bland. For illustration, if you set aside the terrible years during recessions and bear markets, and look for two back-to-back lackluster years in the S&P 500, you have to go back to 1977-78. A new silly acronym got coined to point out how pockets of possible excess are skewing the overall results of the broad averages. The so-called FANG stocks, comprising Facebook, Amazon, Netflix, and Google, had blowout stock performance in 2015. In fact, the two that started the year with the most questionably high valuations both kept partying like it's 1999 and increased over 100%. Since most stock indices give more weight to the companies that have the biggest valuations, those stocks have a disproportionate impact on the overall index returns. In the case of the FANG stocks, removing those four from the S&P 500 would have meant that the average of the other 496 companies would have caused the index to show a loss for the year.

Overall, since stocks ended the year being valued about 15 – 20% above their historical norm when compared to annual corporate profits, having the markets tread water while company earnings catch up is better than the alternative of a more serious decline.

POSSIBLE ECONOMIC ISSUES FOR 2016

It wouldn't be a surprise to see the year's big economic issues continue to be dominated by the Fed's rate increase decisions, the fallout from the oil industry's turmoil, and fear of China's slowdown pulling the rest of the world into a recession. Certain areas of the bond markets look overextended, but it doesn't appear to be as misaligned as it was a decade ago. Bright spots that propel growth could be the continued boost received from household formations from millennials along with all the additional consumption that takes place when starting out in the workforce.

POSSIBLE INVESTMENT MARKET SCENARIOS FOR 2016

2016 started off with a new record. A few days into the year, the Dow Jones Industrial Average had booked its worst start to a year ever. In the grand scheme of things though, this "record" is just the normal type of drop that happens from time to time. The reason is once again China, and this type of trigger-happy response is what happens when markets are in lofty territory to begin with. Once again, if last year the market had galloped higher, it would have just caused these declines to be worse.

Technically, above average stock valuations are okay as long as interest rates are below average *and* expected to stay there for the foreseeable future. This interest rate environment is actually what is expected for quite a while, so it might not cause a problem. However, since investors have already gotten the pop in the various components of return that come from price increases caused by people being enthusiastic and willing to pay up a little more for the same dollar of company profits, it means that for a while the return components are likely to only come from actual company profits. Since overall economic growth is currently slow, this could mean that it could take some more wheel spinning before the economy provides enough of a tailwind for company growth to start cruising along at the rate to which everyone is accustomed. Looking on the bright side though, the past several years of extremely low interest rates created an era where the proper thing for a company to do was have its finance and accounting departments create growth in earnings per share (EPS) by using their skills to refinance debt and buy back stock so the remaining investors get a bigger share of the earnings. These transactions are risk free and generate EPS growth, so it has been the correct thing to do. For example, in a bad economy, people are less likely to try to improve their household finances by taking the risk of getting a new job or career, but they would be foolish not to grab the low-hanging fruit of refinancing their mortgage. Going forward, when interest rates are higher, the benefits of these corporate actions decline and the focus shifts more towards taking the risk of spending money to try to sell more stuff. When this is successful, the growth in profits is considerably more than the finance-driven gains, which propels the economy and markets even further. At some point, this level of corporate activity will increase.

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