State of the Economy

December 2014

As 2014 comes to a close, the stock market seems destined to end with another positive return. This prolongs the 4th longest bull market in history. While equities had a solid year, the treading was far from smooth, especially in the fourth quarter. The market is proving resilient in overcoming cyber-attacks, unrest at home over racial conflicts, and the continued threat of terrorism. The autumn selloff and recent nosedive in oil prices did not make things any easier. In the end, the strength of economy and the support of the Federal Reserve, continue to outweigh the obstacles for now.

Oil prices have recently dropped almost 50% from their peak in June 2014. While this is currently a shock to the global market, the plunge has been slowly building up throughout the summer. The supply of oil rose throughout much of 2014, but fears of violence in Iraq kept oil prices high. Traders were worried that instability in the Middle East created by the Islamic state, could cut output from the region. While these fears held prices at bay, the United States gave permission for its first export of US oil in a generation this past June. Additionally, the largest oil producer in Africa, Libya, added to the world's supply. Libya agreed to open two of its oil export terminals that had been closed for the prior year. Also, due to growing global competition, Saudi Arabia decided to continue the same level of production. Saudi Arabia has been burned in the past from cutting its oil output while losing customers. As the largest oil producer in the world, Saudi Arabia is aware they are well positioned to withstand a drop in oil prices. However, the same cannot be said for other oil producers including Iran and Russia. Consequently, there is now an oversupply in oil around the world. The sudden drop has caused collateral damage to the energy sector in the United States and abroad, with oil companies scrambling to cut production.

Despite the volatile energy sector, the US economy continued to progress forward outpacing the rest of the world. This growth is attributed to positive economic news and help from the Federal Reserve. This has become a familiar story over the past few years. The growth in the job sector cannot be ignored, with a 321,000 gain in payrolls in November compared to a consensus estimate of 230,000. The unexpected jump in November helped keep the unemployment rate at 5.8%. The manufacturing and services industries are also tracking towards their highest levels based on their economic indicators. The US is starting to see employees leaving their current positions to take other jobs. This indicates the job market is improving, particularly for manufacturing. Equally important, the Federal Reserve flexed their muscle (whether they intended to or not) this past week as Janet Yellen stated they would stay "patient" before raising interest rates in 2015. Yellen's rhetoric was the primary reason for the 700-point increase in the Dow Jones this past Thursday and Friday, while the S & P 500 increased 3.4% for the week. The Fed also suggested the drop in energy prices would be a net benefit for the US and the consumer. Overall, it seems like the Fed will continue to support the economy which should be beneficial for equities in the short term.

The outlook for 2015 from overseas does not look as favorable. Russia is on the verge of a recession as their currency is tanking and the drop in oil prices is crippling their economy. Meanwhile, Western sanctions are hurting their exports. The rest of Europe is currently executing their version of a stimulus program to spur growth. In early December, the European Central Bank President Mario Draghi stated that the ECB will reassess the drop in oil prices and their quantitative easing program in January. Draghi is willing to do more if necessary showing how unstable their economy is right now. In China, the factory sector contracted for the first time in seven months, as calls for more stimulus measures continue to mount. This is a bad sign for China, especially after their central bank surprisingly executed a rate cut in November.

For the upcoming year, I see the stock market returning modest gains based on the continued strength of the US economy and the support of the Federal Reserve. The labor market appears that it will continue to trend in a positive direction and lower energy prices should provide a break for consumers, enabling higher spending. This will help boost revenues for companies dependent on consumer spending. I also expect this coming year to witness various pull backs similar to 2014. The first increase in interest rates by the Federal Reserve could create such a situation. The majority of experts predict the Federal Reserve to approve the first hike in over 5 years sometime in the middle of 2015. The increase could have a temporary negative effect on the bond market (as rates rise the value of bonds falls) and the stock market as well. Although the market is expecting the increase in rates, this will be confirmation that the Federal Reserve's safety net is slowly fading away. The key will be how quickly the Fed continues to increase the hike. I expect this to be a slow process to enable the market to better absorb the change to the economy.

Overall, the market has displayed a central theme the past few years. The various selloffs in equities were cut short by actions and announcements from various central banks around the world. We shall see whether 2015 stays consistent.

Have a Safe and Happy Holiday Season.

Sincerely,

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