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The Financial Counselors

MARKET UPDATE
February 25, 2015

OUR VIEW

Watchful Waiting (Anxious investors standby while the Fed exhibits "patience," and the ECB attempts to manage Grexit and deflationary tendencies)

As investors, pundits, and Wall Street fret about a full plate of real and media-generated global crises, Main Street USA attends to business. Against this divergent backdrop, US equity markets reached new highs late last year, encountered an air pocket in January, and climbing on the proverbial "Wall of Worry," now threaten to break out into new high ground once more. In some respects, the current rally in the US seems more fundamentally grounded (NASDAQ Index now hitting new highs has recently confirmed other broader larger company indexes); and even though some company managements are cautioning analysts about the outlook for 2015, stock valuations relative to bonds continue to seem reasonable. But, as always, in an equation as complex as our global econometric model, if some of the dependent variables move out of sync, the potential outcomes require reassessment.

US vs. Other Developed Countries vs. Emerging Countries

Anxious investors await Eurozone developments and central banks' next policy moves…

Known to most, the headline issues today are the price of oil, when (no longer if) our Federal Reserve Board will begin to return the structure of interest rates back toward "normal," the widening income and wealth dispersion gaps, unresolved geopolitical issues, and developing religious conflicts in the Middle East and Africa. To this short list should be added, the strengthening US dollar, resulting currency skirmishes as weaker economy countries try to become/stay competitive, and for many emerging countries controlling capital flows, and through all this managing political stability.

In addition to the anomalous performance of US equity markets some other divergences are developing:

- Rising employment in the US has not been accompanied by notable increases in business capital investment, a usual development in later stage economic recoveries;
- An appreciating US dollar has begun to affect US multi-national corporation earnings, many of which derive major amounts of revenue from non-dollar markets;
- Smaller US and European companies, whose revenues are usually home-country-bound, continue to command expanded P/E's vs. large diversified multinationals, and
- Divergent central bank policies become a real future possibility if, as expected, sometime this summer our Fed moves toward a less accommodative monetary policy.

But one needs to keep in mind that the global financial markets are massive information discounting mechanisms continually appraising in real time the impact of all the above and more, instantaneously rendering the conclusions of institutional and individual investors, traders and regulators. Most of these concerns are already reflected in current global investment market valuations.

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What can we learn from recent market experience?

It's often difficult to break the psychological bounds of recent trends and question the conventional wisdom.

In a few words; "very little." The tendency to extrapolate current trends into the future (*recency* in behaviorist's lore) can be a trap for investors. Forecasters and pundits are often ambushed by this tendency and find it difficult to call inflection points. Virtually no one suggested last summer that the price of a barrel of oil (then at $100) would decline 50% during the subsequent six months. And yet in retrospect, the signals (a flattening demand curve, rising output in the US, bulging storage tanks, warming weather patterns) might have at least raised a cautionary flag. The price of oil today is a supply-driven equation. Even if one had anticipated the coming energy price decreases, the knock-on effects would probably not have been anticipated by most. As Herb Stein (or was it Yogi Berra?) used to say, "If something cannot go on forever, it will stop."

The economic and political ripple-effects of declining energy prices are still playing out through world financial markets. The net benefits to a diversified consumer-based economy like the US are manifest. For energy exporting countries (Russia, Venezuela, and OPEC Middle East producers) the implications of $50 oil are dire. For example, Russia's break-even fiscal budget is based on $90+ per barrel oil. Venezuela is almost certain to default on its foreign currency debt. OPEC, until recently thought to be an invincible cartel, seems headed toward relative insignificance.

The disruptive impact of this, and all the other imponderables discussed above, cannot be denied. But attempting to be too tactical, reacting short term to each new shift in outlook can be hazardous to one's wealth. The temptation to "do something, don't just sit there" at times like this is often palpable. What hasn't, it seems, been baked into all these imponderables is the possibility that some may be resolved positively. Resisting the urge to shift gears at the moment would seem the more prudent course.

As always, we welcome your comments and questions.

Sincerely,

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