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Asset Management, Inc.

Never a Straight Line

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Reflections & Perceptions

2014 was another year of gains for the U.S. stock market. During the second half, the U.S. economy gained greater traction and stock prices rose even as the Federal Reserve reined-in its post financial crisis stimulus. Many domestic stock indexes rose to new all-time highs. The S&P 500 was up for the 6th year in a row, with a return of 13.7%, led by a 29% gain in its Utilities sector, and 25% and 20% moves in the Healthcare and Technology sectors, respectively. (Energy had the worst return among the S&P 500's sectors, down 7.8% for the year, but more on that later….)

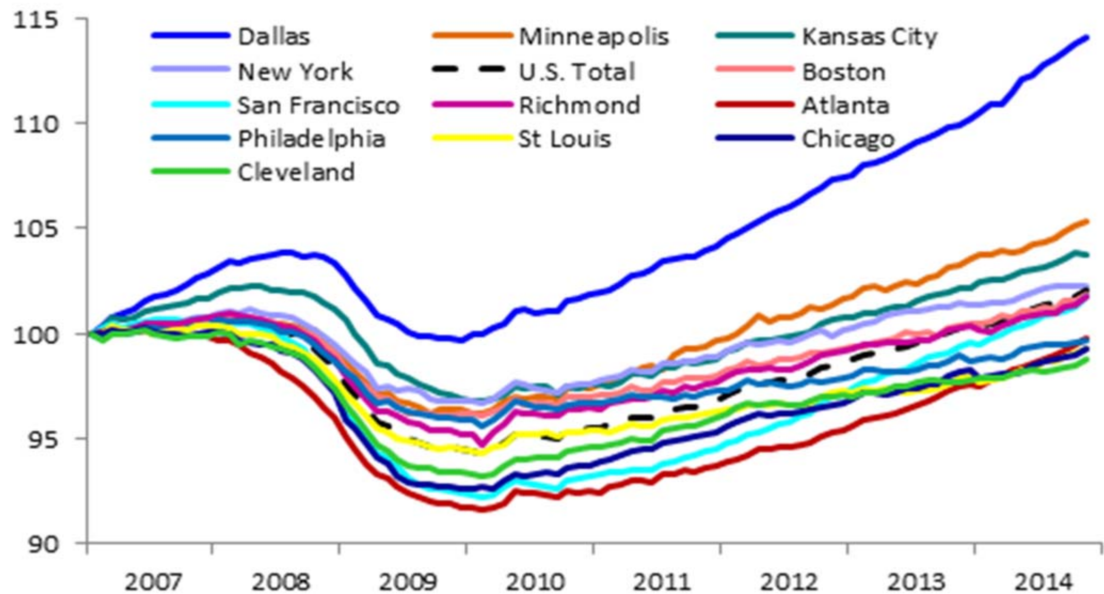
It was a different story in much of the rest of the world in 2014. Japan slipped back into a recession. European economic growth slowed to the point where many U.S. companies have built their 2015 plans assuming no growth in this geography. And, inflation there slid to levels where markets began worrying about the effects of deflation. In China, signs of slowing developed after many years of double-digit growth. Many expect China to miss its 2014 goal of 7.5% GDP growth, its first shortfall since 1998.

Consequently, the performance of foreign stock markets was mixed. The MSCI Europe index lost 8.6% and the MSCI emerging markets index fell 4.6%. Due to aggressive easing by the Bank of Japan, the Nikkei rose 7.1%. Despite the growth fears, China's Shanghai index rallied 52.9% for the year, off of a 6.8% decline in 2013.

One of the biggest stories of the year was the upending of the global energy markets due to plunging oils prices. From a price of $107 in June to breaking the $50 per barrel mark in the early days of 2015, crude has been cut by more than half over the last six months. While no one has been able to pinpoint the exact reason for this dramatic decline, some of the potential factors affecting price are a simple increase in supply during a period of weaker demand growth and OPEC's attempt to defend market share against U.S. shale producers. Whatever the reason(s), the price of oil is likely to remain volatile and potentially well below its five-year average price of approximately $94/bbl. If true, what does this change in dynamic mean for the future?

The old adage that falling oil prices are like a tax cut, resulting in an automatic benefit to the economy and consumers, will likely be called into question. While we agree that consumer spending does benefit from a higher level of disposable income, the aggregate impact of lower oil prices is yet to be determined. One of the most important factors not broadly assessed is that recent domestic employment gains have occurred disproportionally as a result of growth domestic oil and gas production.

The chart below from the Federal Reserve Bank of Dallas displays the payroll employment index in the U.S. and each of the 12 Federal Reserve districts since the beginning of 2007. Interestingly, the chart shows a meaningful divergence in the rate of payroll growth among geographies. The two areas with the highest rates since 2006, Dallas (royal blue line) and Minneapolis (orange line), are direct beneficiaries of the domestic energy production boom. (The Texas connection is obvious, and the Minneapolis Fed district includes North Dakota and the Bakken oil fields.) Also noteworthy is the acceleration in the growth in the San Francisco district (turquoise line) since 2011 due to the rapid growth in social media/technology.



As important, it is estimated that about 30% of the total capital expenditures made by the companies in the S&P 500 are derived in some way from or related to the Energy sector. Recently, energy companies have begun to announce lower capital expenditures in 2015, with some budgets cut by up to 50% versus last year. This, too, will have a dampening effect on the economy, although we do not know to what degree. Businesses that benefit from lower oil prices, such as retail and restaurants, are not as capital intensive, meaning that it's unlikely that any increases in their expenditures will fully replace those being cut. Additionally, consumers may save and/or reduce debt with part of the energy windfall.

Despite the economic dislocations occurring due to the decline in energy prices, our expectation of a continuation of a "muddle through" economic environment remains in place. As we discussed, lower energy prices can have both positive and negative effects on growth in different geographies and among business sectors. So far, much of the emphasis has been on the positive impact of higher levels of discretionary spending for the consumer. However, we expect the topic of the impact of lower capital spending will soon come to the fore and potentially create some negative surprises in the short-term.

Yet, we expect 2015 will be another year of earnings growth as companies adjust to the commodity volatility. (The only sector likely to have negative earnings growth is Energy, which makes up only 8.4% of the S&P 500.) With higher earnings come higher stock prices. Price-earnings ratios have expanded during this six-year bull market as stock prices moved up faster than earnings. Going forward, investors should expect future returns to be influenced more by the level of earnings growth and dividend yields. Stocks should be able to move higher, over time, with an occasional healthy correction along the way.