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**Oil Prices are Driving the Markets – A Bottom is Likely in 2016**
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The global stock markets were moving forward quite well in 2015 until the major investment themes changed mid-year. Expectations of increased inflation and improving global growth shifted to concerns about commodity deflation, a stronger dollar and Fed tightening. European economies slowly improved over the course of the year due to ongoing European Central Bank stimulus. European stock markets were up 5%-10% in local currency terms but down 3%-4% on a dollar adjusted basis. The year-long threat of the Federal Reserve raising short-term interest rates caused the U.S. Dollar to strengthen against the Euro, Yen and Emerging Market currencies.

China entered a period of general economic malaise as it moved from internal infrastructure development to a more consumer-driven economy. As a result of China's transition the demand for raw materials (iron ore, copper, oil) has collapsed and a major recession in raw material producing countries has occurred. The price of oil fell from $105 in mid-2014 to $38 by the end of 2015. Emerging market stock markets were down 10%-25% this year. Even Canadian and Mexican stock markets, which declined 21% and 16% respectively, were impacted by China's economic decline and the oil price collapse.

Europe's persistent economic stagnation is becoming quite troubling. The Continent has made slow progress in solving its longstanding economic, political and social problems. The relative prosperity of Germany and Austria diverges vastly from that of southern Europe, so much so that it calls into question the European Union's viability. Indeed, there has been a surge of anti-immigrant parties not only in southern Europe but in the rest of the Continent as well. While none have crossed the threshold to power, many of the movements are gaining strength along with the idea that the benefits of membership in a united Europe are outweighed by the costs. There is a growing risk that either the European Union will have to be revised dramatically to survive or it will simply fragment.

Most European and Asian central banks are still in easing-policy modes and this is continuing to provide strength to the Dollar. In the Americas, where there are more synchronized monetary policies, it will only increase divergence in economic performance. It is not unreasonable to expect that some countries raise their interest rates to defend the weakness in their currency.

During the first half of 2015 the U.S. stock market continued the upward trend of 2014. However, with global growth slowing and the prospects of a September Federal Reserve tightening, markets reacted to disappointing sales and earnings growth. Stock markets swooned 10% during August and September but bounced back going into Thanksgiving. December was a choppy and generally negative month resulting in near unchanged stock prices for large cap stocks. U.S. portfolio performance was generally dependent on owning a handful of transformational stocks (Apple, Facebook, Amazon and Netflix). By year-end the majority of market sectors registered negative returns for the year.

Over two years, the performance difference between U.S. and foreign equity markets is approaching 25% on a currency-adjusted basis. The chart below shows the magnitude of this financial divergence between the U.S. and the Rest of the World. In 2014, the U.S. led the Rest of the World by 18% this was followed by a 7% relative increase in 2015.

**Exhibit 1 - <u>The Gap in Performance Between the U.S. and the World continued to widen in 2015.</u>**


## <u>Market Performance for 2015</u>

Most investment portfolios are composed of a blend of large-cap, small-cap and international equities and various maturities of fixed income. Typically, the performance of bonds and equities offset each other. But, in 2015, nothing worked. While small-cap stocks lagged their large-cap brethren, most commodity, energy and international investments provided negative returns (Table 1). Even though European and Japanese stock markets were up 5%-10% in local currency terms, they were down on a U.S. dollar basis due to the strong currency. In summary, outside of a few selective areas all of the other traditional investments found in a well-diversified portfolio were negative contributors to overall return. As a result, investors will be disappointed by their blended portfolio performance as few market sectors achieved the performance of U.S. large-cap stocks and government bonds.

**Table 1. Financial Market Returns for 2015**

| **<u>Stock Market Indexes</u>** | | **<u>Bond Market Indexes</u>** | |
|---|---|---|---|
| Dow Jones Industrial Index | 0.2% | Lipper "A" bond funds | (1.3%) |
| S&P 500 Composite | 1.4% | Lipper "BBB" bond funds | (1.8%) |
| Russell 2000 Small Cap Idx | (4.2%) | Lipper High Yield bond funds | (4.8%) |
| Lipper Global REIT | (0.2%) | Foreign bond funds | (5.6%) |
| Lipper Intl Large Cap | (3.2%) | Emerging Markets | (14.5%) |
| Oil index | (39.0%) | | |

## The Oil Price Decline is Driving the Market

The collapse in oil prices has decimated U.S. and foreign energy stock and bond prices with many U.S. energy stocks down 40% to 60% and some bonds off 20%-30% and at risk of possible default. Many U.S. shale producers are unable to make a profit at current price levels. High yield bond funds and even investment grade bond funds have suffered losses from distress in the energy sector.

The panic in oil prices is man-made: if the Saudis or OPEC decide to cut production by $2MM barrels tomorrow, oil would be back to $50 in a heartbeat. In reviewing past energy collapses, when the market finds a bottom it typically rebounds one-third to one-half of the prior decline. From today's price levels, this would bring the target range to $50-$60 a barrel. Once a bottom is found, energy stocks and bonds should rebound nicely. But first the market needs to find a bottom.

From an investing standpoint it is clear that there will be a great opportunity to purchase energy and emerging market stocks at fire-sale prices. These new investments may take time to grow but will generate future returns for the portfolio.

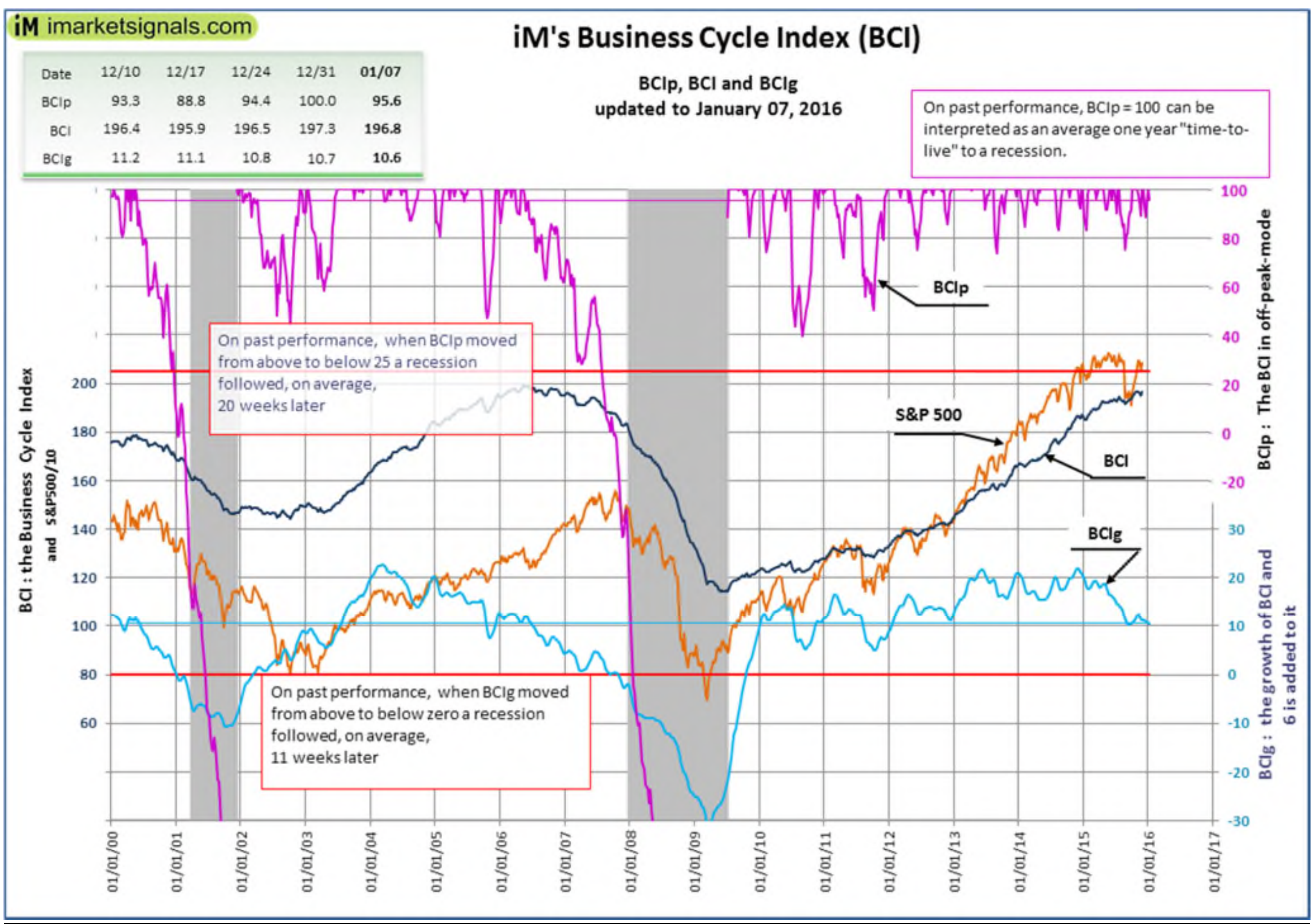
**Exhibit 2 - By the end of 2016 Oil Prices Could Rebound to the $50-$60 range.**

## Prospects for the U.S. Economy

The leading indicators suggest the U.S. economy is on track and there is no sign of inflation. In addition, U.S. economic indicators such as employment, business confidence, retail sales and auto sales remain robust. During the last two years the economy slowed in the first quarter due to unusually cold weather. The reverse of this situation could occur in 4Q 2015 and 1Q 2016 as warm weather has allowed construction and other outdoor forms of economic activity to proceed at a quicker pace. This was reflected in the December Unemployment report which indicated that 292,000 new jobs were created and upward revisions were made to both October and November reports. October's figure changed from 298,000 to 307,000 and November's increased from 211,000 to 252,000. Among the industries with the most new jobs were construction (+45k), health care (+39k) and food service (+37k). I do not believe investors should worry about a U.S. recession at the present time.

The chart in Exhibit 3 is a forward-looking business cycle composite. It shows that the U.S. economy remains on track. This index correctly predicted the last two recessions with an average lead of 5 months. It currently shows that the economy is fine and the recommendation would be to hold equities.

## Exhibit 3 – My Best Indicator of the Business Cycle Says Not to Worry



## There is no Inflation!

Investor expectations of reduced inflation expectations is solidly in place. Brent crude has declined over 65% in 18 months from approximately $105 per barrel to below $38! It could very well bottom in the $30's. The Saudis' efforts to drive out higher-cost producers in the U.S., Europe and elsewhere will likely result in a bounce in energy-related unemployment and deferral of capital spending on energy infrastructure in the U.S. and many countries around the world. Over time there will be a positive effect on consumer income from a decline in energy costs, but this will take time. The combined drop in oil and commodity prices should just about extinguish any expectation of global inflation for the foreseeable future. In my opinion, it is unlikely that the Federal Reserve will raise short-term interest rates as projected without a true threat of future inflation.

As a result of lower inflation expectations, global long-term interest rates have dropped precipitously since mid-2014 (Table 2). European interest rates have declined dramatically, the German 10-year bund rate is now at 0.54%, clearly pricing in little or no inflation. With European rates so low and the dollar rallying, there is a compelling reason for foreign investors to buy U.S. bonds and stocks. In spite of the recent Fed tightening, intermediate maturity U.S. bonds are still attractive. Lower long-term interest rates helped several income-generating sectors of the stock market outperform: including utilities, REITs and consumer durables. While the decline in U.S. interest rates was clearly originated overseas, the concept of deflation has now taken hold in the U.S. as well.

**Table 2. 10-year Government Bond Interest Rates Have Declined Globally**

| | June 30, 2014 | Jan 7, 2015 | Jan 11, 2016 |
|---|---|---|---|
| U.S. 10 yr. | 2.53% | 1.98% | 2.16% |
| German 10 yr. | 1.24% | 0.49% | 0.54% |
| Italian 10 yr. | 2.73% | 1.91% | 1.56% |
| U.K. 10 yr. | 2.67% | 1.62% | 1.78% |
| Japan 10 yr. | 0.59% | 0.30% | 0.23% |

## The Federal Reserve and Future Rate Hikes

On December 16$^{th}$ the Federal Reserve raised its benchmark overnight rate from 0% to 0.25%. The initial reaction was a small jump in rates, but they have since settled back to where they were before the Fed rate hike. The Fed also indicated the path forward will be gradual with the median expectation among FOMC participants remaining at four rate increases in 2016. However, in recent years the Fed's rate expectation has been consistently wrong and too hawkish. So just because they call for four rate increases in 2016 it doesn't mean that they will actually happen. I am sticking with my forecast for one rate hike possible in March and a 50% chance for a second hike later in the year.

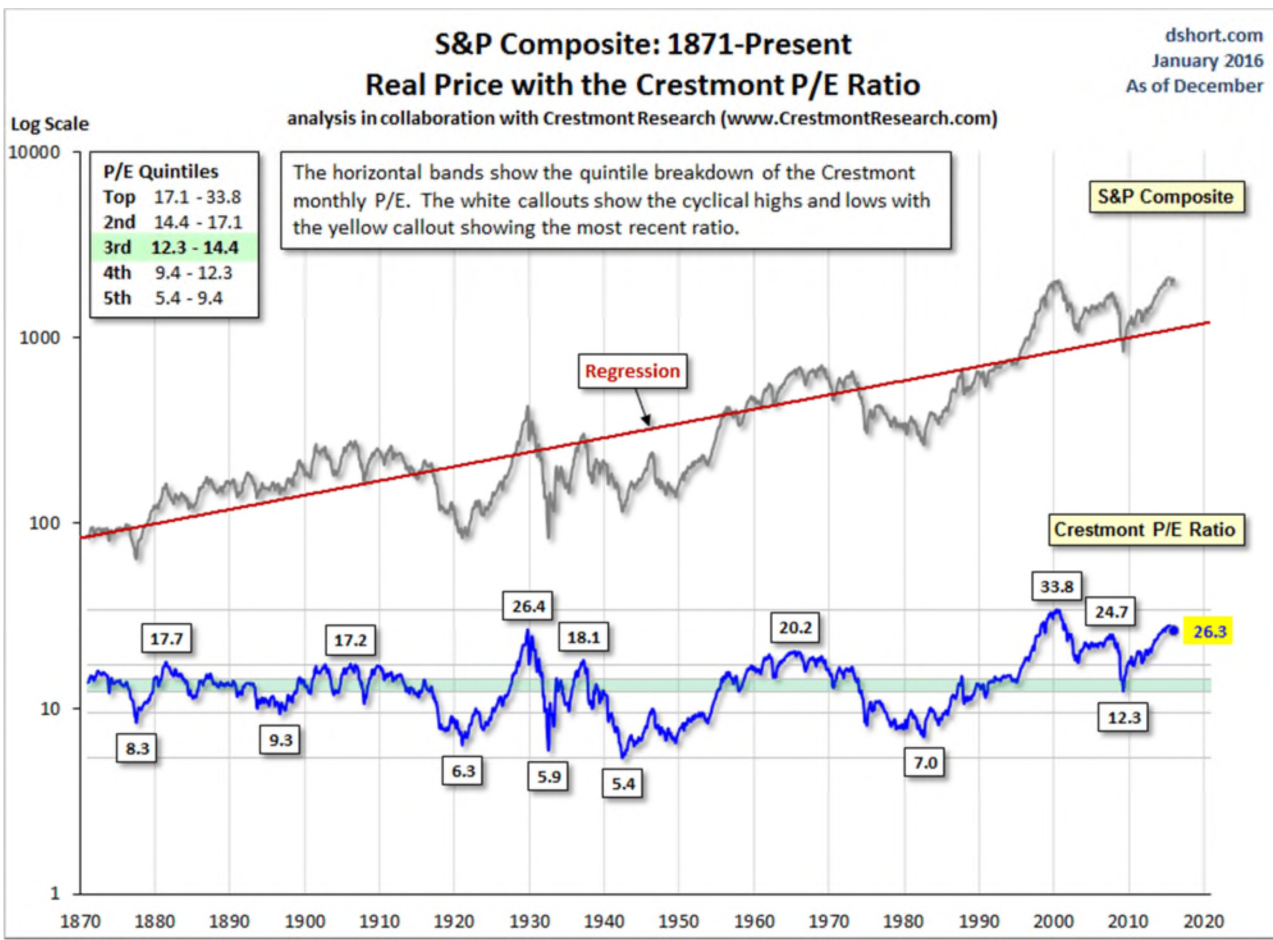
The Fed claims it will remain data dependent and in very broad terms this is likely true. But a central bank is by nature focused mainly on the economic outlook, except in times when it is trying to reign in high inflation which is not the current environment. To the extent that the Fed really is data dependent, the biggest concerns are global growth, potential inflation and deteriorating credit quality in the fixed income markets.

## Market Valuation

In spite of a strong economy and low interest rates, the U.S. stock market could compress through price/earnings multiple contraction. Over the last 6 years, the stock market has exceeded expectations as it rose on the premise of strong future growth and cheap money from the Federal Reserve. This theme has been struggling since last summer as companies have found it difficult to grow top line revenues in a low-inflation world; cost cutting and more labor efficiency is the mantra of the day now. While there has been little real effect from the Federal Reserve ending its Quantitative Easing program in 2014 and raising rates slightly in late 2015, the psychological change in the outlook for an endless supply of free money could cast a pall over the markets.

With a Crestmont Price/Earnings (P/E) ratio of 26.3 stock market valuations are stretched when compared to the historical median (Exhibit 4). The market's P/E has only been at higher levels during the technology bubble in 2000 and pre-depression euphoria of 1929. Currently the P/E ratios for Europe and Japan are in the 16-18 range and Emerging Market indexes are even lower at 10-11 times. Logic would suggest shifting investments from the U.S. into the less expensive European and Emerging Markets, but recent performance has made this choice very unappealing.

**Exhibit 4 – The Stock Market is at Near Record P/E Multiples**



## Stock Market Prospects for 2016

In listening to the many dire predictions for the stock market that have been floated over the last few weeks, I take comfort in the resilience of the U.S. economy and the opinion that interest rates will clearly remain low. The Oil and Commodity crash is reaching depression price levels. This is the first time in two years that interesting buying opportunities are developing.

## Key Points to Consider

- Although equities are no longer a bargain, they offer better value than other financial assets and should outperform cash and bonds. It's the T.I.N.A. principal—there is no alternative. CD rates are still well under 1%.

- At some point, energy and emerging market shares will become the best buy of the year. The key is when.

- In the short term, strong seasonal equity buying patterns should continue through mid-May.

- Without inflation, I doubt that the Fed will start any meaningful tightening process. The U.S. yield curve should continue to flatten as long-term rates trend lower and shorter-dated Treasuries face continued bearish headwinds.

- The U.S. Dollar is likely to trend higher over time. I believe the Euro could fall below parity in 2016.

- Even if lacking significant economic growth, the profitability of European companies should benefit from a weaker Euro and declining energy and commodity prices. European stocks appear inexpensive when compared to their U.S. brethren.

- The rise of anti-immigration and nationalist protests in Europe, particularly against those from Muslim countries, is becoming a major political concern which has spread to the U.S. and elsewhere. I would not be surprised to hear about more Islamic terrorist activities globally. This may be good for the price of gold and military stocks.

- There is no doubt that the wide range of global "problems" makes us very nervous from time to time. But these problems will just keep central bank liquidity plentiful and financial assets on a strong footing. Europe, Japan and possibly China may pump more central bank funds into their economies in 2016.

I expect the bull market in equities to continue to be driven by U.S. economic growth, foreign central bank liquidity, pre-election gridlock, strong seasonal buying patterns and improving investor sentiment. The intermediate theme of the market should turn from deflation to growth as investor confidence improves. Our portfolios are invested in equities and bonds up to your target asset allocation.

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