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A TIME OF PROSPERITY

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CHANGING PLACES

In October of 1973, the oil sheiks of Saudi Arabia-led OPEC (Organization of Petroleum Exporting Nations) launched a global oil embargo. By the end of 1974, the price of a barrel of crude oil rose from $3 to $12 – a quadrupling. This first oil price shock contributed to a serious U.S. recession as consumers had to allocate substantial amounts of resources to cope with higher energy prices. By March of 1974 the embargo was lifted but oil prices remained substantially higher. After a mid-decade recovery, there was another energy crisis fomented by OPEC and oil prices rose above $80 a barrel and the U.S. once again fell into recession in the early 1980s. Not until mid-2014, over forty years later, did OPEC lose its ability to control oil prices as a worldwide glut powered by the discovery and implementation of a process known as "fracking" in the U.S. drove oil prices substantially lower.

During those forty years the Arab states, Russia, Venezuela and selected African nations that produced oil became wealthy as industrialized nations had little choice but to pay a higher price for oil. Periodically there was some price competition on a global scale but, by and large, OPEC maintained a monopoly over oil pricing and created a new Arab world order that concentrated wealth in the Middle East.

Since June of 2014, oil prices have been sliding continuously from a high of $112 a barrel to under $50 per barrel, a decline that has never occurred during good economic times. In addition to a huge surge in supply in the U.S., countries such as Iraq and Libya have dramatically increased oil output by hundreds of thousands of barrels a day so that global supply is growing rapidly while demand in the U.S. is weak due to years of innovation and substitution. The rapid decline in oil prices may penalize domestic oil output but this phenomenon will not last forever. In the meantime, there is an enormous shift of wealth back to the American consumer. Since oil is such an important factor in many types of commerce, the dramatic fall in price will translate into lower prices of goods and services as lower energy prices work their way through the cost structure.

This shift in wealth from energy producer to energy consumer, to the extent it is not short-term, will play out as the Dan Aykroyd/Eddie Murphy comedy, "Trading Places" where a diabolical plot forced a wealthy man to trade places with a street beggar. In the movie, the world of each man was turned upside down, and, at first, each one found it difficult to function normally. However, over time, both men managed to benefit from the change.

We are in the early economic stages of such a shift from the oil producer to the oil consumer. This move will favor the consumer even though producers will suffer. The net economic effect will be positive as the consumer accounts for ~68% of the economy while the energy sector and related capital expenditures account for less than 10%.

KING DOLLAR

Global economic turbulence has been accelerated by the surprising strength of the dollar. As the U.S. economy is growing faster than both Europe and Asia, the dollar is strengthening against the Euro and the Yen and is currently trading at an 11-year high. A stronger dollar benefits importers, and thus consumers, while it penalizes companies that export and accept payment in foreign currencies or translate their foreign earnings into dollars. The strong dollar also benefits oil exporters who price their oil in dollars. The biggest beneficiary in terms of these two variables is China where the country's reserves (that are in the trillions of dollars) are rising in value while their cost of imported oil is falling. American travelers abroad will also get a bonus when transacting in local currencies. There may be some bargains for Americans when considering the purchase of foreign produced cars. On the other side of this equation are countries such as Russia that produce oil but also have to pay interest on dollar denominated loans that fund oil production.

Another factor driving the dollar higher is the demand for the currency by foreigners who want to be invested in government securities issued by a country with strong fundamentals. Yields on U.S. government securities are near record lows but in other respected developed economies yields are much lower thus resulting in increased demand for U.S. securities.

The combination of lower oil prices, a strong dollar and the resulting low inflation rate for the foreseeable future is ringing in a time of prosperity.

RISING INTEREST RATES

Even though the Fed has opted for an "easy" monetary policy by keeping interest rates low, there has been no explosion in inflation as many market pundits feared during the financial crash. The collapse in oil prices is a continuing contributor to much lower inflation for the foreseeable future. Low inflation reduces the risks of lost real incomes and lower economic output that accompanies high inflation. Low inflation is an important ingredient in the performance of common stocks as the price of a stock can be discounted by the rate of inflation. In other words, low inflation increases the future value of corporate earnings. In a low inflation environment, stocks can have a greater value than when inflation is high.

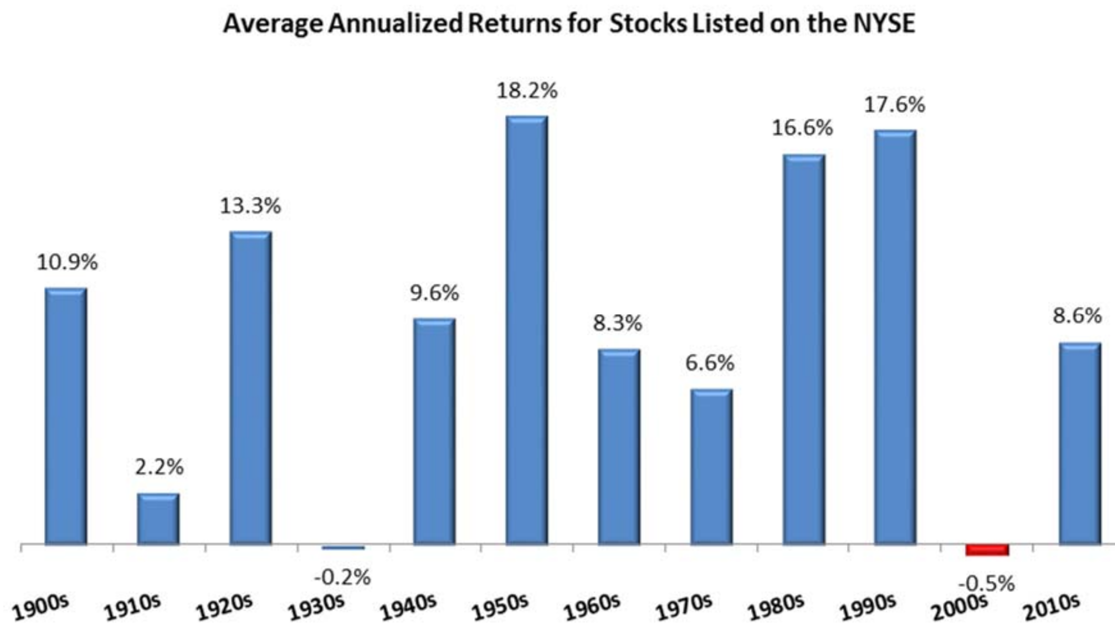
The Federal Reserve has two mandates from Congress: (1) to control inflation, and (2) to foster full employment. In addition, the Fed acts as a safety net under the economy as witnessed in the 2008-09 financial market meltdown when it purchased sub-prime loan pools to stave off economic collapse.

Stock market observers are concerned about a shift in monetary policy toward higher short-term interest rates. Such a move may not be a thorn in the side of the current secular bull market because rising interest rates shift wealth from borrower to saver. Since there are millions of savers, especially individuals in retirement who want "riskless" investments, rising interest rates on CDs or money market funds will fuel increased spending and improve standards of living—thus creating more prosperity. Don't be surprised to see higher economic growth even though interest rates are rising.

A LONG TERM PERSPECTIVE

There is critical significance to this shift from producer to consumer. In the 1970s, the power of the producer versus the consumer had a negative impact on the economy and financial markets for the next 40 years! When the industrial revolution in the Twenties improved our living standards, the economy boomed and prices of goods and services fell, not because of weakness in demand but because of a surge in supply. The technological innovation in the Eighties and Nineties gave us another period of economic prosperity and falling inflation that continues today.

The downside related to periods when there are enormous economic gains is the lull that occurs afterwards. The history of the stock market provides a glimpse of economic progress during these types of periods. The chart below shows annualized stock market returns through the end of 2014 including five years through the "Teens." The stock market fell in only two out of the eleven decades depicted in the chart. Since the 2000s and the 1930s share the same negative characteristic, it is interesting to note that, following the 1930s, the stock market rose, on average 9.6% per year in the Forties and 18.2% per year in the Fifties. So far in the Teens, the gain has been 8.6%. For long-term investors, these data provide a powerful case that the broad stock market is likely to continue to provide rates of return that are near or at an historical return in the vicinity of 9% per year.



We can look at the history of stock prices in general and come up with an estimate of future returns based on history but such an exercise doesn't work for the bond market. The best estimator of future interest rates and future returns for bonds is the current interest rate. Many investment professionals point to historic returns of bonds as some type of benchmark to use for making bond investments. Such exercises are flawed especially when historical returns are well above the current rate of return. For example, the current yield on the ten-year government bond is about 2%. Therefore, over the next ten years that bond will provide about a 2% return unless the interest payment is invested in a higher yielding investment. While investors are penalized by low rates, borrowers continue to benefit enormously in this record low interest rate environment. Historically such low rates have only existed during times of economic hardship. Today's

environment combines low interest rates with accelerating economic growth. Another indication of prosperity is that interest rates are likely to remain unusually low for some period of time. When compared to the history of the broad stock market, equity investments today offer an unusually large premium over bond investments.

Since the lows in March of 2009, the stock market is up approximately 245% and earnings have tripled over that time period leaving some room for further appreciation in prices. During the cycle from 2009 to 2014, earnings growth has been about 20% above the average level of growth cycles since 1957. Profits, referred to as the "mother's milk of stocks" by Larry Kudlow, stand at a record-high share of GDP and are likely to keep growing by 5-10% or more given our current time of prosperity.

CONCLUSIONS

We are in a long-term secular bull market that will be characterized as a time of prosperity but will experience volatility related to the shift in energy and the strength of the U.S. dollar. Today, investors have the wind at their back for several reasons: the U.S. economy is strengthening, approaching a sustainable rate of growth in the 3-4% range; consumers are benefitting from falling oil prices and a strong dollar; low interest rates and low inflation will keep the economy on a positive track; the political structure in Washington may lean toward promoting private enterprise and reducing government regulation; the political cycle favors another strong year for stocks and corporate profits have never been higher and the trend is likely to continue as the economy strengthens and interest costs remain low. However, the strong dollar may penalize companies whose earnings come from Europe or Japan and lower oil prices will penalize oil producers and related energy-support companies. As a result, stocks could experience short-term shocks emanating from the energy sector. We expect another positive year for the stock market with returns in the 8-10% range while corporate bond yields are likely to remain in the 3-4% range. Foreign markets will remain volatile and subject to the impact of lower oil prices and a strong dollar. As usual, there will be divergent returns among foreign markets subject to individual country dynamics and geopolitical events will gather headlines from time to time only to be shortly forgotten.

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