Palmetto Wealth Management

Are we there yet??

John Gustafson – 3 January 2016

After finishing off the first negative year in the stock market since 2008, we reflect in reality that the broad averages masked quite a bit of the specific pain seen in certain sectors: energy, biotech and anything relating to China or Emerging markets, just to name a few.

Much of this began, as outlined in previous missives, with “our friends” in the House of Saud using their "oil hammer” to punish their enemies, the Iranians. The fact that it also hurt producers across the oceans in the United States was an added bonus. Even much-loved Apple suffered a year where its shares ended down, also for the first time since ’08. Basically, everything that had been working and making folks money came to an ugly and abrupt end in 2015.

China continues to struggle as their economy matures and growth slows. Again, I feel that their move toward more transparency and honesty in their numbers is also somewhat to blame. For years, most of their business figures were pure fantasy, but because everyone knew they really were growing like wildfire it was overlooked. Now, they want to become a more accepted, developed economy in the world and realize that their standards need to improve – that coupled with a “slowing” economy (still growing at multiples of the U.S.) is scaring the pants off folks and it is roiling the global economy as well.

And of course, our old friend politics… In last quarter’s note the Republican clown car was still running at full capacity and there was no clear leader. We've had a few drop out, several big developments (at least on the Republican side) as they march toward the inevitable showdown with Hillary. More on that later…

As far as the oil market is concerned, until the Saudi's reach the point of not being able to handle anymore financial pain, not much is likely to change. However, the massive downside volatility does appear to be behind us, especially in the face of growing conflict amongst the Muslim leaders in Iran (Shia) & Saudi Arabia (Wahabbi / Suuni).

In terms of how much more financial pain Saudi Arabia can handle, their recently unveiled budget may give some clues as it outlined the first significant deficit they have planned for in over a decade. And remember, the "royal family" is allowed to remain in their seats, despite their harsh and oppressive rule, is simply because of their massive welfare (bribery) system that is funded by all that oil income.

In terms of the US oil industry, the last time we had oil this cheap there were some bankruptcies from the smaller, higher cost producers that will likely be seen in this downturn as well. However, the larger companies tend to use these times to take market share and come out the other side of the valley stronger. Same thing with a lot of the stronger pipeline companies, who may cut dividends (as we've seen a few do so far) but as long as they don't actually own and hold the commodity, they can be much more flexible and their cash flow is much less likely to suffer longer term. Remember, this is a supply driven glut not a dramatic drop in demand from a recession or other shock to the economy as we saw in 2008.

Also as a sign of bottoming, our old friends at Goldman Sachs have called for oil to fall another almost 50% - into the low $20's. These are the same folks who said that oil was going to $150 and never looking back a few years ago once it reached $110. They were "talking their book" a bit back then and I suspect they may be doing the same at this point.

Fundamentally speaking, when oil was over hundred dollars a barrel, much of that had to do with the fact that oil is priced internationally in U.S. dollars - after the 2008 financial crisis, the dollar was incredibly weak and we were in a recession. In fact, if you recall, the Russians and many in Europe we're discussing the possibility of pricing the international trading of oil in several other currencies. Smash cut to Greece on the verge of failure, with Spain, Portugal and Italy all following same path and that talk was quickly scuttled. Developments that served to drive the dollar to record levels against most currencies currently as our economy has gotten back on its feet.

That is also something I think that may help drive the Saudi's to blink sooner rather than later. They can live with running an economic deficit for awhile in terms of operation, because they have good credit and not a lot of debt. However, their currency is a different story… The Saudi Riyal is artificially pegged to the dollar and requires massive amounts of manipulation by their finance system when the dollar is this strong. Not a problem when oil is close to twice the current price, but becomes crushing at current levels.

They are also spending massive amounts of money trying to fund what is supposed to look like an anti-terror coalition but it appears more and more like a military operation designed to further fight the Shia's of Iran, Yemen and several other areas in the Middle East. Conflicts where the new Saudi regime has chosen to really ramp up the aggression via several high profile executions the most recent making headlines involves a very popular and significant Iranian cleric. Stay tuned…

Back here in the US no matter what the presidential candidates may tell you, we are not in recession - and Janet Yellen and the Fed Governors are not crazy for beginning to raise rates. Just as disastrously low oil prices are truly only a disaster for those in the oil business, allowing the rest of us to enjoy a massive tax break, finally being able to pay people to save money in traditional bank accounts and money markets, and also reload the Fed's ability to react to negative economic situations will be a positive in the intermediate and longer-term. It may be painful in the short term in the bond markets but we have lived through that before. The current talk about how the Fed needs to be concerned with other global economies is almost silly. When they were instituting their massive cuts to our current near zero rates, many Central Bankers in the rest of the globe didn't move nearly as aggressively, because they are/were concerned with their home economies, as our Central Bank should be as well.

The reality is that the Fed would never have taken the first step at the last meeting if they were not almost 100% certain that they would not have to take it back. Making a move like that after nearly 4 years of nearly 0%, only to reverse course a few months down the road would look like a complete failure. I don't think that multiple rate increases will be coming fast and furious in 2016 either – the Fed NEVER wants to appear political if it all possible. They were simply giving a vote of confidence to our economic recovery and reloading their gun for future use.

I'm not being contrarian just for the sake of being a contrarian on these issues either. The one thing that has changed over the past several years in the markets is the speed at which things move to extremes. There is so much money being run by machines that don't think, they simply "do" once whatever programmed trigger is hit. It really ramps up this crazy volatility we've seen spike recently – both to the upside and down.

On the political front, not much is changed on the boring Democratic side. Bernie and Hillary continue to somewhat politely duke it out over who is more likely to give away the most free stuff to their base, while everybody else thinks "Who's that O'Malley guy anyway?" It doesn't appear the early primaries will make much of a change toward the likelihood of Hillary garnering the final nomination either, unless Bernie absolutely destroys her in New Hampshire and picks up new momentum.

The GOP side has morphed into The Donald, and everybody else… The only one still within hailing distance is Ted Cruz, and he clearly appears to be auditioning to be the VP nominee on a trump ticket. The rest of the field other than Marco Rubio and Dr. Ben Carson should probably just pack it in. In reality, all we have witnessed is the preamble with no actual votes cast, so I suppose we can all give them their shot for a few more weeks and see what happens once real voting occurs.

As these notes are allegedly about investing and not strictly politics let's discuss what each one might bring to the economic table. Once again, the Democrats are basically in the same boat and appear to be Obama 2.0. A few tweaks here and there, but the message will remain the same. If that should occur, it seems likely that the Republicans will be able to hang on in the Senate and keep the House, continuing the path of aggressive verbal conflict, diametrically opposed ideologies and in all reality getting little or nothing accomplished. That's not a terrible outcome per se, as most companies have learned to operate in that exact environment over the past several years. It also likely means than any tax problems found in the Affordable Care Act will also be unlikely to be remedied, which will be a significant drag on the economy as premiums continue to jump almost exponentially each year.

Donald Trump… whether you like him or hate him (and let’s face it, nobody is right down the middle on him) the two attractive characteristics that he brings to the race is the fact that if you ask him a question, he gives you an honest answer. It could very well be an answer that you don't like, but it's his belief and not a memorized and rehearsed talking point. Every single other candidate in the race is a politician first and an honest answerer second. That is what caused the Rick Perry debacle during the debates in the last election cycle. He couldn't remember two of his three disappointments because they weren't truly his beliefs, they were merely words written on his election script and he forgot his lines.

The next thing Trump brings the table, which is actually my favorite characteristic, is the fact that he does not have the Koch brothers, George Soros, Sheldon Adelson, or any other mysterious billionaire with a personal agenda throwing money at them and pulling the puppet strings. Something that every single other candidate has in their corner - the biggest flaw in our political system. (IMHO) Also unlike every other candidate, Trump is/has seemingly harmed his earning ability by jumping into this race. All the rest of them (Bill & Hillary Clinton as exhibit “A”) have become or are planning to become incredibly rich after marching through this meat grinder of a process.

From an investment standpoint, the tax plan that seems best for the economy and for businesses is the Cruz flat tax plan. It's palatable for the populists because those at lower levels of income will not be taxed at all – even on the payroll side - which is a huge break for small businesses. Everyone else will pay basically the same rate with very limited deductions.

The Trump plan is more similar, as far as I can tell, to where we stand now - though it would lower rates at lower levels and slightly increase rates at the higher income levels. Either plan appears to be far less complex than our current system and could be truly stimulative if the numbers actually add up. (The devil is in the details as they say…) From a personal standpoint, regardless of what anyone says, I'm all in favor for trying either plan because almost anything is better in the disastrous tax code that we have currently.

One final note on the political front… If Americans truly want a discussion of the issues that face our citizens and our economy during this election cycle, then the two we should all be rooting for are Clinton and Trump. The horrible way our campaigns run currently, that everybody purports to hate is negative campaigning - yet it’s been proven over and over again to be successful It's how President Obama beat Hillary in ‘08 in the primaries, it is how John McCain got finally pushed aside, to Michael Dukakis riding around in a tank. There are no “gotcha!” ads that would score any points against Tromp or Clinton. No two candidates have had more of their dirty laundry aired in the public spotlight for multiple decades than the two of them. There is simply nothing that we don't know about either of these folks.

That means, Trump can be as snarky as he wants on the campaign trail and Hillary can play the victim card as often as she would like, but in reality when the hot lights of the debate stage for the actual presidential campaign come on, there should be a true discussion of taxes, terrorism, healthcare, social services, etc. It will certainly be an interesting year and as ugly as the system to get at times I don't know a better way to do it.

2015 was a year, for the first time in a long time, where asset allocation simply didn't help. Bonds didn't protect you, companies of all sizes had a rough and volatile year, and most areas outside of the US also had troubles. However, one year does not disprove a theory that has held for years and years - after all, regression to the mean works both ways.

The Fed, China, the junk bond market, oil and continued Middle Eastern strife are certainly front and center on our market radar heading into 2016 – layered over the background of American politics. It’s going to be exciting for sure…

Thank you for your trust, friendship, and business. Please call or email if there is anything specific you would like to discuss.

Cheers!