Palmetto Wealth Management

"fine!"

John M. Gustafson – 31 December 2014

2014 came to an end with more of a whimper than a bang, with a little profit taking / tax positioning to put a bow on a pretty good year. For what felt like the 10th time, but was really more like the third or fourth, markets rallied off a short-term bottom – this time caused by the energy sector. It's amazing that with all the negativity still out there in the media and in public, ("the malaise") corporations continue to build on their belt-tightening from 2008 and reap the rewards of ever-growing profits. I can't recall a time of more negative sentiment having more positive results. Quite unique…

Unemployment has continued to improve – much to the chagrin of the right side of the aisle - interest rates remain low, and generally things have worked the way we would hope – though not the way many "pros" have expected or discussed openly for months. The biggest negative that was constantly thrown up in everyone's faces was a pending Fed implosion caused by the end of QE and their inability to extricate themselves from such a massive undertaking. So far, they have done an admirable job. The policy of more open and transparent communication instituted under Chairman Bernanke appears to be helping as well. It's difficult to be a rumor-mongering speculator "talking your book" on TV when they simply come out and tell everyone what they're up to and why. You may not agree with it, and many clearly think they are foolhardy, but there is no mystery.

A recurring theme in these notes over the past few years, in the face of continued negativity, has been that sometimes things simply work out as planned. It has been incredible how the markets continue to rise, though not lifting all ships, but I still believe we are far from a bubble situation in most sectors and surely the US market overall. It is a bit of a fallacy of the market averages, they can be quite skewed at times by strong (or also very weak) performances from a minority of their members.

There has clearly been enough turmoil off-and-on this year to keep the bears from completely throwing in the towel and walking away. The ursine also still seem to control much of the cautious themes continuously broadcast and written regarding the global markets. The hunt for the next "house on fire," rather than the next opportunity, continues daily.

Having been a fairly positive voice for a couple of years now, even I've been surprised at how resilient the equity markets have been and how relatively tame the bond markets have remained. Things will continue to be on a knife's edge, in my opinion, through the early months of 2015 as a few current events are digested.

As mentioned, the bears have not given up and any little hiccup in the news (Ebola, ISIS, oil prices, and our old favorite, politics) can be exploited for short but scary drops. The old market saw, “Bulls take the stairs but bears take the elevator,” has been quite evident at several points this year. However, the fallacy of market timing was once again proven true.

I’m certainly not saying that it’s impossible to get out of the way of a pending market drop – or avoiding the extension of one you witnessed begin. (i.e. Ebola) The problem comes when you miss out on a great deal of the positive return after the recovery, once the non-economic panic subsides. I know, I know… I’m assuming there will be a recovery – but as the Sage of UBS, Art Cashin has said numerous times, “Be careful betting on the end of the world, it only happens once.”

Alas, as much as folks hate to admit it, our long-term trends are still bullish economically and the general public, with trillions on the sidelines, have really still not bought in en masse. Remember, the objective for most investors should be to make a reasonable return that compounds over time. That strategy does require you to actually play offense at some point.

The recent elections have also made things slightly more positive in my opinion… No, not because the GOP controls both houses of Congress – simply because neither side of the aisle has any place to hide at this point. They will all finally be forced to put-up or shut-up. The divided government of the past few years easily allowed either side to point the finger across the aisle when nothing happened. Now, the GOP has no excuse not to pass whatever their little hearts’ desire and force the President to either fall in line or take a stand with his veto pen. Either way, we should get palatable corrections in things like healthcare that most reasonable folks will agree to, and the extremist nonsense of both sides will likely be impossible to pass into law. A good scenario in which to continue our overall, slow economic improvement…

Time for a little truth corollary: the government does *not* “create jobs” – period. Businesses create jobs, and the government can either make it impossible for them or merely difficult. Hopefully this actual two-party system will take the latter path.

Here at PWM, it has always been the philosophy that the emotions of the market in the short term do a very good job of masking the reality found in the background. Both in 1999 and 2007 market participants were very optimistic in the face of glaring fundamental deterioration and wild overvaluations in specific sectors. For the past couple of years the general consensus has been a negative one, even in the face of constantly improving employment, corporate earnings, low interest rates and a government who has basically done nothing but posture and blame. It’s hard to call it a bubble when nobody’s interested in participating. We’re still in an environment where bulls are shouted down and the predominant market story and headline is some variation of “What could go wrong now???”

Of course 2014 has had plenty of volatility, most of which has been completely exacerbated and inflamed by that ridiculous thievery known as high-frequency trading (HFT), and many of the short-term causes (other than energy) have been completely non-economic.

Let's talk about oil for a minute… If you are in the energy business right now, other than the transport and/or storage of petroleum, distillates, natural gas, etc. 2015 is definitely going to be a challenge. If you are a general consumer, or in almost any other business, you have already begun to feel the enormous tax break of a 50% drop in oil and gasoline.

I don't believe for a second that this is all strictly economic supply and demand – a fact stated in one of these notes either at the end of Q2 or Q3 – this is our "good friends" the Saudis unhappy that America has finally become a producer of significance for our own consumption. Perhaps even more important than that, I've read several articles lately regarding the Saudis using their "oil hammer" to punish the hated Iranians as well as their Russian supporters, lest they become strong competitors. This is another one of those situations that bears watching closely, as world-politics once again intrudes upon business and economics, but the bottom line is cheap gas is a positive for America.

What else is in store for 2015? A close eye on Europe, specifically their ongoing problem children in Greece, will be necessary. We don't appear to be in a "contagion" situation as we were a few years ago, but it is certainly a negative that can spread quickly. This may cause us to alter our allocations slightly, as happened the last time, if things deteriorate quickly.

Some good news is that January is traditionally positive simply because of cash flows… Even folks who hold their cash conservatively on the sidelines in their normal investment accounts thankfully don't turn off their contributions to retirement plans. All those who hit the upper limit in the prior year are once again eligible as well, causing a pretty significant blip in inflows to mutual funds early in the year. We may (finally) be in a position where the good returns in properly allocated retirement portfolios over the past few years inspires confidence for the retail investing public – there have been rumblings in that direction of late. Certainly something we will be watching here...

The specter of terrorism and social unrest is always hanging over us these days. Although, I'm not so sure it's that different from the nuclear Sword of Damocles that was held over all of us for decades. (Though nobody in "Gen-Y" or the ever popular "Millennials" has any idea what "duck and cover" means – or immediately hears the Frank Capra song in their heads simply by hearing those words.) The big difference today is that the media needs to fill 24 hours of content 365 days per year, so every threat turns into an imminent danger – thus magnifying emotion and volatility.

To summarize… I believe that the Bull is healthy, especially after the energy sector selloff from quite elevated levels at the end of the year, reining in expectations once again. If the public jumps on board, the rise to new heights could be strong.

Keeping an eye on the usual non-economic suspects as outlined above, the increased volatility we've been seeing will likely continue, testing confidence in overall allocations and strategic choices. Also look for a shift in the pattern of risk-taking. Cheap energy is certainly good for our economy overall, but that particular sector being a large driver of market performance as it has over the last few years, is certainly not very likely. New leadership needs to emerge for the next leg higher.

And unfortunately, I'm afraid our old friends in DC have a good chance to drive sentiment in either direction once again. In the near term, as the new session begins next week, the tone of aggression or reconciliation will likely be evident quickly and will have a good chance to affect quite a bit discussed in this note. Stay tuned…

Finally, thank you to all of you who've been around for years, your trust and confidence (and friendship) is what makes this job so enjoyable. To the new folks who've recently joined, thank you as well and I hope we will have many great years together.

Cheers!