Palmetto Wealth Management

"Miles from Nowhere"

John M. Gustafson – 8 April 2015

Miles from nowhere,
I guess I'll take my time.
Oh yeah, to reach there.

Look up at the mountain,
I have to climb.
Oh yeah, to reach there.

As the great Cat Stevens, nee Yousuf Islam once crooned, a very exciting first quarter slumped to the finish almost flat from where the year began – leaving us miles from nowhere, with a mountain left to climb for 2015. Through all the noise, there has also been little in terms of thematic change: Oil is still struggling, which is been keeping our portfolios in check unfortunately, and the economy remains soft enough to keep the Fed on hold, likely for a couple more quarters. Although, to be controversial right out of the gate, I think a Fed rate increase will actually be seen as a positive by most. Don't get me wrong, the initial reaction will be a violent snap lower – as it always is – but once people realize that what a small rate increase really means is a vote of confidence in the economy by the Federal Reserve. At that point, I think things will fly a bit once again.

Compare those thoughts to the unending theme continuing in the media of nothing but negativity. Personally, I think that's healthier in the long run - things do tend to work out in the long run, as long as you survive the trip - and always viewing the glass half empty keeps the dreaded "irrational exuberance" out of asset prices. Does there appear to be incredible value across the broad market? Not really… But things aren't as wildly overvalued as many folks seem to trumpet.

Once again I think the lessons in the media, especially television, are a useful study on market participant behavior. As unbiased as they claim to be, the people sitting behind the anchor desks facing the camera want as many eyeballs on them as possible. Being controversial and adamant in your opinion / line of questioning is an effective way to reach that goal. Their guests, especially on financial segments, (but you can see this on the Sunday political shows too) are filled with people "talking their books." I'm not accusing anyone of pumping and dumping, or whatever the opposite would be labeled, but a money manager running a portfolio that owns a certain stock is not going to go on television and trash that company. They will, however, knock down a stock that they may want to purchase if it were priced lower, or a position they may have recently sold in order to make themselves look better to their clients.

In our portfolios, energy has been an ugly albatross – as it has for everyone else in the world right now – but I also don't think with the ever growing and expanding modern world that people are going to suddenly stop using fossil fuels to power their lives. Based on predictions in the 70's, we should be completely out of dead-dinosaurs by now – however the news would lead you to believe that not only will the black gold be lapping at your porch sometime soon, we will all be driving hydrogen / electric powered cars by next spring. As with most extreme positions, they are incorrect…

Everything I read still shows that our "good friends" the Saudis are using their oil hammer against sworn enemy, and their new annoyance, the shale drillers of America. When oil first started to drop last fall, we mentioned what Aramco looked to be up to and compared it to the 1970s only in reverse. That narrative seems to be gaining more followers. The latest I've heard is that they are going to continue at their current output, or even slightly increase it, until some of the shale drillers can no longer afford to operate. Enjoy your cheap gas now; I have a feeling that within a year a lot of that excess supply will be gone.

Our rebalance and model update triggered in the middle of the first quarter appears to be performing as expected, even though the bonds and cash don't really contribute much at this point. I would describe myself as "uncomfortably long" currently in the equity market. I beleive we're due for a correction, but a couple of things are holding that up right now.

The general public seems to be finally coming to grips with the fact that they've missed an incredible move in equities over the last few years, at least in the United States, and in surveys express much more confidence in the economy. However, they are still not putting their money where their mouth is… In fact, 2014 still showed negative mutual fund flows for domestic equities. Those flows stand slightly positive in 2015 but nowhere near the avalanche that it could/should be at this point in the bull market. This is why I say "uncomfortably long," there isn't huge value here, but the averages only recently returned to levels we reached 15 years ago with underlying earnings almost triple at this point. Definitely not a bubble…

Going forward, the sideways grind we've been experiencing through the first quarter may continue for a while, as there doesn't seem to be too much of a catalyst to break one way or the other. Earnings comparisons year-over-year are getting challenging, but low unemployment will continue to push our economy forward.

The one thing this churning can do for us is bring value eventually. Stock prices can either correct in the short term creating quick dislocations, which is what we've seen a lot over the past couple of years. Or, you can simply see flat prices - letting earnings look little soft for a quarter two - allow companies to adjust their plans and then move forward from there. It's boring, uncomfortable, and makes people impatient but still a better ride than jumping on the bearish elevator headed to the basement.

As for what's likely to be seen from our portfolios, I'm comfortable after the update having slightly reduced fixed income, some of the cash and eliminated most of the bad parts of Europe - I don't think there's any way improve further at this point.

I do see some value being created in the energy space. For decades we've seen plenty of volatility in oil and the large, integrated companies and pipeline companies (not the speculators, the longtime operators) always seem to survive and thrive. In fact, as I sit and write this note, Royal Dutch Shell has agreed to purchase one of their competitors in the liquefied natural gas space, because they believe that even though the prices are down currently, LNG will be an area of complementary growth long-term. I wouldn't be surprised if we see more of those transactions going forward. What I'm saying is, don't be surprised if you see some additions to energy MLP's and/or specific oil companies in the portfolio over the next few months.

On the political front, always my favorite/least favorite topic when it relates to investing, things seem to be finally getting underway in the Presidential fight. Too soon to see how that plays out obviously, but it will be were nice to watch both sides try to tear each other to shreds over unimportant points for the next 12 - 18 months.

I'm also happy to see that a prediction made after the last election has begun to rear its head. The time for excuses and inaction has passed! Even though both sides want to be careful and not hurt their chance at the White House next year, it will be very difficult to hide their true platform and intentions with one team controlling Congress and the other team controlling the White House – inaction can no longer be blamed on your opponents. Juicy.

The threat of terror, especially domestically shown by recent arrests, is always on the market's radar -and makes me a little more uncomfortable because we seem to be lulled to sleep at this point. (Which is how things felt the morning of 9/11…) I'm not predicting anything big, I'm merely saying that I see no complacency in the financial markets currently, but I do when it comes to diplomacy and security. I hope I'm wrong…

Not wanting to write simply to see words on a page when I have nothing new to report, I think I'm going to end this note here. There's nothing more to do right now other than be vigilant, continue to look for opportunities where value has been created and monitor our newly updated allocations.

Thank you as always for your business and especially the referrals we've received recently - it is the greatest compliment one can get. If you have any questions, comments or want to discuss things further I am always only a phone call or email away.
Cheers!