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Greetings,

Have you seen the price of crude oil and/or noticed the price of gasoline lately? If you or someone you know predicted this huge drop in energy prices over the past six months, please let me know. I would be curious to know their other predictions, as well as their thoughts going forward. Maybe you can see why it makes no logical sense to attempt to make short term predictions like returns of the stock market, commodities prices, interest rates, currencies or even the economy. Virtually no one can get them right. So many, however, insist on continuing to try and they ultimately fail. It didn't surprise me that crude oil entered a bear market in the fall. Additional domestic production resulted in increased global supply. Simultaneously demand decreased due to the slowdown of international economic growth. The bear market in crude oil prices was inevitable. That does not explain the collapse of energy prices over the past six months. Similar to the stock market, selling tends to lead to more selling in the commodities market. Oil futures are traded like stocks, just rarely by individuals. The hedge funds, as a group, trailed the market badly last year. They use leverage and are now making an effort to play catch up. As part of this effort, hedge funds have been pushing the price of oil down, piling in on the momentum play. Historically, the stock market has rallied when the price of oil drops. History was re-written early last month when the market had a 4% pull back as energy prices continued to collapse. When any asset class collapses in price for any reason, people get nervous. People are especially nervous now because not only is the price of oil collapsing but it is collapsing so quickly. When people get nervous, stocks are sold. The market quickly recovered last month because people soon realized that the reason for the collapse was because of a supply shock, combined with the short selling. The selloff had nothing to do with any kind of economic slowdown. If anything, lower energy prices (if they stay this low that is) are expected to add ½ of 1% annualized growth to GDP in 2015. That is a significant increase. The reason why the increase in growth will be so large is because such lower energy prices will result in a huge tax cut for the consumer. It will result in a huge tax cut because similar to a tax cut, lower gas prices will provide the consumer with more disposable income. I don't believe that the stock market has factored in lower energy prices into increased corporate earnings estimates for 2015. Earnings for energy companies will be a drag on overall earnings next year but corporate profits excluding energy companies will be very good.

Big surprise number 2 for 2014 was lower long term interest rates. Short term rates are zero so they can't be any lower. Just about everyone including yours truly expected long term rates to go up in 2014, not down. The discontinuation of quantitative easing added to this expectation. Boy, were the bond bulls chirping up a storm last year! They continually chattered about the "new normal" in interest rates and how they will stay this low for a long time. The last time I heard this much chatter about a "new normal" was back in 1999 during the tech bubble. How did that turn out? While the bond market will

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not crash and burn as the technology stocks did in 2000 and 2001, it is difficult to imagine fixed income doing well from these levels once short term rates begin going up and they will be going up some time this year. The market's call at this point in time is that increases will begin in late spring or early summer. Since the Fed is reluctant to raise rates and with low energy prices giving the Fed "cover", I think it is more likely to happen in the later part of the summer, perhaps in early fall.

The question that will be on many people's mind will be, what will higher short term rates mean for us and the stock market? It will certainly lead to negative total returns for the fixed income market. How poor those returns will be is debatable. I think that the Fed will raise short term rates slowly and if that happens and inflation remains tame, the fixed income returns may not be that bad. The problem is that with yields being so low, it won't take much of a loss in principal to cause a negative total return. This will especially be the case with the Treasury market. The simple fact is that there are a lot of people, especially large institutions with an addiction to bonds. Whether this comes from an aversion to risk or a search for yield, people just love their bonds. This insatiable appetite for fixed income by people who control a lot of money could keep the fixed income losses from being higher than they ordinarily would be, given how high prices result from low yields. Thinking intelligently, many things would have to happen for the bond market to continue to rally. Either the Federal Reserve would have remained on the sidelines or, if the Fed does raise rates, (a near certainty this year) this would soon result in a flat yield curve for long term rates. Then, for a bond rally to continue, long term rates would have to go lower, resulting in higher bond prices. If the Fed continued to raise short term rates while long term rates decreased, the result would be an "inverted yield curve". An inverted yield curve is the result of short term rates being higher than long term rates. Historically, this happens when the bond market sees a recession coming. Considering that third quarter GDP was just revised up to an annualized growth rate of 5% and 2015 GDP is expected to be in the 3-3 ½% annualized growth range, the likelihood of a recession in the near future is remote. Based on the explanation that I provided, it makes little logical sense for the fixed income market to do well over the next 2-3 years.

As far as the stock market is concerned, while I hate to be a wet blanket, equity returns over the next 3 years will be a fraction of what they have been over the last 3 years. The broad market has averaged an annualized return of just over 20% over the last three years. I think that a realistic expectation for the next 3 years is a return of one third of that. A 7% average annual return is within range of normal historical returns. During the recent bull market, many questioned its markets validity given the weak economy. My response is that low interest rates trump a weak economy where the stock market is concerned. We will now see that the reverse is true. As the economy continues to improve and, subsequently, the Federal Reserve takes liquidity out of the market, stock valuations (PE ratios) will at best stay the same and will possibly contract. This has happened before and it will happen again. Higher interest rates will not lead to a bear market. Historically, recessions lead to bear markets. Higher interest rates will lead to more market volatility and lower stock market returns than we have seen recently. After doing so well over the previous 5 years, I expect that we can manage with returns in the 7-9% range over the next 3-5 years.

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