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Greetings,

Zero interest rates are now a thing of the past. Good bye and good riddance. For full disclosure, interest rates are still at near zero, just not at zero, so don't think that your friendly banker will be giving you a safe, nice return on your money. As a matter of fact, under the heading heads they win tails they win, the banks will be making slightly more on loans outstanding tied to the prime rate but will not be paying a higher rate on deposits. I say good bye and good riddance because unless you were invested in the stock market, these zero interest rates didn't help the majority of people anyway. The broad economy has shown virtually no improvement over the past 5 years. Yes, the economy is not nearly as bad as it was during the recession as our President (not for much longer) frequently likes to remind us. After a certain point in time, I expect the economy to be good, not simply less bad. Some people who defend the Fed's policies make a case that the economy would be much worse had their not been several rounds of quantitative easing as well as zero interest rates. I find it difficult to state what would have been had something not happened. What I do know is despite the nearly trillion dollar "stimulus" going back 5 years, zero interest rates and several rounds of quantitative easing, we have a GDP growth rate of about 2% per year. My expectation is that there will be some improvement in the rate of GDP growth but nothing to excite anyone. At the same time, all these senior citizens in the country who wanted a safe return of at least 5% were essentially hung out to dry by the government that is supposed to look out for old people who have paid their dues.

The big question is where do we go from here as far as interest rates and the stock market? Just about anyone who has attempted to figure out what the Fed will do has been wrong including yours truly. Part of the problem is that the Fed doesn't even know what they will do. The "Fed" is giving the impression that it wants to raise rates 4 times next year, ¼ of 1% each time. At the same time, the Fed has made it clear that their decisions will be "data dependent" while every year, they move the goal posts back. The Fed now looks at the global economy in determining what to do. Previously, it was full employment and each year, they have changed their definition of full employment. Before full employment, it was inflation. The stock market is pricing in 2-3 rate increases next year. I think it will be one and done, at least until after the election. The bond market determines long term rates which are more important than short term rates. If the bond market expected 4 rate increases next year, then long term rates would be increasing now with the expectation of additional short term increases this year. With the 10 year Treasury yield at a paltry 2.3% (slightly higher than Apple's dividend yield), it doesn't make sense for 4 rate increases next year. I also believe that low energy and commodity prices are giving the Fed cover to keep rates lower for longer. Janet Yellen has made it clear that she wants to be accommodative to the markets.

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Corporate earnings last year turned in their worst results since the recession. Corporate earnings over the past several years weren't that good. They were pretty much beating lowered expectations and much of that was because of financial engineering. Until last year, the stock market has been doing very well for the past several years. The market did well essentially for two reasons. The first was because of historically low interest rates, both long and short term. The markets multiple continued to expand because a higher multiple was justified in such a low interest rate environment. The market also did well in anticipation of a pickup in the economy which would result in a higher growth rate for corporate profits. Last year, there was neither the pickup in the economy nor an increase in corporate profits. The result was a weak stock market performance.

For the market to do well going forward, it is essential to have some economic improvement. Corporate profits should improve next year if for any reason, since they were so poor last year, many sectors are coming off easy comparisons. Energy prices are expected to remain at low levels for much of the year. Low energy prices were expected to help the economy. They did help the economy. It just wasn't the "boom" to the economy that many people, including myself expected. There is evidence that the casual dining, home improvement, technology, and auto sectors did benefit from falling energy prices. Many of the companies that we own have also benefited from low energy prices. There was one major problem though. Energy prices may have fallen by too much. Much of the growth of the economy (until recently) was because of investments in the energy sector. Not only are energy companies not hiring people, they are laying people off. Instead of increasing their budgets, energy companies are drastically cutting their budgets. Thus, the companies on the receiving end are also being hurt. This has had a ripple effect on the economy and has offset much of the benefits to the economy from the consumer.

Going forward, I expect much volatility for the stock market for the next two years. The stock market detests uncertainty. Between rising interest rates and a fragile economy, there is much uncertainty. On a positive note, there is a tremendous amount of negativity in the investment community, both among the talking heads and the retail investors. Historically, the market climbs a wall or worry. I become concerned when there is too much optimism. That is certainly not the case at the present time. Since I expect an increase in volatility, it is possible that I will keep larger than normal cash balances this year. I say possible because I will look to sell on strength. I don't plan on selling just for the sake of raising cash. Please email me or give me a call if there is anything that you want to discuss or if you have any questions.

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