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2015 First Quarter Review

Markets seesawed in the first quarter with a downdraft in January, a rally in February, and a volatile March that went pretty much nowhere. Volatility increased with only six trading days in March that did not include triple-digit moves in the Dow Jones Industrial Average. That index fell .26% for the quarter while the S&P 500 rose less than ½ of one percent. Interest rates continued to decline slightly with the US Treasury 10 Year note recently yielding 1.82%. For all the activity, the market during the first quarter was what traders call "range-bound."

Though the financial markets gyrated around the same level, there are several potentially important factors that are in the process of changing. At least four themes have developed in the financial markets that may have important influences upon their direction: the value of the dollar, the price of energy, earnings estimate revisions (downward), and possible increase in short-term interest rates by the Federal Reserve Board.

The value of the dollar has risen in relation to most other currencies by approximately 25% since the middle of last year. This makes for a pleasant surprise if you travel to Europe and find that your money buys more than it did last year. However, it penalizes the profits of the large, dividend-paying multinational companies whose stocks have been the stalwart performers of the last several years. It means that the prices of their products (priced in dollars) just became 25% more expensive for non-U.S. consumers, and those foreign profits translate into fewer dollars when they are brought back home. The prices of those stocks like Proctor & Gamble, Johnson & Johnson, and other multinational standouts have levelled off and declined recently as this economic "headwind" has slowed down or stopped their recent growth. Additionally, currency moves of this magnitude are rare and can cause economic dislocations far beyond the prices of individual stocks. The "Asian Contagion" of 1998 was precipitated by rapid currency changes and wound up causing problems for our markets as well.

The price of oil fell by 50% during the second half of last year and the change is probably a boon to importers like Japan and the European Economic Union, but it is more of a mixed bag in the energy-producing U.S.A. Oil service stocks have largely been crushed as drilling activity has fallen sharply. Refiners have benefited as their costs of production have declined more than the price at the pump. The "integrated oils," those with both production and refining operations, have the benefits of expanded refining profit margins that can help offset the weakness from producing oil that must be sold at lower prices. The price of oil shows signs of possibly stabilizing in the $45 to $50 per barrel range, but there is the possibility of another decline to lower levels if storage capacity becomes overwhelmed during the next several months. However, the general declines in the prices of some of the stocks may be presenting an opportunity for those with an investment horizon extending over the next few years.

A troubling divergence between earnings estimates and stock prices began to widen at the end of 2014. Although the indices moved higher, earnings estimates were being ratcheted downward. As of now, instead of their previous expectation of earnings increases for 2015, analysts estimate that earnings will be down 5.8% for the first quarter, down 4.2% for the second quarter and down 1% for the third quarter. The profit picture has darkened while the market has not reacted. If investors pay more for any given dollar of earnings, the price/earnings ratio goes up. If profits decline without a reduction in stock prices, then valuations have increased even though there is no market advance. That may be happening now, and it is troubling. No less troubling is Nobel prize-winner Robert Schiller's recent declaration that his "CAPE" ratio (Cyclical Adjusted Price/Earnings Ratio) is currently at a level that has only been reached three times before; in 1929, in 2000, and in 2008. The aftermath of each of those times was not pleasant.

The linchpin to the whole puzzle may be the actions of the Federal Reserve Board. Six years into what some Fed Governors even call "an unprecedented experiment in monetary policy," the Fed appears to be terrified of upsetting financial markets with the thought of raising short-term interest rates by as little as ¼ of one percent from a floor of zero. If it is a testimony to the health of the patient that the doctor is afraid to prescribe the slightest reduction in the morphine drip, then it is not a testimony that inspires confidence. After Fed Chairman Janet Yellen's verbal contortions around the word "patient" after the last Fed meeting, the efforts to psychoanalyze the minds of the members reached a new extreme. Suffice it to say that the Fed claims to want to slowly return interest rates to "normal" and wanted to begin with a .25% increase at the June, but now more likely the September meeting. That is, if the financial markets don't mind too much. Former Fed Governor Kevin Warsh recently said, "Interest rates need to be set by financial markets, not by central banks. Central banks are setting prices seven years into a recovery, leading to misallocation of assets." He called the current policy a "radical experiment" and said that, "Using the stock market as a guide for policy may have been appropriate in 2008, but is dangerous in 2015."

Many long-time value investors have described this as one of the most difficult investment environments we have faced. Money markets yield close to nothing, bonds yield so little as to be vulnerable to capital losses with any increase in interest rates, and the general stock market is, by some measures, in historically dangerous territory. The difference this time is that the world's central banks have pumped so much money into the economic system that the danger signs may be ignored, with the possibility of a "melt up" in prices at the end of the cycle.

Every dislocation has its opportunities and ours at this time may include banks and financial companies that stand to profit with increases in interest rates. Precious metals prices have been pummeled for years and gold may have double-bottomed recently at $1,150 per ounce. Any rebound would send mining shares higher. Energy related shares could see more pressure, but will likely present a buying opportunity as distressed sellers unload shares over the balance of the year.

We have largely cleaned house of our most disappointing underperformers (Monitise and Ocwen Financial) and have pared back some long-held positions in pharmaceutical stocks (like Bristol-Myers) wherever they have grown to be too large a percentage of portfolios. We plan to continue to reposition portfolios for what may come for the rest of 2015 and beyond.

Enclosed you will find your reports and statements for your review. Please call us if you have any questions or would like to discuss any changes in strategy. If you need any help with your tax information just let us know and we will get it to you or to your preparer quickly.

Best regards,

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