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U.S. capital markets ended 2014 on a high note, with domestic stocks and bonds racking up gains for the quarter and the year. While the end result was positive, the ride was bumpy at times, with stock prices swooning on a couple of occasions over the last three months before recovering to set new highs. (The same can't be said for non-U.S. stock markets where 2014 performance generally ranged from mediocre to poor).

The first episode of market indigestion sprang from fears that weakness in Europe and China might drag down the U.S. economy. Two months later came news that U.S. GDP soared at a 5.0% rate in the third quarter, the best performance in eleven years. Conventional wisdom now accepts that the listless pace of the economic recovery, stalled for years at around 2%, has finally given way to more vigorous growth.

In the meantime, however, investors were jolted when the slide in oil prices that began last summer turned into a rout on the heels of OPEC's late November refusal to cut production quotas. It may seem not so long ago that investors were concerned about too little oil, not too much. Indeed, in the early years of the recovery from the Great Recession global oil demand spiked and production didn't keep pace. Surging consumption was led by China, where factories and cranes were operating at full tilt. With demand exceeding supply, the price of oil nearly tripled between early 2009 and 2011. At that point, torrid growth in China began to ease and the shale oil and gas revolution¹ in the U.S. moved into high gear, allowing production to catch up. For several years there was a rough balance but last year supply began to outstrip demand.

After its early 2011 peak, the price of oil² fluctuated between \$100 and \$125 a barrel until this summer. At that point prices began to drift lower as supplies in Libya came on line faster than expected and estimates of future demand began to decline on a softer outlook for global economic growth³. The supply picture was further bolstered when a feared disruption in Iraqi production by ISIS failed to materialize. Still, the price drop was gradual as markets anticipated Saudi Arabia would play its usual role of adjusting production to get supply and demand back in balance. Hints to the contrary came in early November as the Saudis slashed prices. When OPEC's winter meeting ended with an announcement that the cartel would not cut production, followed by suggestions that

¹ For the uninitiated, the technology of horizontal drilling and hydraulic fracturing (fracking) has unleashed the potential of huge U.S. deposits of shale oil and shale gas. North Dakota is the new Texas.

² We're using the spot price of Brent crude in this discussion.

³ Demand has been constrained by other factors as well, including improved fuel efficiency on the part of U.S. automakers and an aging population (less driving) in almost all developed countries.

Riyadh was embracing the idea of lower oil prices in hopes of driving U.S. shale producers out of business, the bottom fell out.

The dramatic decline in oil prices created trouble in the stock market that extended well beyond the energy sector. Considering the economic lift that will come from lower gas prices, what was troubling investors? True, there will likely be some unpleasant knock-on effects such as bankruptcies among the weaker energy names and a severe economic contraction in oil-exporting countries. And markets don't like economic dislocation as a general proposition. But was there more going on? Yes, and it goes back to concerns that began earlier in the quarter. Capital markets, preoccupied with the possibility of a global economic slowdown, took lower demand for oil as an ominous sign for future growth. On the surface this seems backward looking--decelerating economic growth may have been a partial cause of plunging oil prices but that very plunge should provide an antidote. The IMF estimates that cheaper oil will add between 0.3 and 0.8 percentage points to global GDP this year and next. (Of course much of that additional growth will eventually be reversed when decimated exploration and development budgets take their toll. Excess supply leads to low prices, which reduces the incentive to find new oil, which ultimately leads to less oil and higher prices.)

There is another macroeconomic effect of cheap oil that gets closer to the market's real concern, and that is lower inflation. Certainly "headline inflation," which includes all categories of spending, is lower as a result of the sharp drop in the price of oil. But over time there is also an impact on "core inflation" which excludes the volatile categories of energy and food. Inexpensive oil makes it cheaper to produce all sorts of goods. In this manner lower energy prices will seep into and depress core inflation. We've written in these pages about the danger that lower inflation—disinflation—turns into negative inflation—deflation, which is a very serious problem. Many countries in southern Europe are already experiencing this and concerns that deflation will overtake Europe as a whole have been prevalent for much of the year.

Ironically, intensified fears of deflation may help ensure that the problem doesn't come to pass. For years European Central Bank chief Mario Draghi has been hamstrung by German reticence in taking aggressive monetary actions. Germans, still haunted by the collective memory of hyperinflation nearly a century ago, are fervent on the issue of fiscal rectitude; from Bonn to Berlin the instinctual answer to the problems of the euro zone is always austerity. Still, Chancellor Merkel has a deep well of popular support and when push has come to shove, she has supported measures that were distasteful to her constituents. Fears of deflation may now be sufficient for Merkel and her Bundesbank counterparts to stand aside while Draghi initiates a program of quantitative easing (QE)⁴. Bond markets seem to think so, as prices on European government debt have been soaring, presumably in anticipation of large bond purchases by the ECB.

The situation in Europe is further complicated by upcoming elections in Greece. The leftist party Syriza appears poised to win on an anti-austerity platform. Syriza has promised not to abide by the

⁴ QE, as you may recall refers to central bank purchases of government bonds in an effort to drive down interest rates and stimulate the economy.

terms of Greece's bailout and hinted that it may be prepared to abandon the euro if necessary. The prospect of a "Grexit" is not as terrifying as it may have been in the past as the ECB's toolkit has expanded considerably over the last couple of years and policy makers have had ample opportunity to game plan Greece's possible departure from the currency union. And frankly, a Grexit can't now trigger a depression in southern Europe—austerity has already accomplished that mission. It's important too to realize that should Syriza win, its demands may be considerably reduced by the time it has reached out to more centrist parties to form a coalition government.

Here in the U.S., fears of deflation and anticipation of QE in Europe have exerted tremendous pressure on rates, with the yield on the ten-year Treasury back below 2%. Readers of these pages know that we've been expecting a stronger U.S. economy to create some wage inflation and perhaps force the Fed to raise rates sooner and/or more quickly than planned. The economy has been doing its part but the plunge in oil prices (as well as a stronger dollar) will lower core inflation in coming months, taking pressure off the Fed, at least for the time being. And with anticipation of QE in Europe driving rock-bottom yields on European government bonds to all-time lows—0.5% on the ten-year German Bund!—2% on a ten-year U.S. Treasury looks attractive by comparison.

The stock market meantime, when it's not panicking over the possibility that lower oil prices will trigger widespread deflation, is enjoying that magical combination of microscopic interest rates and healthy corporate profits. (Did we mention that lower energy prices help earnings?) Stocks are rather expensive by absolute standards but with dividend yields on many blue-chip stocks easily outpacing Treasury yields, the allure is hard to deny.

Where does all this leave the outlook for stocks for the remainder of 2015 and beyond? In the short term, all eyes will be on Mario Draghi. Until capital markets are convinced that Europe can fend off deflation stocks will continue to benefit from rock-bottom interest rates but have trouble shaking the idea that a poisonous bout of deflation will take root in Europe and perhaps spread to other regions. As attention alternates between the advantages of low rates and the risks of deflation, we could see continued volatility.

If and when markets decide that the ECB will prevail against deflation—and we do expect that to happen as the year unfolds—the stock market should begin to notice the benefits of cheap oil across much of the global economy. At which point the market may finally begin to worry about rising interest rates.

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