Reilly Financial Advisors

THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – DECEMBER

US Markets and Economy: Stocks capped off an excellent year overall with a roller-coaster ride in December: an early month selloff was followed by a rise to new all-time highs, and then a swoon at the very end of the month. The tally for the year was quite good: the S+P 500 gained over 10%, as did the NASDAQ Index. While the Dow Jones gained only 7.5%, it was pulled down by the heavy weighting of oil stocks among its 30 blue chips. In spite of that weighting, the Dow breached another round number milestone when it closed above 18,000 for the first time. More importantly, the Russell 2000 Index of smaller capitalization companies also rallied to a new all-time high in December, after falling sharply earlier in the year. The small stock rally erased the "divergence" between the generals (blue chips) and the regular troops (small stocks) which often worries market technicians, who much prefer to see all segments of the market moving ahead in tandem.

Of course the one big exception in December was the energy sector. The sudden and sharp decline in world oil prices to $60 a barrel took down the stocks of the integrated oil majors, energy exploration and development firms, and almost all other energy stocks of any type. The overall stock market first fell in December in sympathy with energy, before traders realized that **a decline in energy prices is actually very good news on balance for heavy energy users like the United States.** Stocks then reversed in December to new highs, once this bit of economic theory sank in, only to fall again at the end of the month, as fears that the decline in oil prices meant that world economic growth was slowing.

There will be no slowing of economic growth in the US. The latest revision to 3rd quarter 2014 GDP showed the economy charging ahead at a 5% pace, and the fourth quarter should show solid growth too. Monthly employment gains have reached 300,000, and the tally for the year will be the best job creation total since 1999. Unemployment continues to fall gradually, too. **Adding to this growing strength, consumers have received the equivalent of a $100 billion tax cut with the sharp fall in gasoline prices**. Americans will spend this "tax cut" on cars, food, clothing, and just about everything else in a typical household budget. This additional spending will lead to more hiring and more spending across the economy. With interest rates remaining extremely low, the stage is set for strong economic growth in the US in 2015. This rising tide will lift almost all boats except the energy sector. Ironically, the decline in oil prices has been caused in part by the sharp rise in US oil and gas production from hydraulic fracturing ("fracking") in shale formations like the Bakken shale in North Dakota, which is now the second largest oil-producing state in the US. This increase in US oil production has reduced US demand for imports, especially of OPEC oil. Slow or slowing growth in countries outside the US has also reduced energy demand, and the decision by OPEC leader Saudi Arabia to maintain production in the face of a glut has also pressured prices. The Saudi "long game" is easy to understand: their massive financial reserves, and their very low-cost and large oil reserves, mean that the Saudis can comfortably survive a period of low oil prices, while other producers, including US shale firms, may not. Alternative energy, another existential threat to fossil fuels, also requires high oil prices to be profitable. A prolonged period of low energy prices will thus extend the useful life of all the Saudi oil in the ground, as direct (shale) and indirect (solar, wind, etc.) competition is shut down or abandoned. **This Saudi strategy could keep oil prices low for most of 2015, which will support rapid economic growth in the US, while keeping inflation very low**.

World Markets and Economy: European economic growth continues to lag behind the US, even though low energy prices will also be a net economic benefit. The Eurozone could even dip back into recession in 2015. Part of the relative weakness in Europe can be explained by the actions of the European Central Bank (ECB), which has been much more cautious than the US Fed, both in lowering interest rates, and in adopting Quantitative Easing (QE). Multiple rounds of QE in the US have helped to stimulate the US economy. The British, who are outside the Eurozone, have also used QE liberally and are witnessing much faster growth than the Continent. Even the Japanese have used QE to shock their moribund economy back to life, although a large sales tax increase in Japan offset all the benefits of monetary ease. The ECB is hamstrung, however, because the Germans are so far unwilling to see the bank purchase sovereign debt of member countries, including the debt of the long–suffering prodigal Greeks. And the Greeks may still cause more upset in Europe, since a Greek election in January may put Syriza in power. This nationalist party, riding a wave of opposition to further austerity, has demanded changes in the terms of the Greek bailout, and further writedowns of Greek external debt. The possibility of Greek exit from the Eurozone will again cast its shadow over markets in Europe.

In Asia, the slowing Chinese economy has not daunted the newly-revived stock market. After years of a grinding bear market, Chinese stocks soared by over 50% in the last half of the year. An easier money policy by the Chinese central bank, designed to keep the economy from slowing too much, has provided the fuel for the rally. In Japan, however, stocks fell in December, even though Abe called and won an election to confirm his decision to postpone another sales tax increase for two years. Both China and Japan, who import much of their energy, should benefit from cheaper energy prices in 2015.

Oil-reliant countries like Venezuela, Iran, and Russia will see their economies shrink and their currencies fall. All may have difficulty servicing their debts, both public and private, and much mobile capital may flee these countries, seeking safety in the US and perhaps even Europe. The strength in the US dollar in December, and the decline in long-term US interest rates, signals that the US is still the world's "safe haven" in times of economic uncertainty.

OUTLOOK: In the short term, US stocks can push higher as economic growth continues with low inflation, low interest rates, and a strong dollar. Easy money in Europe, Japan, and even China can support stock prices worldwide, although economic uncertainty in Europe can make stock markets volatile. January has historically been one of the strongest months of the year for the American market.