The Reilly Report:

REILLY REPORT 2014: REVIEW AND OUTLOOK

2014 was another excellent year for the US stock market, with major market indexes rising to new records, and finishing the year near historic highs. The widely-followed Dow Jones Industrial Average broke through the 17,000 barrier in the summer and then the 18,000 barrier in December. The broad-based Standard and Poor's 500 Index (S+P) pierced the 2000 level late in the year and finished with a gain of over 10%. This was all-the-more remarkable since the S+P had soared over 30% in 2013. The NASDAQ Index, heavily weighted with technology stocks, also recorded a double-digit gain for the year, and at 4800, was within striking distance of its all-time closing high of 5048, set in early 2000.

Figure 1:

SPX: 1,750 – 2,000 – 2,250

DJIA: 15,000 – 17,000 – 19,000

NASDAQ: 3,500 – 4,000 – 4,500 – 5,000

01/03/2014, 01/24/2014, 02/14/2014, 03/07/2014, 03/28/2014, 04/18/2014, 05/09/2014, 05/30/2014, 06/20/2014, 07/11/2014, 08/01/2014, 08/22/2014, 09/12/2014, 10/03/2014, 10/24/2014, 11/14/2014, 12/05/2014, 12/26/2014

Four major forces drove stocks higher during the year. First, US short-term interest rates remained near zero, with the US Federal Reserve (the Fed) promising to keep them at zero until well into 2015. Some of the Fed-created excess liquidity in the US banking system normally leaks into the stock market. In 2014, some of this leakage was obvious as the amount of merger and acquisition activity in the US, often financed with cheap money, rose to levels last seen before the last recession in 2007-09.

Second, US long-term interest rates, already historically low, fell even further during the year, making bonds even less attractive as an income alternative to stocks. The Fed had been pushing these longer rates down with its program of quantitative easing (QE), but even the wind-down and end of QE in 2014 did not stop rates from falling even further. This decline was mirrored by declines in other major credit markets, from Germany to Japan, where long-term interest rates on 10-year government bonds approached zero.

Figure 2: 10 Year Bond Yields

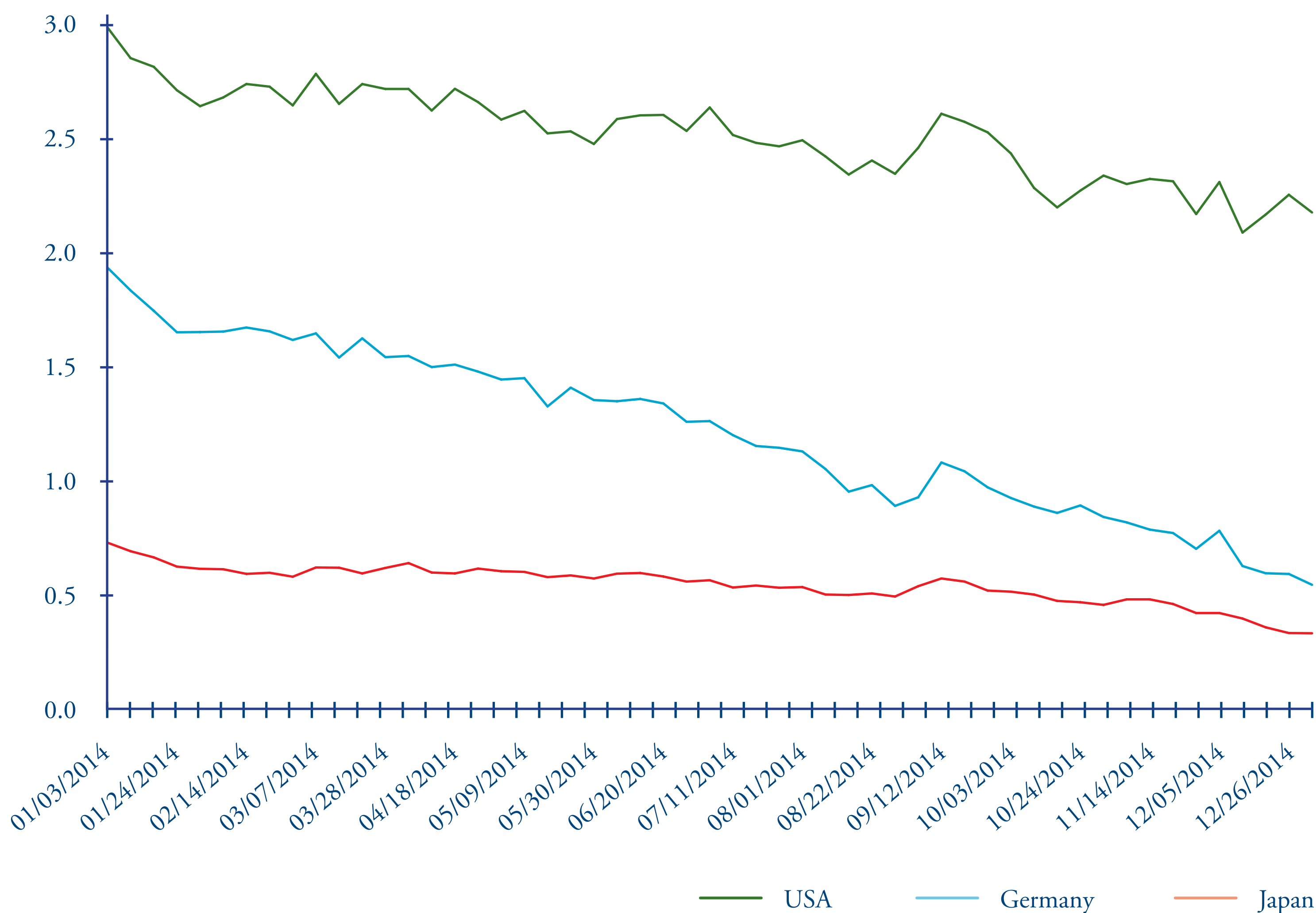


Figure 3: **US Crude Oil Production**

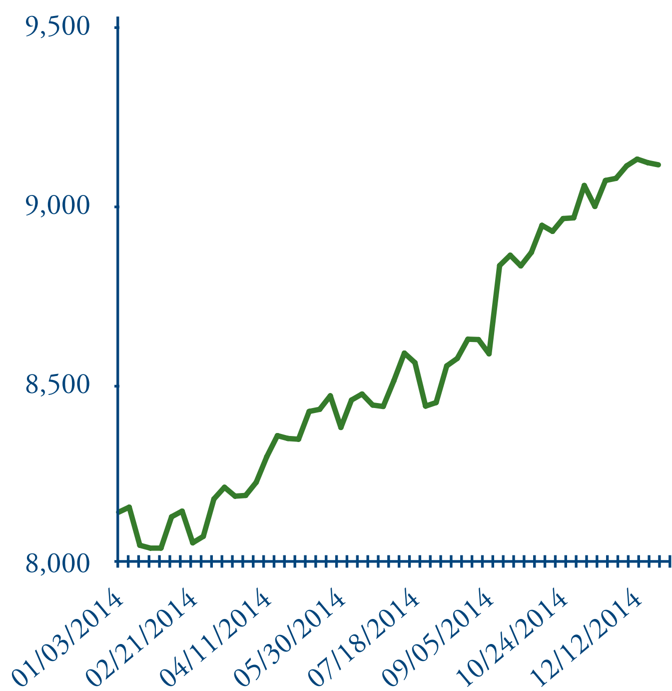
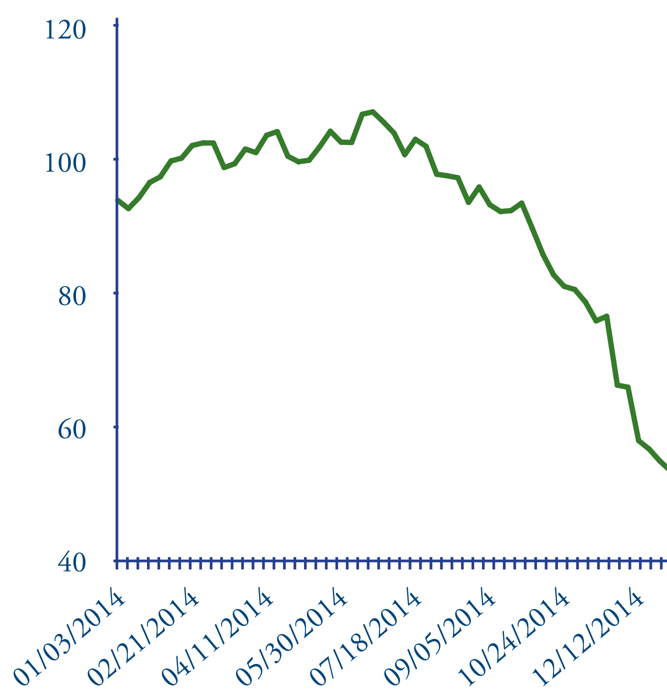


Figure 4: **Crude Oil Price**



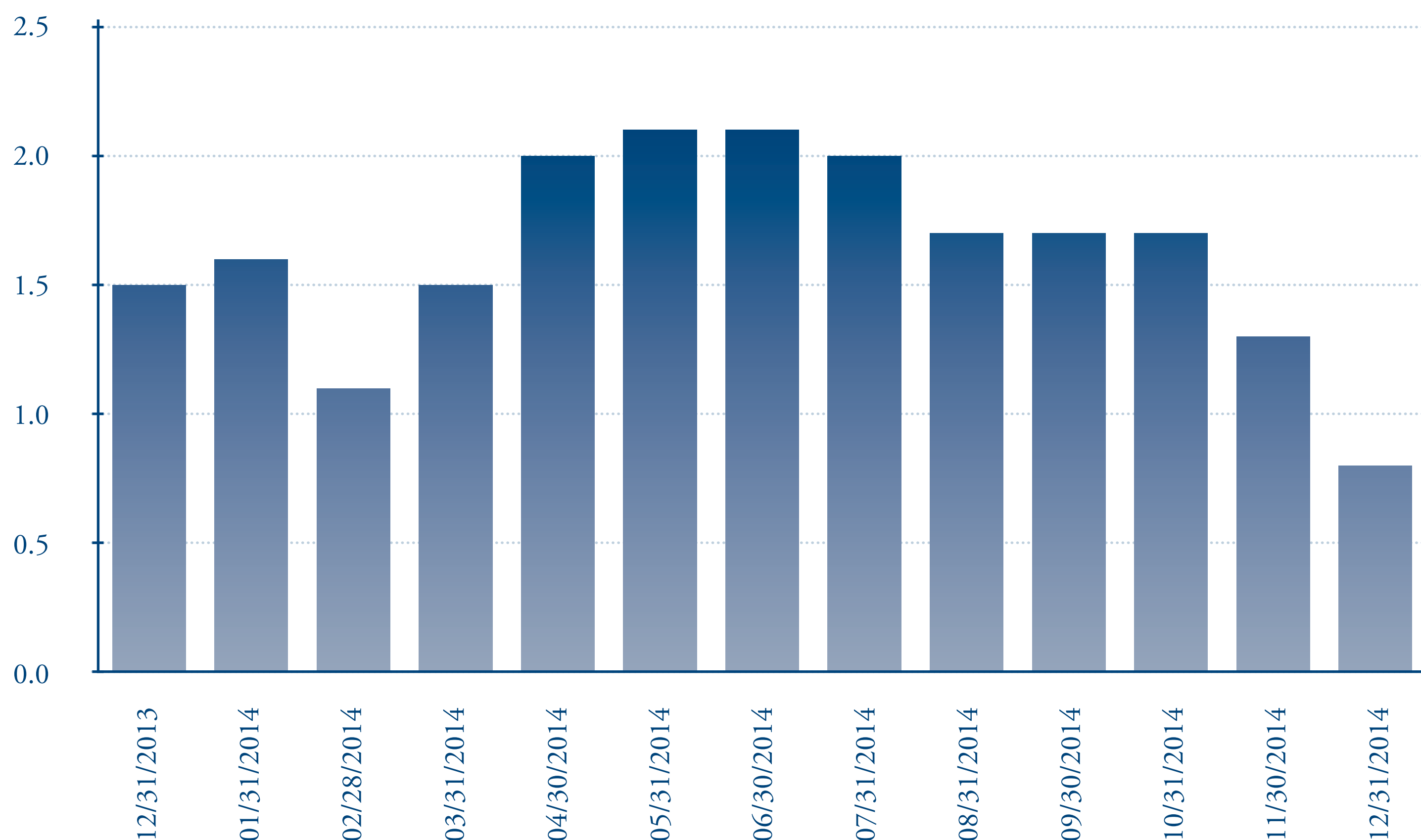
Third, after a dismal first quarter, the US economy, as measured by real GDP, grew strongly for the rest of the year, pushing up corporate profits, which are a fundamental driver of stock prices. After years of sputtering growth, the US economy is now firing on all cylinders, with cheap energy, the fourth major force, providing some of the fuel for sustained GDP growth in 2015, and beyond.

After rising to $105 per barrel in the first part of 2014, oil prices began tumbling to levels not seen in years. By December, crude had dropped to $55 a barrel, a decline of almost half in six months. While there are many explanations for this collapse, two of the most important are the continuing rise in US production (the shale boom), and the decision by OPEC to maintain production levels even as the demand for OPEC oil continued to fall. Saudi Arabia, the leading producer in OPEC, is largely responsible for the decision by OPEC to keep pumping at current rates. The Saudis are playing the “long game:” to protect their massive reserves of oil in the ground, the Saudis want to break the shale boom in the US and elsewhere. Lower crude prices will make some shale production unprofitable, and will also slow the march to alternative energy. Solar, wind, and other alternatives are much less attractive at $50 crude than they were at $100 crude. Cheap oil can also undo decades of energy conservation efforts: gas-guzzling SUVs are more attractive to Americans when they can fill them up with $2 gasoline.

The sharp decline in energy prices is a boon for the stock market (except for energy exploration and production firms) because it stimulates the economy at the same time that it keeps inflation low. This positive "supply shock" is the mirror image of the negative "supply shocks" which battered the US economy in the 1970s and early 1980s, when OPEC production cuts drove up the price of oil, sending the US economy into recession at the same time that inflation accelerated to more than 10%. Today's cheap energy directly benefits American consumers, who save billions of dollars at the gas pump, and on heating bills. Americans can then spend their energy savings on other goods and services. Their extra spending gives a strong boost to economic growth (and corporate profits), since consumption spending makes up almost 70% of GDP.

At the same time, the low level of inflation means that the Fed can maintain its policy of "easy money" that much longer. The Fed's twin mandates are to 1) maintain price stability (interpreted by the Fed as 2% inflation), and 2) maximize economic and employment growth consistent with mandate (1). With inflation well below 2%, and even falling, the Fed can concentrate on mandate (2) for much if not all of the upcoming year, which provides further support for the bull market in stocks.

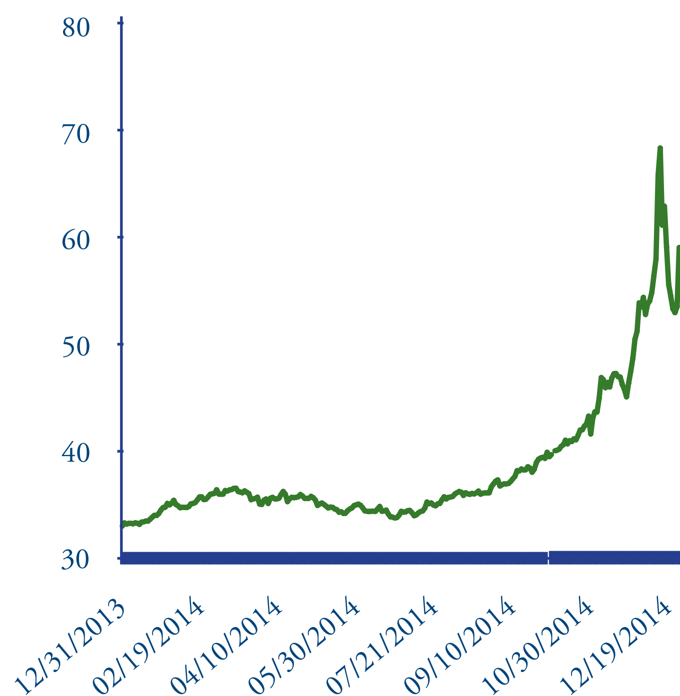
Figure 5: **US CPI Year Over Year**



While oil-importing nations like the US benefit directly from falling prices, and in the case of the US, from falling levels of imports as domestic production increases, oil-exporting countries are hurt. While Saudi Arabia and some other exporters have massive financial reserves to tide them over a period of falling oil revenues, other producers, like Russia, have no such luxury. The Russian economy, already weighed down by Western sanctions for bad behavior in the Ukraine, is now stumbling into recession as its export earnings collapse. Capital has been fleeing Russia all year, seeking safer and better returns in western countries like the US. This capital flight has put tremendous pressure on the Russian ruble, which has dropped dramatically in spite of the Russian Central Bank's attempts to shore it up with sales of dollars from its reserves, and sharp increases in interest rates.

Figure 6: **Euro-Dollar Exchange Rate**

Figure 7: **Ruble-Dollar Exchange Rate**

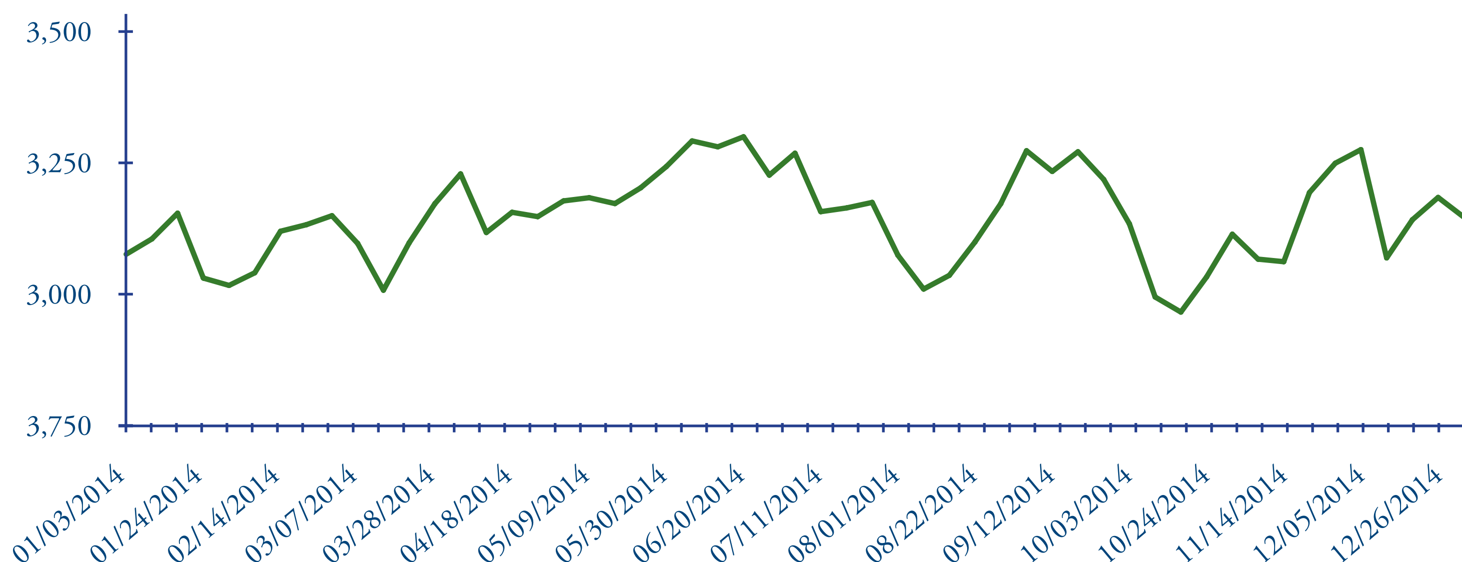


Energy-importers like Europe, Japan, and China, should also benefit from the fall in energy costs. But economic performance in Europe and Japan has been falling far short of the US. In Europe, especially within the Eurozone, economic growth is again close to zero, with European locomotive Germany struggling to maintain positive growth, while the cabooses like Greece and Spain still struggle with 25% unemployment and austerity. With interest rates in Europe near zero and likely to stay there much longer than in the robustly-growing US, the Euro fell dramatically in 2014 This decline has been exacerbated by fears that the Greeks will elect populists in 2015 who might repudiate debt and austerity agreements with its three lenders, the IMF, the ECB (European

Central Bank) and EC (European Commission), collectively known as the Troika. The shadow of another Greek default, and possible retaliation by the Troika, held back European stocks through much of 2014. When combined with a sinking Euro, this weakness created negative dollar returns for many American investors in European stocks in 2014.

Since the Japanese economy imports almost all of its energy, it should have benefitted greatly from the crude oil price collapse. Yet economic growth turned negative in 2014 in response to a sharp increase in the national sales tax. Prime Minister Abe engineered this increase to reduce the Japanese ratio of debt to GDP, which has been one of the highest in the world (even higher than Greece), rising still further in response to the deficit spending of "Abenomics." The goal of Abenomics, which includes massive monetary and fiscal stimulus, is to shock Japan out of its deflationary trap which has kept the Japanese economy stagnating for two decades. Although the Japanese stock market has responded well to stimulus (stocks love easy money everywhere), and Japanese inflation has replaced deflation, the economy still flounders. Abe has now postponed another scheduled increase in the national sales tax in order to give the economy a chance to recover from the last increase.

Figure 8: **Eurostoxx**

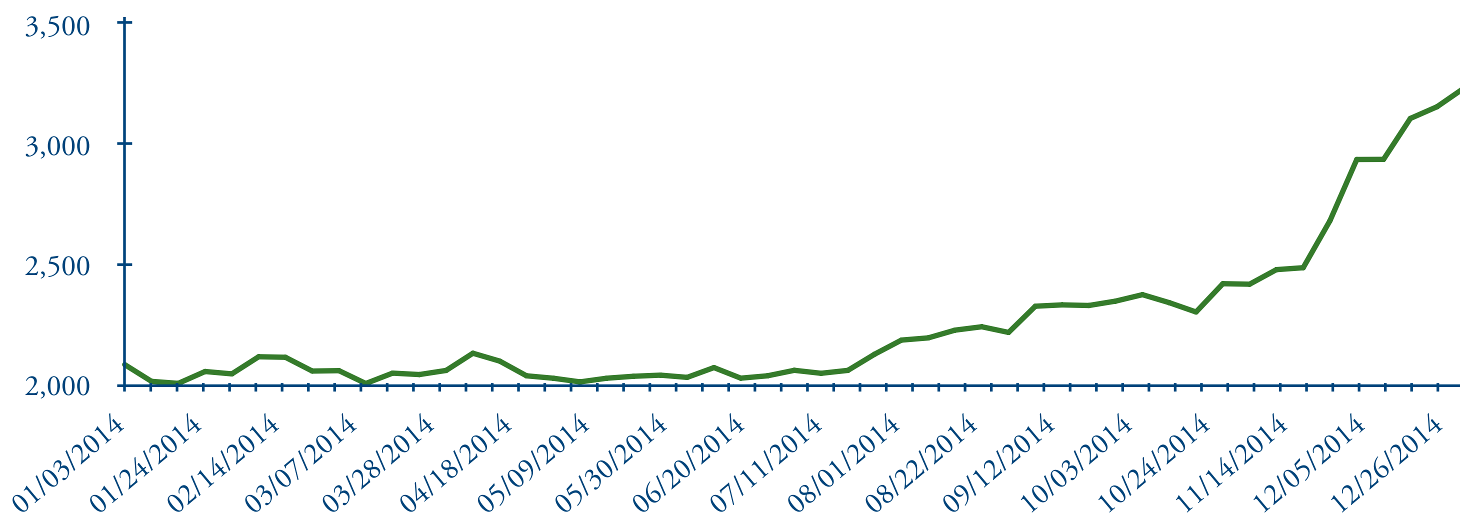


The fear of a Japanese-style deflationary trap has also haunted Europe, as inflation there approaches zero. Once deflation begins, it can be hard to stop. Consumers hold back on spending as they expect prices to be lower tomorrow. The real burden of debt becomes heavier, as borrowers must repay nominal debt with more expensive funds. And the monetary authority, with nominal interest rates at zero, is burdened with real interest rates that rise (and weaken economic growth) whenever deflation gets worse (the real interest rate is just the nominal rate minus inflation). The ECB held off on its own version of QE in

2014, in part because the Germans feared that ECB QE would mean purchases of government securities of the profligate Greeks and others. Yet with economic growth stalled and inflation falling toward zero, the ECB will likely roll out its own QE in 2015. Some economic commentators have argued that even the US could fall into deflation, but this scenario is unlikely. Underlying US inflation (stripping out volatile food and energy costs) is still running at about 1.5%. A strengthening economy, combined with an eventual bottoming in energy costs, should keep inflation close to the Fed's target of 2%.

China's economy, the second largest in the world, is still the fastest-growing of all large countries, even though real GDP growth has slowed to 7.5%. Chinese leaders have realized that 10% growth was unsustainable in the long run, given the environmental damage, the pressure on natural resources, and the growing imbalances created by a low-consumption, high-investment and high-export economy. The necessary transition to slower growth and less dependence on exports is made easier by cheaper energy, which has helped reduce inflation, making it possible for the central bank to ease monetary policy as the Chinese economy glides to a "soft landing." Chinese stocks responded well to easier money in 2014, logging returns that exceeded almost all other countries. This was a welcome development for Chinese stock investors, who had to weather a multi-year bear market until the recent turnaround.

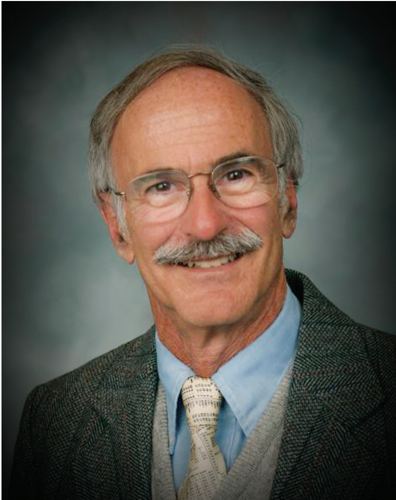
Figure 9: **Chinese Stock Index**



THE OUTLOOK

The US bull market in stocks has a good chance to continue in 2015. The Fed will be under little pressure to tighten monetary policy in 2015, so interest rates should stay low at the same time that economic growth should be strong, with corporate profits (outside of energy) able to grow. With alternative investments (bonds, commodities, foreign currencies) likely to provide subpar returns in 2015, the case for US stocks is even stronger. Yet a crisis in Europe could send shock waves around the world, as has happened in recent years. Stocks could therefore have a bumpy ride on the way up in 2015, so long-term investors should make sure their seat belts are securely fastened.

About Dan Seiver:



As Chief Economist at Reilly Financial Advisors, Dan enhances the firm's global macroeconomic approach and outlook, ensuring that all portfolios are managed within the context of the global economy.

Dan has been a member of the Finance faculty at San Diego State University for many years, where he has taught an array of courses including international business finance, investments, and financial literacy. For the academic year 2014-2015, Dan is teaching full-time in the Economics Department at California Polytechnic University at San Luis Obispo. Dan received the International Business teaching award in 2012, as well as the Finance teaching award in 2007. From 1978 to 2005, he was a Professor of Economics at Miami University (Ohio), where he taught a variety of courses in economics. He has over 20 publications in professional journals. He also coauthored an MIT Press book on regional economic policy, and a Probus/McGraw-Hill book on investment strategy. Dan has also been a consultant to the Center for Naval Analyses, and was the investment adviser to the Population Association of America for many years.

He earned his Bachelor of Arts, Masters and Ph.D., all in economics, from Yale University.

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