MID-CONTINENT CAPITAL

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*advice; judgment; resolution; wisdom

The US Widens Its Lead

American investors have considerable reason for gratitude as they reflect on 2014. Stocks (as measured by the S&P 500 Index) generated a 13.7% total return and are riding a six-year streak of gains. Interest rates unexpectedly fell back to multi-year lows, generating strong returns for a wide range of fixed income investments. The purchasing power of those returns improved as inflation fell for the second straight year (to just 1.2%) and the US dollar index rose (by 12%) to its highest level in nearly a decade. At the same time, domestic economic growth accelerated meaningfully over the summer and fall, with the economy currently expanding at its fastest pace since 2003.

And now, like the proverbial cherry on top of the whipped cream on top of the ice cream sundae, a stunning 45% drop in oil prices is providing consumers with the equivalent of a $200 billion tax cut at a time when spending was already rising.

The stage is therefore set for earnings to be propelled forward in 2015 on the back of economic strength, not just cost-cutting. Readers of *Consilium* are well aware of our view that meaningful additional stock market gains almost certainly require stronger earnings at this point, as stock valuations have risen to levels that suggest limited upside. For now, relatively weak economies overseas and a strong dollar will keep long term interest rates, which are determined in the global market, from rising meaningfully even as the Federal Reserve begins to lift short term interest rates sometime this year. As a result, valuations need not decline as so often happens when growth accelerates. It would be fair to call this environment something of a “sweet spot” for equity investors – optimism is justifiable based on fundamentals, interest rates pose no immediate threat, and few other markets appear to offer competitive potential returns.

There are risks to this benign outlook, and the most significant of them appear to be geopolitical:

- Even weaker economies and currencies lead to political and financial market chaos in hotspots like Russia;
- Low oil prices further damage and destabilize energy-dependent economies in the Middle East and Latin America, causing social unrest;
- Cyber terrorists train their sights on larger targets than Sony Pictures, hacking into and disrupting critical US industries, financial systems and infrastructure.

Any one of these could prove unsettling and lead to a return-sapping drop in investor confidence.

Sources: Baseline, Ibbotson Associates, The Wall Street Journal

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But there are upside risks as well. Investors frequently are surprised by how long a trend can continue once it is well-established – we have seen interest rates, commodity prices, and other key financial market inputs move well beyond levels that were deemed "fair" at the time. The same is true for stock market valuations. The price/earnings multiple for the S&P 500 Index has risen meaningfully in the last three years, from 12 times estimated earnings in mid-2011 to roughly 18 times today. Although this is above its historical average (16 times), a plausible argument can be made that our ultra-low interest rates and inflation allow for even higher multiples. While this is not our forecast, we are open-minded to the possibility that strong earnings growth could be amplified by higher valuations to create potentially significant stock market returns in the year ahead.

The financial markets are rarely boring, and we expect 2015 to be as interesting as ever.

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On behalf of everyone at Mid-Continent Capital, we would like to thank our clients and readers of *Consilium* for their support, and we offer our best wishes to everyone for a healthy and prosperous 2015.

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