MID-CONTINENT CAPITAL

CONSILIUM*

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*advice; judgment; resolution; wisdom

A Very Cloudy Crystal Ball

Investors may look back on 2015 with a feeling of melancholy over "what might have been". Entering the year, conditions were good for further gains in stocks. A stronger economy, led by consumer spending, would propel earnings growth. Interest rates likely would remain low and stable even if the Federal Reserve finally began to lift short-term rates. Valuations, while above average, were not high enough to warrant significant concern. And although the strong dollar posed a headwind for export-oriented manufacturers, low oil prices seemed just as likely to provide an offsetting stimulant to domestic spending.

At mid-year, events were adhering fairly closely to this script. But the 12.3% drop in the S&P 500 index from its July highs to its late August lows, followed by a rebound that began strongly but faded in November and December, left the market with a frustratingly small return of 1.4% for the year. Most investors fared worse than this, as just five stocks (Google, Amazon, Microsoft, GE, and Facebook) accounted for well over 100% of the market's gains; collectively, the other 495 stocks generated negative returns.

We would like to highlight two major events this year, one of which had a large market impact, and another whose market impact probably has not yet been completely felt. The first was the totally unexpected 40% plunge in oil prices since June (following a 45% drop over the preceding 12 months), which had significant spillover effects across numerous markets – especially high yield corporate bonds. Investors have worried whether contagion might take hold, as lenders with significant exposure to energy might reduce the flow of credit to other sectors. Already we have seen that yields on corporate bonds issued by industrial and technology companies have been pulled higher, and that financial conditions overall have tightened in the wake of the energy sector debacle.

The other significant event was the Federal Reserve's first increase in short term interest rates in nine years. The Fed had been warning of this move since 2013; unlike the oil price drop, it was completely expected. But it bears repeating that no one truly knows how the economy and markets ultimately will respond. Old "playbooks" may not be useful when interest rates have never been held at zero for more than seven years. Interest rate hikes have never been implemented with economic data as mixed as it is today. The most likely outcome is that it is a non-event, but this is far from assured.

The optimistic case for equities in the year ahead is remarkably similar to the one from a year ago: a decent-but-not-great consumer-driven economy, with manageable (if not negligible) interest rate and valuation headwinds. A better European economy (of which, some signs are emerging), accompanied by a more stable US dollar, could provide an upside surprise. But an economy with less forward momentum has greater vulnerability to unpredictable external shocks. Any further weakening of earnings growth, for whatever reason, would be a very unwelcome development, and we will be monitoring company-issued earnings guidance very closely over the next six weeks.

Sources: Baseline, FactSet, Wall Street Journal, Ibbotson Associates

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We cannot close this issue of *Consilium* without touching on the "800-pound gorilla" of external influences on the markets: the 2016 election. Presidential election years tend to be good for stocks: since 1928, market returns have been positive in 18 of 22 instances. Two of the losing episodes occurred during the Great Depression. The other two (2000 and 2008) occurred when a president in his second term could not run for reelection and – coincidentally – a lengthy economic expansion was ending. Whoever is elected, the new administration will pursue different policy goals than those in place for the last eight years. Unfortunately for investors, the first instinct of every new president for the last half-century has been to make major adjustments to fiscal policy and the tax code, and there is no reason to believe this time will be different. At this early stage, it is impossible to say how the markets may react, except to note that investors generally prefer predictability over change, and the latter is inevitable.

"Predictions are difficult, especially about the future", according to a Danish proverb (or Nostradamus, or Yogi Berra). We'll amend that old saying by noting that it is harder than normal, as we enter 2016, to defend a strong opinion about the year-ahead outlook. It is important to remain vigilant and open to a range of possibilities. As always, the unanticipated will be the biggest factor in next year's results.

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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 2016.