



2015

Another Good Market Year or Time for Correction?

The US stock market has enjoyed an uninterrupted advance from the Spring of 2009 up through 2014. This bull market has already exceeded the average length of bull markets since 1871 which is 67 months. Does this fact dictate that investors should assume a defensive posture or are there other factors that should be considered?

Of course there are other factors, and the key to success is to identify them and then prioritize them as to which ones will have the greatest impact on determining the direction of the market in 2015.

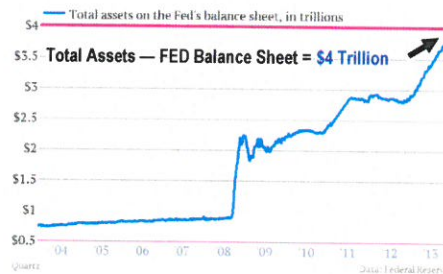
Price/Earnings Ratio

Let's begin the identification process with relative valuation of the stock market expressed as the Price/Earnings ratio or P/E. The current P/E ratio is about 19.37; that means that the S&P 500 index is trading about 19.37 times what the companies included in the index are earning. Historically, this is in the upper range of fully valued but not in the over-valued range and well below the extremely over-valued range. The extremely overvalued range – at 27 to 28 times earnings – is where bear markets typically begin. So for now, we can put the P/E ratio in the cautionary area but not in the imminent danger zone.

Quantitative Easing (QE)

The biggest factor that has impacted the direction of the market over the last five years has been the actions of the Federal Reserve (FED). Their policy called Quantitative Easing (QE) [i.e. creating enormous amounts of money] offi-

cially ended in October 2014. During the preceding five years, the FED created about \$3 trillion in their attempt to use all of the tricks in the playbook of the central bankers to rescue the US economy. A substantial amount of the gains in the US stock market can be attributed to the FED policy and not the US economy which has had a sluggish rate of growth when compared to the stock market. The economy unquestionably benefitted from the FED's activities, but it never received the full benefit of all that



money creation because much of the money went into financial assets instead of entering the "real economy".

Why didn't the bulk of the QE money reach the "real economy"? Basically, there were two reasons why it did not:

- First, the sheer amount of money created was more than the economy could absorb.
- Second, and probably most significant, were the governmental policies that placed many restrictions and additional regulations on businesses that then caused them to be reluctant to expand.

So what happens now since the FED has ended QE and is about to begin raising short-term interest

rates? The ending of QE should not be too significant because there is already an abundance of liquidity (money) in the system. Nor should beginning to raise interest rates in 2015 prove to be too problematical for the market. Janet Yellen (FED Chairperson) has stated that the increases would be very gradual and would be dependent upon economic conditions. However, post 2015, the FED is likely to be raising interest rates more aggressively while trying to engineer a "soft landing." This is when the market will face strong headwinds. (A "soft landing" means taking the extra money out of the system that it put in with QE without destroying the economy and the market)

Condition of US Economy

The actual condition of the US economy is another factor that impacts the direction of the market. At this point this is positive. The recovery coming off of the impact of the "Great Recession" has been sluggish unlike previous recoveries from recessions which are generally rapid and robust. This recovery could be labeled a "soft takeoff" in contrast to the FED's desire for a "soft landing" when unwinding the QE.

The benefit of the sluggishness over the last five years is the fact that the recovery has been extended. Typically, after a lengthy recovery, the economy would begin to overheat and be in danger of slowing down, but since the economy has had an anemic recovery, it is actually strengthening instead of slowing down. If the economy does continue to strengthen as has been predicted, then the E or earnings part of P/E

will grow and be able to support a larger price, which is the price of stocks, and will be positive for the market.

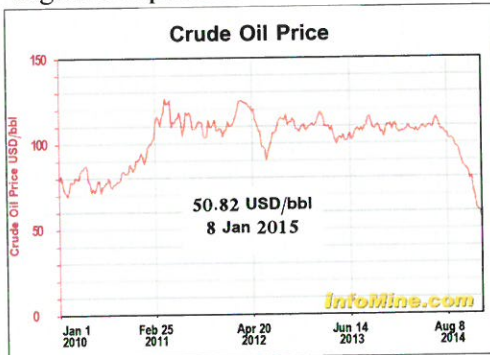
Worldwide Economies

Another factor supporting the US stock market in 2015 is the point that, unlike the US, the other major economies around the world are under varying degrees of stress. The European Union (EU) is teetering on the brink of recession. Japan is desperately trying to come out of a decades-long decline and here are signs that indicate that they are not succeeding. China's economy is slowing down to a greater degree than anticipated, and many oil exporting nations are having great difficulty because of the decline in oil prices. These worldwide circumstances have caused global investors to send an increasing amount of their capital to the US. This capital is supportive of stock prices.

Declining Price of Oil

The rapidly declining price of oil is a factor that is mostly positive but not entirely so. Cheaper energy prices put more money in the hands of the consumer. Consumer spending makes up about 70% of the US economy and is a very good thing. However, a significant amount of the good (high paying) jobs created in the last five years have been in the energy sector. If oil prices decline further and remain low for an extended period of time, US oil producers will

begin to cut back and lay people off. Overall, there is no argument that low oil prices are not beneficial, but it is important to realize that there are some negative impacts as well.



Worldwide QE Policies

Worldwide QE policies is another factor that is currently having a large effect on stock prices and in 2015 is likely to have even more influence. When money is created in the European Union, Japan, or China, it impacts markets and investments all around the world just as when the FED was implementing QE it affected all financial markets. Currencies are liquid investments and, like water, will not stay in one place. Therefore, the money created in these other countries will impact US markets and will have an effect similar to the FED extending the QE program only on a smaller scale. Ironically, a by-product of all of this QE is lower interest rates in the US as well as around the world which is contrary to what the FED is presently trying to do.

Interest rates are so low in Germany (around .5% for their 10-year bond) and Japan (less than .4% for their 10-year bond), it puts downward pressure on US rates (US 10-year bond had been as high as 3% last year and is now around 2%).

Political Landscape

Another market-impacting factor may be the changing political landscape due to the election last November. The market impact of this change is hard to determine because it is not possible to know how the Administration and the Congress will resolve their differences. Generally, the market likes split government (gridlock) because very little is accomplished. This is usually viewed as favorable because most government action involves tax increases or new regulations, neither of which is good for business. This factor will have to be watched and evaluated before a plan of action can be determined.

Bottom Line

The bottom line is that the positive factors of more money creation (international QE) and an improving US economy should outweigh the negatives and produce a positive 2015. However, because the market is pretty much fully valued, it is likely that there will be increased volatility. This type of economic scenario generally favors good management and stock selection over index type investing.

Outlook

The year 2014 was a good year for the US markets and not as good for international investments. International diversification did not produce results as good as those for a US-Only portfolio. Most likely, 2015 will be different since many foreign markets underperformed and are not fully valued as is the US. When the other nations fully implement their QE programs it is probable that the foreign markets will benefit more than the US will. However, the US still has the strongest economy. Therefore, a diversi-

fied approach is the way that we intend to proceed. We expect a positive year based on the factors that were discussed; however, it is not likely to be a strong up year as it could be volatile throughout the year.

As is always the case, unforeseen global events could dramatically change the picture and, consequently, alter anticipated market performance.

We wish all readers of this newsletter a happy and prosperous 2015!

Terry E. Nager is a CFP®, CLU®, and ChFC®. He is also the President of Southern Capital Services, Inc. — a registered investment adviser. The information presented by the author and the publisher is for informational and educational purposes only. It should not be considered specific investment advice, does not take into consideration your specific situation, and does not intend to make an offer or solicitation for the sale or purchase of any securities or investment strategies. Additionally, no legal or tax advice is being offered. If legal or tax advice is needed, a qualified professional should be engaged. Investments involve risk and are not guaranteed. This newsletter contains information that might be dated and is intended only to educate and entertain. Any links or websites referred to are for informational purposes only. Website not associated with the author are unaffiliated sources of information and the author takes no responsibility for the accuracy of the information provided by these websites. Be sure to consult a qualified financial adviser and/or tax professional before implementing any strategy discussed herein.