FirstPoint Financial

WEEKLY MARKET THOUGHTS

December 23, 2014

2015 – Smoke from a Distant Fire

Over the next three weeks, we will release our 2015 outlook for the global economy and capital markets. As most know, I enjoy utilizing themes in my work – themes tend to keep me on track and, in the future, remind me of what I said in the past. Themes help keep me accountable.

Our overall economic/capital market theme from last year was “The Long, Hard Slog - Rounding Third and Heading Towards Home.” In that piece, we forecasted:

- U.S. economic growth (GDP) was going to remain lower than the historical average.
  - Result: While the numbers are still out, it appears overall GDP growth should come in at around 2.2 percent for 2014, as compared to the long-term average growth of 3.2 percent.
- We forecasted the GDP growth would wind up at 3 percent for 2014.
  - Result: It appears we were too optimistic as GDP growth will probably be in the 2.2 percent range.
- We also forecasted that the European economy would grow .7 percent.
  - Result: It appears we were “spot on” in our outlook. The European GDP grew in the range of .5 percent.
- Regarding our stock market outlook for 2014, in December of 2013, I wrote: “We believe the world’s economies and subsequent capital markets are ‘rounding third and heading towards home.’ 2014 should prove a profitable year for global investors as we believe the markets will become more selective as the year unfolds.”
  - Result: Another year where the U.S. equity market led the world’s major indexes in total return. As of this writing, on a year-to-date basis, the S&P 500 is up 14 percent, while foreign equity markets, as measured by the EAFE index, are up 2 percent on a dollar-adjusted basis.

We made some good calls and had others that missed the mark. What about 2015? We suspect economic and socio-political risks in the world primarily reside overseas. Europe can’t seem to get out of their own way regarding economic growth. China’s economic growth rate should continue to contract. Japan’s growth rate, while higher than we have seen, should still be very anemic. On top of that, the world is facing another variable – lower oil prices – which (assuming prices stay low) should be a net positive to overall global growth long-term. Currently, the lower oil prices are acting as an agent of political and economic disruption. So, “Smoke From a Distant

Fire" is an appropriate metaphor to describe our outlook for 2015.

At the very least, we suspect 2015 will be an interesting year for the financial markets. Our best guess is that the markets generate another positive return in 2015, surrounded by a higher-than-normal level of price volatility.

Details of our economic outlook follow:

Global Economic Highlights

- From a global perspective, in 2015 we expect economic growth to accelerate slightly from the anemic growth of 2014. While the global economic growth rate will still be lower than has historically (on average) been the case, we expect global economic growth of 3.4 percent to eclipse 2014's 3 percent growth rate.

- The "developed" world should show a slight degree of growth acceleration in 2015 (1.9 percent vs. 1.6 percent) led by growth improvement in the United States. The real-growth fireworks continue to reside in the emerging economic space. Led by Asia's emerging economies, expect to see GDP to expand by 5.4 percent for the less-developed portion of the world.

- A monetary "baton" is being passed from the U.S. Federal Reserve and the U.K. Bank of England towards the ECB (European Central Bank) and the BOJ (Bank of Japan). We believe both the United States and the United Kingdom will start to move short-term interest rates upwards during 2015, while the ECB and the BOJ should strengthen Quantitative Easing programs, bringing attention to their markets and currencies.

- In this environment of rather subdued growth, global excess capacity is present. Inflation pressures should remain benign. Due to a slow marginal demand growth profile and excess capacity, commodity prices shouldn't see a major upward push. Globally, inflation is expected to remain in the 3.6 percent range – roughly the same level as 2014.

- Oil prices have declined significantly. We expect oil to trade in a broad range of $40 - $70 per barrel for the foreseeable future, as compared to the $80 - $110 per barrel range in which oil has traded over the last four years. The production of oil (lifting prices) has become technologically driven. Over the long-term, we expect lifting prices will continue to decline, leading to a lower overall trading range for oil.

- Europe is not out of the woods on their banking/sovereign debt problems. The probability of a renewed banking/bond market crisis occurring in Europe is on the rise.

- Major economic regions of the world remain at risk because growth in these areas is mired in the low-growth muck.

- During much of 2015, Europe will flirt with recession. Much of the world's economic power has stalled and is near recession (Europe, Russia, Argentina, and Japan). Adding in our expectation that China's economy will continue its growth deceleration, leads us to the conclusion that more than 37 percent of the world's economic growth engine is either stalling or slowing.

- We will see if "Smoke From A Distant Fire" has the power to negatively affect the rest of the world's economic environment.

U.S Economic Outlook

1. It appears the scene is set for U.S. economic growth to accelerate during 2015. We are targeting overall "real" GDP growth of 2.8 percent for the upcoming year, compared to 2.2 percent growth in 2014.
2. Overall consumption growth should be the main driver behind the expected acceleration in economic activity.
3. Overall consumer net worth increased by approximately 13.4 percent and 8 percent in 2014. These increases in consumer balance sheet strength are leading to higher discretionary consumption levels on the higher end of the income spectrum.
4. With the significant decline in oil prices, national gasoline prices have fallen in excess of 30 percent from their highs earlier in 2014. Additionally, gains within the labor market (lower unemployment) have moved consumer sentiment to the upside, which signals higher consumer discretionary spending. We expect consumer spending to rise by 3.2 percent in 2015 following consumption gains of 2.2 percent in 2014.
5. We expect housing to rise by more than 10 percent in 2015 from the pace set in 2014, adding .3 percent to overall GDP growth.
6. Business capital spending was rising by an annualized rate of more than 6 percent during the first three quarters of 2014.
7. Due to falling oil prices, we expect the growth rate in business capital spending to slow to 5 percent for all of 2015. The energy segment of the economy represents 10 percent of the capitalization of the S&P 500 Index, while representing 30 percent of capital spending of companies within the index. By the end of 2015, capital spending growth may contract to the 4 percent annualized rate, as the projected slowdown in capital spending in the U.S. oil patch should gain momentum.
8. Employment trends have been encouraging. The official unemployment rate has fallen below our estimate. We expect further improvement in unemployment through the year and are targeting unemployment in the 5.5 percent range by the end of 2015.
9. The global economy has been struggling for the last few years with deflationary pressures. While still very subdued, we expect inflation to rise in 2015 to 2.5 percent.
10. The Federal Reserve has made it somewhat clear their bias this year is to push short-term interest rates upwards, depending on data regarding the employment base and inflationary pressures. Our expectation holds that the Fed will raise short-term interest rates in 2015 – for the first time in more than eight years.
11. The positive bias of business and consumption activities should lead to rising corporate earnings in 2015, aiding positive equity market movement.

We wind up this piece, wishing all a happy holiday season. Be safe and enjoy this time of year – we will be back next week with our capital market outlook for 2015.

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