FirstPoint Financial

WEEKLY MARKET THOUGHTS

December 1, 2014

Oil Prices and Short Term Market Thoughts

Decline Turned Into Collapse?

Public investment markets are inherently volatile. Oil prices have been declining since June 7th when West Texas Intermediate was selling at $107 per barrel. Last week, the same barrel of oil was selling at $66, reflecting an over-supply of oil on the world market, which has driven oil prices lower. Last Thursday, OPEC decided not to cut production, confounding expectations. Oil prices declined by 10% following the decision.

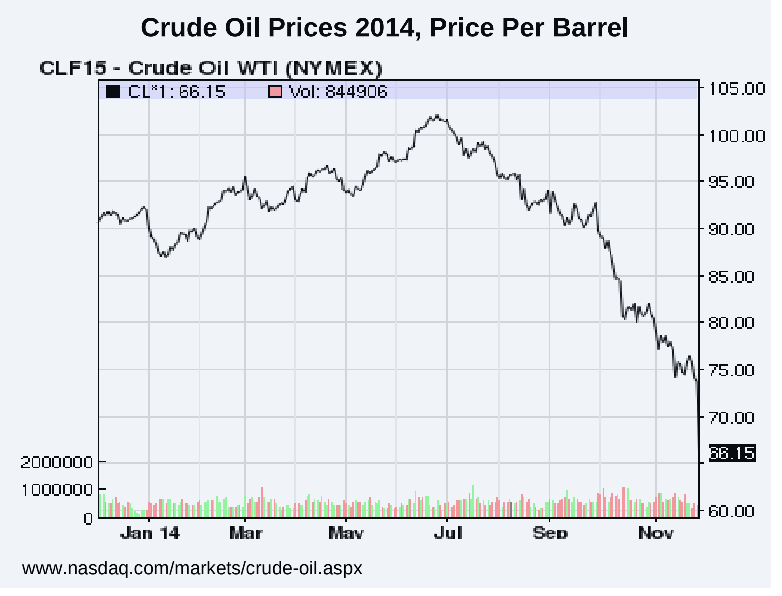
We have been consistently stating our view that oil price weakness is a function of excess supply, rather than a problem with demand (recession, for example). It is true that much of the developed world is struggling with growth and the emerging economy's growth profile is contracting. However, global GDP is still growing and demand for oil is still rising – just not as rapidly as supply. Regarding the volatility of oil prices, I would rather deal with a supply issue than a lack of demand issue. Why? Oil supplies (production) can be cut fairly quickly. An oil price decline driven by a falling level of demand takes an economic contraction to fix. ***Oil prices fell on Friday of last week by 10% due to the fact that OPEC didn't blink, as the market expected them to by announcing a supply cut.***

From an economic standpoint, ***the oil price decline is a mixed blessing.*** While oil prices have declined by 38%, gasoline prices have declined by 34% over the same period of time. ***The decline in gasoline prices by 34% acts as a cut for most consumers, as the amount they spend on gasoline has declined significantly.*** The average American family spends 4% of their monthly budget on gasoline. If gasoline prices stay at these levels over the next 12 months, ***the 34% decline in gasoline prices will act as a direct stimulus to consumer discretionary spending, at the annualized level of $152 billion dollars or 0.92% of GDP.***

However, there is a downside to lower oil prices the U.S. economy will have to absorb, if oil prices remain at $66 per barrel, instead of the old highs of $107 per barrel. A key driver to economic growth over the last few years has been capital spending within the new "oil patch" in the U.S. Domestic oil production has soared in the U.S. over the last few years to 9.9 million barrels per day, satisfying more than 50% of our daily demand for the slippery stuff. Oil imports have declined rather dramatically***. OPEC's decision not to cut production appears to be an attempt to drive prices lower until domestic U.S. oil production is cut.***

The new drilling in the U.S., driven by newer technologies and fracking practices, has widely varying costs of production. Much of the production in North Dakota (in the Bakken formation) can remain profitable at $50 per barrel. In Texas, the Eagle Ford formation also supports low costs. That being said, U.S. oilfield production has fallen by 500,000 barrels per day from Sept. 12th to

November 14th, according to data from Ed Yardeni. This is how oversupplied markets generally work – production cuts eventually provide a downside floor to prices. In the interim period, from a macro-economic standpoint, oil production cuts hurt U.S. capital spending.



Declining oil prices help most of the developed world. Japan, Europe and the majority of the emerging economies are net oil importers. If oil prices remain at their current levels for a reasonable period of time, overall global economic growth should benefit by 0.5% - 0.6%. So, while most of the world benefits by falling oil prices, oil producers suffer.

The combination of lower supplies and higher demand will eventually lift oil prices. Expect this to occur sometime during the first half of 2015.

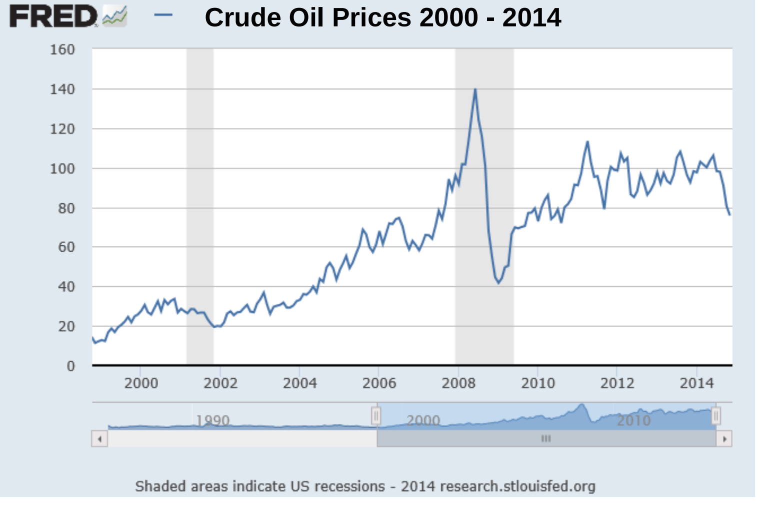
Longer-Term Perspective

The current oil price decline is making headlines, and for good reason. However, ***it is productive to keep a long-term perspective regarding oil prices.*** The chart below is instructive. Oil prices bottomed in 1997 at $11 per barrel. Even with the declines we have recently seen, ***oil prices are still more than 500% higher than they were 17 years ago.*** While the world has become much more energy-efficient than in the past, we have not yet found a reasonable replacement for oil.

In the past, oil price declines have usually been associated with an economic recession – when demand for oil contracts. ***The current price decline has been driven by an increase in supply and a slowing in the growth rate of demand. The most probable outcome is for oil production to continue falling until prices firm. Eventually, oil prices should start rising again***.

Short-Term Equity Market Considerations

I consistently urged investors to remain fully invested throughout the period of volatility we experienced in October. Now that the market has rebounded from the October swoon and is setting new highs, I am receiving questions as to what to do. Put more cash to work? Wait for a pullback in prices? Sell existing shares?



While I don't "know" where stock prices will move over the short term, through the process of the collection of relevant evidence, I can provide guidance as to the current internal market indicators. Timing the market is next to impossible. However, from my analysis of the evidence, I believe we may see another upward push in stock market valuation.

Weight of the Evidence – GDP Growth

It appears ***the U.S. economy is experiencing an upward shift in overall growth***. Revised 3rd quarter GDP growth came out this past week at +3.9% vs the +3.5% growth previously-released. Overall economic growth has been +2.5% on a trailing-12 month basis, as compared to +2.2% over the previous 12-month period (this includes the weather-related slowdown in the first quarter of year when GDP shrank by -2.1%).

The revised ***GDP growth rate includes strength in the all-important personal consumption expenditures***, just in time for the holiday spending season. The University of Michigan Consumer Sentiment Index has risen, and is now at a level that, ***historically, has corresponded with a GDP growth rate of 4.6% vs. the current 2.5% trailing 12-month reading***. Additionally, the small-business sentiment index has continued to improve to 95, a new post-recession high.

Market Seasonality

To put a little "jazz" in the conversation, I would like to address calendar ***effects and oddities within historical market movements***.

Sell in May and Go Away:

(or, Buy in the Fall and Have a Ball) One of the more powerful and consistent seasonal oddities of stock market movement is the "Sell in May" concept. This concept is simple: An investor buys the Dow Jones Average (which is impossible, as an investor cannot invest directly in an index, but bear with me) on the first trading day in November and sells those positions on the last trading day in April. If an investor had followed this simple concept, an ***initial investment of $100,000 invested in November of each year, staring in 1950, would have generated a net worth of $816,894*** as of April 30th, 2014. With this strategy, the investor would have made money 78% of the time. However, if the investor was so ***hapless to buy the Dow Jones average on May 1st of each year and sold the investments on the last trading day of the following October (starting in 1951), that investor's initial investment of $100,000 would have been worth $93,220 as of October 2013***. This investor would have made money 59% of the time.

Presidential Cycle:

The four-year Presidential stock market cycle coincides with the 4-year Presidential term. Since the end of WWII, there have been 17 Presidential cycles. By far the best year for stock market returns, on average, has been the pre-election year. Next year, of course, is a pre-election year. The historical data is rather stunning. The 1st year of the Presidential cycle has shown an average index gain (S&P 500) of 6.2% over the 17 cycles. The 2nd year (the year we are currently experiencing) has shown an average index gain of 6.4%. ***The third year (next year) has shown an average index gain of 17.1%.*** The fourth (election) year? An average index gain of 6.6%. In the ***17 observations of the Presidential Cycle since the end of WWII, 94% of the 3rd years were up years for the stock market.***

Mid-Term Election Cycle:

Since 1949 there have been 17 mid-term elections – 16 of which we know how the stock markets (as measured by the S&P 500 Index) performed during the following November – January timeframe. On a price only (not including dividends) basis, the S&P 500 has, on average, ***generated a return of 9.13% over the 3-month period from November to the following January in the 16 mid-term election years.*** 9.13%! That return isn't annualized – it is the average 3-month return. A normal or average 3-month return is 1.9%. What about consistency? Out of the 16 periods, 14 generated positive returns for a positive batting average of .875. Take that, Babe Ruth!

Like all good trends, there tends to be a reasonable level of logic to each of these oddities.

Historically, pension and profit sharing plans tend to fund their annual contribution during the November to December timeframe. Consequently, large institutional demand for various asset classes tends to rise towards the end of the year. In addition, many workers receive bonuses at the end of the year, which leads to increased investments during this period.

Bottom Line

Irrespective of your leaning – whether you are a fundamental or a trend investor – there is something to your liking in the current environment. ***We stand by our view that investors should use periods of price weakness to add to existing equity holdings.*** If the fundamental weight of the evidence changes, we will change our view. For the time being, we remain bullish on global equity markets.

We will be back next week.

William B. Greiner, CFA
Chief Investment Strategist

More Information

[FirstPoint Financial]
[FirstPoint TV]
[Market Insight]

P. S. Please feel free to forward this commentary to family, friends, or colleagues. If you would like us to add them to the list, please reply to this e-mail with their e-mail address and we will ask for their permission to be added.