April 17, 2015

Cheap Energy

Dear Investor:

Several themes have developed in the recent quarter. The first one I would like to discuss is the continued low energy prices. WTI (West Texas Intermediate) crude oil is currently trading around $56 a barrel and has dipped below $45 a barrel several times since my last letter. Producer price data have shown that low energy prices have kept a lid on wholesale prices, and thus the cost of production in many industries. This has played out as we expected. The surprise has been the fact that a good portion of the savings on gasoline have not been spent by consumers thus far. According to VISA, for every dollar saved on gas, 50% is being saved, 25% is being used to pay down debt, and 25% is being spent on other items. Other data on income and spending have confirmed that savings rates have risen for the last several months. Data from the Fed show that consumers have been deleveraging since 2008, and that trend is still in place. Consumers remain cautious concerning both spending and debt. Most economists believe more of this money will be spent in the months ahead, and a lag is not that unusual. Time will tell if this is the case.

I think the bigger issue with low energy prices is the cutbacks in the energy industry and the impact on S&P 500 earnings. Some analysts have estimated that energy profits could fall by as much as 60% in the first quarter. Companies large and small have announced big cutbacks in their capital expenditures going forward. The Commerce Dept. recently announced a large decline in orders for equipment used in the oil and gas industry. The Baker Hughes Rig Count[1] shows that active rigs have dropped by almost 50% since the summer of 2014. These actions will help to bring supply in line eventually, but it also means a lot of workers have been laid off and many related businesses are affected up and down the supply chain. This has definitely contributed to the fact that the market did not make much headway in the first quarter of the year. You may have noticed that the market did better on days when the price of oil was rising. This seems almost backwards, but it shows you how far reaching this concern is. A lot of economic activity has come from the fracking boom, and right now that activity is slowing down significantly. There have been some signs that oil may have bottomed, but there's really no way we can know for sure at this time. Big players like Boone Pickens believe the oil market will be much higher within a year, as he states that the industry cannot operate on prices this low.

Another big theme has been the strong dollar. If the strong dollar is good or bad depends on your position in the economy. There's really no certain answer to the question as it affects different groups in different ways. My personal preference is for a strong dollar. A number of factors have led to a strengthening dollar over the last few years. The most obvious one is the US economy is clearly outperforming the other major economies of the world right now. Another is our long term interest rates are much higher, and there's a good chance our short term rates will be increasing sometime this

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year. The shale energy boom is also having a significant effect on reducing the trade deficit as we import much less oil. This is also positive for the GDP and the dollar. The strong dollar has had an impact on earnings of US multinational companies. Approximately 30% of US firms in the SP500 get more than half their revenue from outside the US. As I'm reading company reports, it's common to see that revenues and earnings have been reduced due to currency headwinds. A recent example is Coke (KO). Argus Research, one of our partners, states that Coke's Q4 2014 revenues were reduced by 4% due to currency exchange. For 2015 they expect their revenues to be reduced by 5% and their operating income by 7% -8%. These are significant amounts, and this puts pressure on the value of the shares. As this effect is multiplied across the SP500, you can see that it becomes a headwind to the market advancing.

Likely the most important story of all is the continuing saga of the Federal Reserve and their plans to begin normalizing interest rates. The last rate cut was in December 2008, so we've been at the "zero bound" for over 6 years now. That's a long time. The Fed has made it clear that any meeting after the April meeting later this month is "live" and a rate hike is possible. They are working to balance several major competing issues. On one hand we have a strengthening economy and strong job gains. On the other hand, we have concern that inflation has been below target for the last few years, and there are still many people who are underemployed and would like better jobs. There are risks with either course of action. If they raise rates too soon, it could damage the recovery by causing a slowdown. This would undo a lot of the progress and could risk bringing us into disinflation or even deflation. That would be a very bad scenario. If they wait too long to begin to normalize rates, inflation could begin to build and the Fed could find themselves behind the curve. They would then have to raise rates at an uncomfortably fast pace in an attempt to gain control. Being late could also lead to asset bubbles, as it's commonly agreed that very easy money tends to inflate asset values beyond their true worth. We've mentioned this valuation issue in the past. They have stated repeatedly that their decision will depend on the flow of incoming data and I believe them. We know they are close to moving. Recent data has been soft and that may delay things awhile longer. We had our second very harsh winter in a row, and the Q1 GDP will likely be very low. I expect things to pick up again as they did last year. If they do, I think we can expect a small increase in rates by the end of 2015. Although there may be a market reaction at first, I think we need to focus on the positive aspects of the economy. There was tremendous anxiety over the taper, and we got through that with no problem. I do think this will be similar. We also know that the Fed's intention is that rate increases would be very slow and gradual. As long as they are able to stick with that game plan, things should work out alright. Modestly higher rates should not stop the recovery or the companies we own from being profitable.

I hope all is well with your family since the last time we talked. Please feel free to contact me anytime to discuss your portfolio.

Best regards

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