Financial Wanderings

December 2014

A masterful examination of the previous month's financial events, written by Brad Blackburn, CFP ®
(and made even awesomer by Andrea Dickerson)

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2014 Market Numbers:

S&P 500: +11.4% to 2,059

NASDAQ: +13.4% to 4,763

DJIA: +7.5% to 17,823

10-Year Treasury Yield: -28.6% to 2.17%

Gold: -1.5% to $1,184/oz

Although the commentary in this newsletter has been thoroughly researched, well-reasoned and contains many impressive multi-syllabled words, please enjoy it responsibly. There are many economic minds that are far smarter than mine—and even they can't agree on even the simplest economic questions. In other words, please enjoy this newsletter with the full understanding that it may be entirely wrong.

2014 - The Year in Review

As we look back on 2014, I think it's helpful to recall 2013, which I dubbed *"The Ugliest Pretty Year in Stock Market History*." The stock market boomed, but the economy was sluggish, and our politicians spent their time accomplishing lots of "big things" (The Fiscal Cliff, the Sequester, a government shutdown…).

With that as the backdrop, I courageously made the following prediction about 2014:

"The only way this strong run in the stock market can continue is if the economy charges forward. I don't want to jinx it, but that is starting to look like a real possibility. After somehow managing to limp through everything 2013 threw at it, the economy seems poised for a jump… However, even if the economy picks up speed, it's hard to imagine we are headed for another year in the stock market like 2013…"

I don't mean to brag (of course I do), but that's a pretty solid prediction. I must be pretty good at wildly guessing the future. It did turn out to be a good year for our economy, and a decent year for stocks. The other major financial themes of the year were the weak global economy, interest rates falling even more, and the sharp drop in the price of oil.

After a lackluster first quarter, our GDP grew 4.2% in the second quarter and 5% in the third quarter. That's the best 6-month period we've seen since 2003. The job market was impressive in 2014 too: Our economy averaged nearly 225,000 jobs added per month (anything over 200,000 is considered strong). Job growth has been remarkably consistent: According to Forbes, this is the longest stretch of 200,000 or more jobs added a month since 1995. There are still some "warts" on the job market (low participation rate and weak wage growth), but strong, consistent growth like we've seen is a great way to finally clear those up.

Unfortunately, the global economy isn't doing nearly as well. Let's start with China, which recently passed America as the largest economy in the world (gulp).

(Cont'd on Page 2)

(2014 - The Year in Review……Cont'd from page 1)

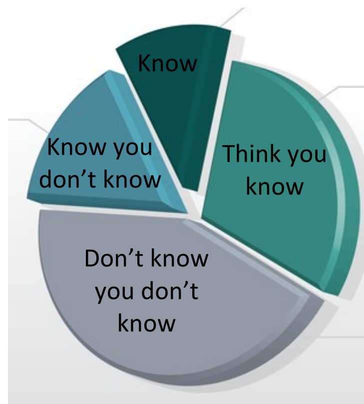
Even China's "official" numbers show they are slowing down significantly. But what if their official numbers are a bunch of Kung Pao Hooey™? (Trademark: Blackburn Financial)

As worrisome as China is, Europe would trade places with China every day of the week, and twice on days they could get Vladimir Putin to go away quietly. The European economy was already struggling – and then Russia pounded some vodka and started a fight in Ukraine. Between the resulting economic sanctions and the falling price of oil (which some would say IS a deliberate sanction), Russia is now engulfed in a legitimate economic crisis. Russia is a big deal all by itself, but the Russian crisis will also have a major impact on Europe. If Russia's response to their crisis is to pound even more vodka and start even more fights, the European economy will be in trouble. Thankfully, I think we can trust Vladimir Putin. He seems nice.

2014 was also *"The Year of the Tapering,"* as the Fed slowly ended their QE program. The end of QE prompted me to write the following ill-fated words:

"It's also good that interest rates are likely on a long-term upswing. That's the mark of a strong economy."

If interest rates are on "a long-term upswing," it sure hasn't happened yet. It makes me feel better that I wasn't alone in my incompetence. In May, a Bloomberg poll of economists found that every single one of them believed rates would rise over the following 6-months. It's been six months… and rates have fallen even more. This is just the most recent example that no one really knows anything.



That's the perfect segue to the following question: What's going to happen in 2015? I worry about Russia, Europe and China. I also worry that the stock market isn't cheap anymore. We might be pushing ever-so-slightly into "bubble" territory. For years, I've argued against using the "B" word, but the stock market just keeps moving higher and higher. Every step makes a bubble more likely.

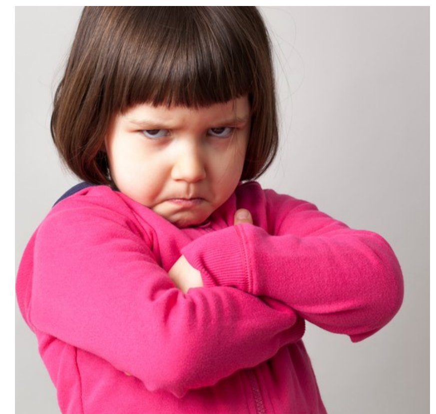
Even if there is a bubble, that doesn't mean it's about to burst in spectacular fashion. It might slowly deflate, it might keep growing for years, or I might be completely wrong. But given that stocks are up more than 40% over the last two years, and the global economy is a mess, my official 2015 prediction for the markets is this: Zero. I expect a year of pushing, pulling, and grinding our way to the same place we are now.

Who won the "Predict the Performance of the S&P 500 in 2014" contest?

In my December 2013 newsletter, I challenged my readers to predict the performance of the S&P 500 in 2014. At the time, you might have thought to yourself: *"Ummm… Aren't most of Brad's readers people who hired him precisely because they don't want to think about the S&P 500? No one is going to take him up on that stupid contest."* But that would be wrong. After issuing the challenge, I was quickly inundated with predictions. In fact, I ended up with 503 (the margin of error is +/- 500).

Had the year ended on December 17th, my prediction of a 7.5% gain would have looked brilliant. But over the last two weeks of the year, the S&P 500 grew nearly 5%. All those wonderful gains for my clients really ticked me off. I've never been so angry about the market going up.

Despite the misleading title of this article, I'm not going to actually name the winner. That's for confidentiality reasons, and also because I don't want everyone to know how much smarter she is than me. There will be no contest in 2015. I don't want to play anymore.



Will 2015 be like 2011?

As I sat quietly with my crystal ball and pondered the fortunes of the stock market in 2015, I slowly came to the following realization: 2015 might look a lot like 2011. Remember 2011? We had a slowly improving economy, an upcoming presidential election, an international crisis that threatened the global economy (the PIIGS European crisis), and in the year before, the S&P 500 gained 12.5%.

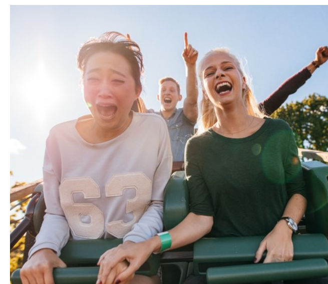
The similarities are notable: Like 2011, there's a presidential election next year. It's also easy to imagine an international crisis causing waves in the markets (Russia, ISIS, Greece, North Korea, Iran…) – and the S&P 500 grew 11.5% in 2014 (which is close enough to be noteworthy). The biggest difference is that our economy now is much stronger than it was in 2011. However, the global economy is really struggling. 2015 will likely be a tug-of-war between the global economy and the US economy. If we can pull the world up, 2015 might be another great year. But what if the world pulls us down? I believe the economy will stay fairly strong, but the markets have serious headwinds to fight through.

If 2015 really does resemble 2011, what do we have to look forward to?

Here's how I described 2011 at the time:

"I struggled mightily to come up with the right metaphor for the stock market in 2011. We experienced all kinds of drama, stress and suspense – yet made very little headway. Should I have gone with a hamster on a wheel? A roller coaster? A dog chasing its tail? "

Roller coasters are fun, right? Have a great 2015!



What will the next bubble look like?

If it wasn't for the technology/dotcom bubble in the late 90's, I'd probably have a different career. The booming stock market brought in millions of new investors, so the demand for new financial advisors was high. Although I was an unproven recent college graduate, I was hired, trained, and thrown to the public. The bubble got me in the door – which means all my blissfully happy clients owe their happiness to a bubble.

So bubbles aren't all bad… but I really, really, really want to identify the next one before it pops. So let's look back on the last two bubbles to see what we can learn.

The tech bubble was caused by wildly optimistic projections about the internet. Given the amazing new technologies at play, no one really knew just how profitable tech companies might turn out to be. The market ended up pricing the stocks of exciting new companies on the idea that they'd all be extra-super profitable. When it turned out that many never made a buck, the bubble burst.

I don't think there's much risk of a repeat of the tech bubble, at least not soon. While technology is still changing rapidly, there's nothing quite as game-changing as the internet. Even more importantly, investors still remember the tech bubble. It'll take quite a few more years before we repeat that mistake again.

The bubble that led to the financial crisis was a little more complex. Low interest rates fueled a boom in debt, and that boom increased demand for real-estate, which led to a bubble. At the same time, giant financial institutions turned all those real-estate transactions into wildly complex "investments" like CMO's (collateralized mortgage obligations) and then borrowed billions of dollars to invest in them. The result was a real-estate bubble made much worse by how exposed our financial institutions were to that bubble.

So… Could something like that happen again? This one is more likely than another tech bubble, but I'm still not convinced. Our financial institutions haven't changed much, but they have changed. Further, there's been a small but significant culture shift. The general public isn't likely to start borrowing again like they did before the financial crisis.

So if a repeat of our last two bubbles isn't coming, what could be? My best bet is a Fed-fueled bubble in the economy. If the actions of the Fed helped our economy finally start to grow, what happens when the Fed has to cool the economy down? What if the "Fed-like Actions" of the Bank of Japan and the European Central Bank put the global economy into a bubble as well?

I'm not saying this is likely, but of all the bubble scenarios, this is the most worrisome. But I think the odds of this are low. The world is still on high alert for bubbles – I just can't imagine investors allowing another one to grow big enough to burst.

Probably a Mountain or a lake

As much as I enjoy winter, sometimes I want summer back. Here's a picture of a great moment from high above Cashmere.

I should probably stop dreaming of warmer times, and just enjoy what winter has to offer. Here's a picture from a similar vantage point.

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