Chapel Hill Investment Analysts, Inc.
Financial Planning • Investment Management

"Cup of Joe"

First and foremost, we at Chapel Hill hope all of our clients had a very Merry Christmas and a Happy New Year. Since the start of 2015 has been rather volatile, we wanted to provide insight into what may be causing the market to act like this. Several newsworthy events including plunging oil prices, the possibility of the ECB (European Central Bank) starting their own quantitative easing program and if and when the FED will raise rates.

Let's start with the Federal Reserve and interest rates. Janet Yellen, Federal Reserve Chairwoman, has stated that the FED is data-dependent on when they will raise rates. The employment rate has been steadily dropping, coming in around 5.6%, and the GDP is picking up - hitting 5% last quarter. These are both great improvements. Conversely, there are a couple sticking points that seem to be weighing on their decision. One being inflation, which hasn't been rising fast enough to attain the 2% target they have set. Energy prices dropping actually lowers inflation and makes the Fed less likely to move. The FED is also worried about wage growth. Our thoughts however are that inflation will pick up quickly once the economic boon hits from a substantial drop in gasoline prices as more people have extra money to spend. We are a consumer-driven economy and my guess is that when the people of the United States have extra money, we spend it! Wage growth in December missed estimates as well. We feel this is an outlier caused by many workers being hired in temporary service jobs to fill the holiday demand. If the January wage growth numbers come in better than expected, we feel the FED is still on pace to raise rates by June. If inflation stays low, it may happen later in the year, likely in the third quarter. If rates rise, expect some volatility but remember, they are rising because the economy is growing!

What is happening in Europe!? With the severe risk of deflation in Europe due in part by extremely high energy prices, many of the experts (including us) feel that the ECB will start buying sovereign bonds - essentially injecting money into their floundering economy. This is exactly what our Federal Reserve did 6 years ago and it worked. "Look where we are now." I'm not saying this is a cure-all for Europe's many structural problems, but we feel it will be quite the tailwind for what has been a very sluggish economy. This will most likely be announced in a week or so, which should provide hope for future global expansion.

Now, my dad's favorite topic of most of my adult life…OIL! Well, the rubber has finally met the road and oil has plummeted more than 50% in a very short timeframe. This is causing many economists and market experts to scratch their heads. Is this drop in oil an oversupply problem, a weakening demand problem, a way for the Saudi's to destroy the shale producers in the U.S. and Iran, or the U.S. dismantling Putin's quest to grab more countries like Ukraine? I personally feel it's a mixture of all of the above. First, I truly believe that the onslaught of green energy (electric cars, renewables) is making an impact on oil consumption. This would affect demand. I also believe the U.S. is now adding an incredible amount of oil onto the world's supply causing a huge glut. And finally, and most importantly, I believe that the U.S., in conjunction with the Saudi's, have waged an economic war with Russia, Venezuela, and Iran. There is no other reason for the Saudi's, who are so dependent on oil for 85% of their income, would want

the price of oil to drop to half of what they need to balance their budget. If you think back, the Saudi's were not happy with the U.S. for backing off on Iran's nuclear ambitions. Could they be in on this together? I think so. A last little caveat for my dad's sake, we believe as well that the big banks and commodity traders have dumped a huge amount of oil contracts back on the market due primarily because of impending commodity trading regulations that prevent the manipulation of prices. With this perfect storm of geopolitical and economic warfare, a huge onset of U.S. oil, and the commodity traders having the rug pulled out from under them, oil prices had nowhere to go but down.

So, isn't this supposed to be good for the economy??? YES, well kind of. It's a double-edged sword to some extent. When oil prices plummet, oil exporters are hurt, along with refiners, drillers, exploratory firms, etc. Companies who have large amounts of debt in the energy complex are hurt as well and risk default hurting the high yield markets. But, in a recent study, the drop in oil prices has injected a 1.1 TRILLION **(with a T!)** tax cut in the world economies lap. HOOORAY! Now, it takes some time for people to start seeing this money flow into their checkbooks. First, people pay off their debt, build reserves back and finally, they start to spend. This is called a spending lag. We feel once this lag hits the economy, great things are ahead for the markets. Countries like Japan, India, China, Europe, and the U.S. will benefit tremendously by giving everyone an extra chunk of money to spend creating demand for goods and services that in turn creating jobs and upward pressure on wages. We also feel this will jump start many emerging market countries who make the cheap goods we buy. THINK WAL-MART!

Ok, so what does all of this mean for the markets currently? We feel that until the ECB does something to jumpstart the economy (most likely this week), global growth concerns will remain. This makes the market uneasy, which is causing the volatility you are witnessing. We also feel that as oil continues its descent, with many predicting it could hit $30/barrel, portfolio managers are being forced to sell their risky assets to cover their oil positions in which they are getting killed. Once oil finds a bottom, the consumer realizes they have more money in their pockets, and Mario Draghi fires the monetary stimulus bazooka, we feel optimistic that we could see another good stretch of positive returns for many years to come. Now remember, there are always bumps in the road, much like we are experiencing this January, but the long term economic environment looks to have sunny skies ahead.

We at Chapel Hill hope you, the clients, enjoy these email blasts that are intended to inform you about what we feel is actually going on in the economy and in your portfolios. Please remember to keep funding your IRA's and referrals are greatly appreciated. If you have any questions or comments, please feel free to shoot us an email or call. We love hearing feedback.

CONTACT US

jsc@chapelhillinvestment.com

rmc@chapelhillinvestment.com

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