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# OBERMEYER WOOD **NEWS**

WINTER 2015

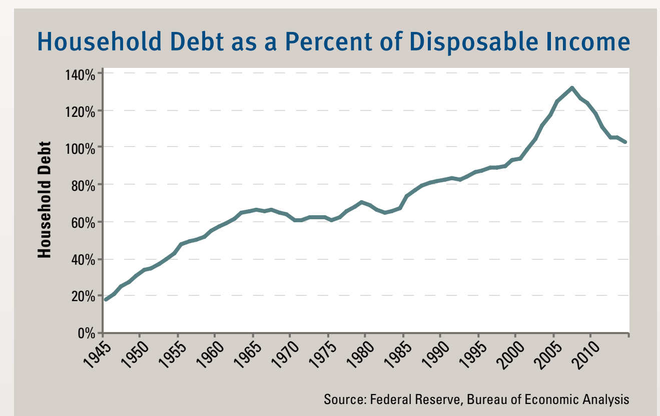

**MARKETPOINT**

## THE ROAD AHEAD

2014 capped off six straight years of improvement in the U.S. economy and financial markets. Domestic growth has accelerated, corporate earnings have been robust, and the unemployment rate has fallen below 6%. Top of mind for investors is if and when the Fed will raise interest rates—with many anticipating that it will begin hiking rates to more normal levels in 2015. However, limited wage growth and decreasing consumer debt continue to dampen confidence and consumption, prompting others to believe that the Fed will remain on hold and interest rates will stay low for the foreseeable future.

U.S. Treasury bond prices rallied in December, with the 30-year bond yield dipping below 3%. Oil prices also fell dramatically from their summer peak, with November seeing the biggest monthly decline since 2011. Rising volatility in financial markets and slumping oil prices (which slow inflation) have relaxed expectations of an aggressive Fed tightening. As such, U.S. Treasury bonds have again become more attractive to some investors. The irony in this is that lower oil prices benefit consumers and could therefore cause improving GDPs in the consuming economies—especially as households' balance sheets continue to improve (see chart). If so, the Fed may raise rates nonetheless.

Apart from declining commodity prices, the backdrop for global financial markets hasn't changed much in recent months. The U.S. is widely expected to continue leading the world in the *rate of change* of economic conditions (improving as others slow). Because of this the Fed will probably lead other central banks on the timing of monetary policy re-normalization (raising rates), and we wouldn't be surprised to see a rate hike over the next twelve months.




While many market participants fixate on Fed moves, the biggest factors to consider for U.S. stock investors will be corporate earnings, which should rebound alongside the economy. We are already seeing indications that business activity could pick up steam soon: numerous confidence indicators are pointing to better days ahead and November retail sales reported the highest reading in eight months. Also, it can be argued that falling oil prices are turning the sweet spot for equities sweeter ›

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as lower prices will dampen inflation and improve the overall profit outlook for non-energy equities by reducing input costs.

With this optimistic backdrop, however, there are indeed plenty of worries that could unsettle markets: the possibility of monetary tightening, an overshoot in the dollar to the upside (which would lower profit expectations for U.S. companies that do significant business abroad), and renewed angst over the fragile state of the eurozone. These are on top of renewed geopolitical risks, which are now heightened as crude oil trades into the $50s. Following several years of relatively sharp U.S. stock price increases, attention to valuation will be paramount.

In our view, U.S. equities have additional upside potential. Fed policy remains ultra-stimulative and real rates (interest rates minus inflation) are in deep negative territory and will stay that way—even if the Fed slowly hikes rates in 2015. Nevertheless, the risk-reward profile for U.S. stocks (particularly those trading at stretched valuations) is more balanced as prices have moved higher in the last few years. The most likely outcome going forward is that the current bull market will enter a more unstable stage with larger price swings than those of the last few years. This occurred in the late 1990s when both stock prices *and* volatility indicators rose concurrently. The bull market remained intact as price multiples expanded, but the uptrend was not without periods of dramatic downward moves. As such, our long-held focus on valuation remains front and center.

**Forward Price-to-Earnings Ratios, 2006-2014**

Source: Bloomberg

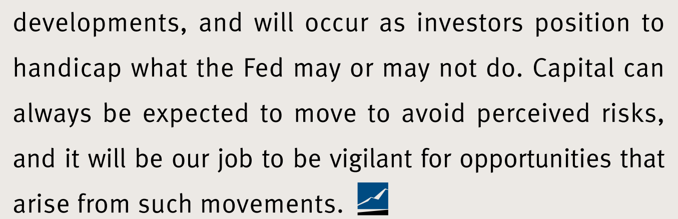
Moving overseas, foreign stock markets should benefit from renewed monetary easing, which is now occurring in Europe, Japan, China, Korea, and Mexico. We anticipate slowing economic growth in these areas will keep their central banks active. However, it is important to understand that anemic economies do not presuppose poor stock markets. After all, U.S. stocks boomed under sluggish growth conditions as sentiment improved over the past several years. The key for markets is whether the policy environment, interest rate levels, and prospects for profit growth are becoming more conducive to potential stock price appreciation—and the answer in many energy-consuming nations is yes, they are.

The case for some exposure to investments that benefit from emerging markets or outright investment in emerging markets remains strong for long-term investors. Not only are EM stock prices cheap on a relative basis compared to other markets (see chart below), but any improvement in U.S. consumption should benefit their economies, and hence their corporate sector's profitability.

Lower oil prices should provide an added kicker for major importers such as China, Korea, and Eastern Europe. *When* sentiment will turn in favor of the EMs is difficult to time, but periods of poor sentiment are often (though not always) good entry points for long-term, value-focused investors.

These trends are fairly well-priced into global equity markets, as evidenced by the U.S. market leading the charge again in 2014. Of course, opportunities *within* markets are plentiful. But while the investing backdrop remains relatively benign, signals sent by plummeting commodity markets and the potential for a Fed rate hike mean that caution may be warranted and that investing with a margin of safety will be key.

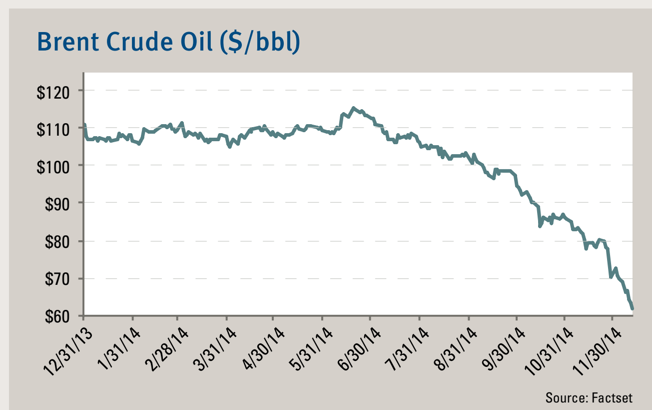
As always, it is important to *expect the unexpected* and not be surprised by more frequent, dramatic corrections going forward as the investment backdrop and sentiment change. Corrections will be normal reactions to any geopolitical changes or unexpected developments, and will occur as investors position to handicap what the Fed may or may not do. Capital can always be expected to move to avoid perceived risks, and it will be our job to be vigilant for opportunities that arise from such movements.



# TOP OF MIND

## IMPLICATIONS OF OIL PRICE DECLINE

While markets have seen price volatility in several asset classes this past year, changes in oil prices have been the most severe and attention-grabbing. Over the summer, the price per barrel of oil began to slide, moving from $115 to below $60. Markets roiled, and investors are debating where the bottom is.



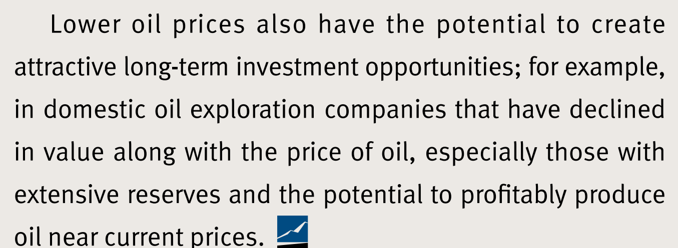

At the heart of the 50% price decline is the perceived oversupply of oil, given the world's current demand for it. Some blame the U.S. energy renaissance, which has added about one million barrels a day this year and has the capacity to add an additional one million barrels a day in 2015. Others point to OPEC's decision to keep output constant in the face of falling prices. Yet the most notable cause is sluggish global growth—a hangover from the past decade's financial crisis.

While there are increasing signs of recovery, the general consensus is that the world is growing slower than it should at this point in the economic cycle. The U.S. jobless rate has fallen to cheer-worthy levels of 5.9%, yet many are working part-time, new job quality is low, and wage growth has barely kept up with inflation. In October, the IMF cut its outlook for 2014 global growth from 3.7% to 3.3%. This move roughly translates to world consumption of oil declining by 200,000 barrels per day. While this is a seemingly small change, it has a big impact on price levels when coupled with new supply from the U.S. and other regions.

In light of this price decline, U.S. energy companies will likely reduce oil production since producing oil from shale is less profitable when oil is sold at today's prices. Meanwhile OPEC is barely budging on their production targets as they have more flexibility to continue producing at lower prices since their marginal costs are less than those of our domestic producers.

The benefit of lower oil prices is that consumers are getting relief at the pump. The average U.S. family will experience the equivalent of a 1-2% pay raise and save $750 a year because of lower gas prices.[1] Since cost savings generally lead to higher spending, the hope is that there will be an upturn in economic growth.

Lower oil prices also have the potential to create attractive long-term investment opportunities; for example, in domestic oil exploration companies that have declined in value along with the price of oil, especially those with extensive reserves and the potential to profitably produce oil near current prices.



[1] Source: IHS Global Insight

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# FIRM UPDATE

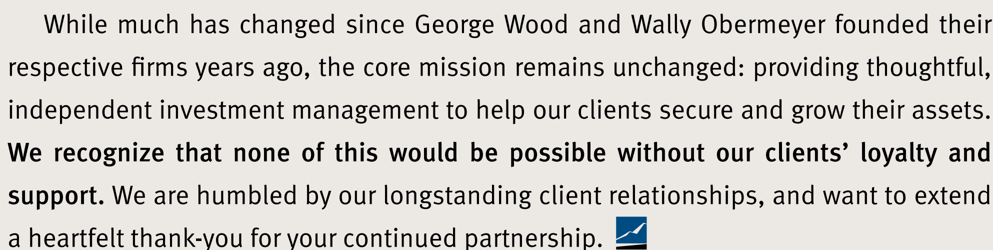
It is with great excitement that we pen our first company update as Obermeyer Wood Investment Counsel, LLLP.

Obermeyer Wood is seventeen people strong, operating out of our offices in Aspen and Denver, with $1.7 billion in managed assets. These past few months have been active ones, with the merged teams focusing on investment collaboration, idea exchanges, operational coordination, and generally working on ways to provide an enhanced client experience.

Our investment team consists of eleven members: Wally, George, Skip, John, Ali, Joe, Roger, Lonny, Wade, Tod and Dana. This group is charged with portfolio management, security selection, and providing strategic, individualized advice to our clients. Our expanded team has enabled us to consider more investments, attend more conferences, read more investment research, and work with more relationships. Our merger has also allowed team members to specialize, with some spending more time advising clients and others devoting their attention to security analysis. As a group, we have spent the past few months analyzing securities across the Obermeyer and Wood portfolios as we work to thoughtfully integrate positioning over time. Historically, both firms have embraced a value-oriented approach and sought to own high-quality, attractively priced securities, giving us a broad range of investments from which to select as we work towards meeting clients' goals.

Our professional team now numbers six: Mary, Danby, Elise, Chris, Molly, and Kimbo are working closely together across both offices to serve our clients' daily needs and integrate operations. Similar to our investment group, our merger has allowed people to focus on their strengths and interests, including client service, compliance, operations, communications, and internal functions.

While much has changed since George Wood and Wally Obermeyer founded their respective firms years ago, the core mission remains unchanged: providing thoughtful, independent investment management to help our clients secure and grow their assets. **We recognize that none of this would be possible without our clients' loyalty and support.** We are humbled by our longstanding client relationships, and want to extend a heartfelt thank-you for your continued partnership.



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