10300 SW Greenburg Rd.
Suite 115
Portland, OR 97223

Client Newsletter – Quarter Ending December 31, 2015

Of Sheiks and Shale

"None of the postwar expansions died of old age; they were all murdered by the Fed."
-Rudi Dornbusch, MIT economist

In May 2015, the markets hit an all-time high. By August the markets were down 11%. The decline was due to an apparent slowing in the Chinese economy and a surprise devaluation of the yuan by China. While the Chinese economy, the second largest in the world, appeared to be slowing, confirmation was hard to obtain owing to the opaque nature of Chinese economic reporting. But, there was no mistaking the yuan devaluation; it caught everyone by surprise. Another sign that the Chinese economy was slowing was the decline in commodity purchases by China. Lacking many resources, China is a big buyer of commodities on the world stage, and producers were definitely seeing a slowing of purchases. With the yuan falling and commodities weakening, Chinese investors began to pull money from their markets and move money out of China. Companies did the same. The Chinese equity markets tumbled. This upheaval was felt throughout the world, as prices of commodities fell sharply. Extraction of natural resources, except for oil, was cut back. The price of oil fell dramatically.

OPEC continued to produce oil for which there was not enough demand. Predominately Sunni Saudi Arabia used oil as a political weapon to punish Shia Iran. Iran reached an agreement with the U.S. and European countries which allowed for Iranian oil production to reach the world market; Iran forecasted an additional one million barrels a day in production. Iraq was also able to increase production. Even ISIS was selling approximately one million barrels a day. In the face of diminishing demand, oil prices fell further. But the U.S. shale producers kept producing. Saudi Arabia had hoped to drive the shale producers out of business, but the pesky shale people kept producing even as prices fell. The U.S., now in a surplus oil position, was allowed to sell oil outside of the U.S. for the first time in years. All of this surplus oil led to uncertainty and to declining income for oil producers.

With this backdrop of declining commodity prices and slowing economies, the Federal Reserve decided it was time to raise interest rates by a quarter of a point on December 16, 2015. Never mind that they had been warned by numerous people, including Christine Lagarde, Chair of the International Monetary Fund, that the global economy was weak and weakening, the Fed decided to proceed. The Fed said that the economy was strong enough, having created 300,000 jobs in December. It is not clear how an economy with less than one percent growth can create 300,000 jobs.

U.S. retailers saw a decline in sales in December from the prior month, even as the Fed cited "solid" gains in spending as a reason to raise rates. For the year, total sales were up 2.1%, the slowest pace of growth since 2009. A separate report from the Federal Reserve showed factory orders falling for the second month in a row. Bill Dudley, head of the New York Fed, projected accelerating inflation even as he joined colleagues in pointing out the decline in inflation expectations. Inflation seems to be heading down, raising fears of deflation. Consumer prices fell 0.1% in December.

For a few days the markets absorbed this rate increase, but not for long. The U.S. equity markets started a steep descent, which is not yet over. The markets quickly went into a correction, a decline of ten percent or more, and threated to proceed to a bear market, a twenty percent correction. Some thought that the market was forecasting a recession and expectations of one increased dramatically. But what occurred was a continuation of the very slow growth in the U.S. economy. Indeed, fourth quarter 2015 GDP was revised downward to 0.8% from 1.0%.

Emerging markets came under mores strain as the U.S. dollar rose. Emerging market debt is largely owed in dollars. The global economy looked fragile indeed.

The U.S. equity markets ended the year mixed, with the Dow down 2.23% and the S&P index up 0.83%. The NASDAQ was up 5.73%. The average diversified U.S. equity fund was down 2.20 % on the year.

Markets became more volatile. In recent years volatility has increased because of headline news and high frequency trading. Robots now control market swings, amplifying them. Ordinary investors cannot keep up with the swings.

We start 2016 with the markets in a correction mode, and it appears that the future looks grim. However, we have experienced these sharp downdrafts before, even at the beginning of a year, and yet the markets have recovered. The Fed has to be vigilant, because among other things it begins to look like they have laid a big rotten egg. As I said in my book, "*Who shot Goldilocks?"* the Fed has caused most of the recent recessions. I don't think Yellen and company want a repeat of the Greenspan years. Just this past week, James Bullard, the President of the St. Louis Federal Reserve and an incoming voting member of the rate setting FOMC, suggested that the Fed should be in no hurry to raise rates, and that they may have gotten it wrong with their December rate increase. Treasury market futures have dropped to a 30% likelihood of an April rate increase, down from over 70% a month ago. Look to the markets, not the Fed. Rates actually dropped after the Fed raised rates, also suggesting that the Fed got it wrong.

So what is an investor to do? First of all recognize that we are going to have continuing, even increased volatility. That is the kind of market we are in. Do not panic; keep your eyes firmly fixed on the horizon. We often say that the markets are like an ocean. If you are out in the small craft on the ocean, you will get tossed around, even on a good day. If you focus on the near horizon, you will probably get sick. Focus on the distant horizon and you will stay well.

As always we will have a diversified portfolio and hold long term. We will trim where indicated and the cash we realize will be available to us when the market turns.

Call if you have questions.

William D. Rutherford
Rutherford Investment Management

Phone: 503.452.1210 • Fax: 503.452.0120 • www.RutherfordInvestment.com