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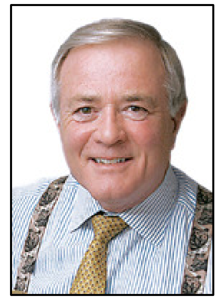

William Rutherford

Bull market climbing a wall of worry

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U. S. equity markets rose over the course of 2014 as the U.S. economy continued to strengthen. In December the Dow was flat, the S&P was down 0.4 percent, and the NASDAQ was down 1.2 percent. For the year the Dow was up 8 percent and the S&P was up 11 percent – 13.7 percent when dividends were reinvested; the NASDAQ was up 13 percent.

The best sectors among S&P stocks were utilities (up 25 percent), health care (up 24 percent) and information technology (up 19 percent). Energy was the worst performing S&P sector. In late 2014, the S&P finally rose to a new inflation-adjusted high.

Stocks in 2014 as represented by the Russell 3000 were worth 143 percent of gross domestic product, the highest since year end 1999. Increase in household wealth is over $7 trillion over the past three years, according to the Federal Reserve.

Third quarter GDP was revised upward to 5 percent – stronger than expected. Consumer spending rose .06 percent from October to November with the effects of lower prices for gas at the pump taking hold. Oil and natural gas prices both dropped as moderate weather and slowing world economies created a supply glut in those commodities. Crude oil fell to $53.30, the lowest price since May 2009.

Personal income increased .04 percent over October. The strengthening dollar has made investments in the U.S. more attractive. The dollar might well be headed to parity with the euro, where it has not been since 2002.

The only dark spot in the U.S. numbers was that the consumer sentiment declined slightly to 93.6 percent from 93.8 percent in November, according to the University of Michigan consumer sentiment numbers.

The market has weathered another eurozone crisis, the steep drop in oil prices, the end of quantitative easing and the threat of rising interest rates, among other things. The market rise has not been smooth, with a drop of 7.4 percent in early fall and another sell-off of 3.5 percent in December.

The run-up has now lasted nearly 70 months, making it the fourth-longest bull market since World War II.

Bond markets do not share equity market enthusiasm, with declining yields suggesting wariness among investors, even as the Federal Reserve makes plans to raise rates. A rise in yields brings its own worries. A spike in yields in 2013 rattled global markets.

With profits expected to rise about 8 percent in the next 12 months, the markets should see a similar increase in 2015, assuming no change in the price-earnings ratio of stocks. Based on the markets' current price-earnings ratio of 15.8 times future earnings for the next year, U.S. stocks seem fairly priced.

But profits may not be as strong as they look. Per-share earnings have been increased by share buybacks. Investment in capital expenditures is only a little more than buybacks and dividends. The percentage of buybacks to increased capital expenditures is higher than any year since 2007, which suggests that companies do not have a better use for their money.

As readers of this column know, I often say the market climbs a wall of worry. There is nothing wrong with that as worry keeps a damper on exuberance, which we all know can get out of hand. Just as success breeds success, the strength of the U.S markets compared to the rest of the world and the strength of the dollar has attracted foreign funds.

The U.S. Federal Reserve is poised to raise interest rates in 2015, but they have promised to "be patient." The decline in oil prices will partially offset the rise in interest rates.

Central bankers all over the world are doing their best to strengthen their economies with little success. European markets have been subdued as fear of deflation takes hold in Europe. The growth rate of European economies has been low, with Eastern Europe especially under duress because of Russian bellicosity. Emerging markets have been under stress too, primarily because of the strengthening dollar and in some cases the fall in oil prices. Because emerging economies often borrow in dollars, they are especially susceptible to a strengthening dollar.

Asian markets have had problems as China's growth rate has declined. The Chinese central bank has pumped money into the economy, but has not been able to stop the decline in the growth rate. The Chinese property market, which has been robust, is now under pressure and Chinese investors haven't been looking more to the U.S. as a safe haven for investments.

The recent purchase of the Waldorf Astoria is reminiscent of the Japanese purchase of Rockefeller Center at the height of the Japanese property bubble. A few years later, the Japanese were scrambling to get out of their U.S. investments at a steep discount. The Japanese were propelled into a two-decade recession. Now Japan has entered another recession.

With the growth in U.S. GDP, the resulting increase in profits and the influx of foreign capital, we can expect the U.S. markets to continue their strong run. We can expect rising capital spending, higher dividends and share buybacks. With so much investing feeding the markets and such a positive outlook among investors, one can easily be suspect of the strength of the markets. Thus we are back to the wall of worry – a good thing.

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