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Fears rise as global economic growth slows

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U. S. equity markets rose 4.71 percent in the fourth quarter of 2014, as measured by the S&P 500. Strong earnings overcame a sharp mid-October correction. Coupled with disinflation fears in Europe, political turmoil, fear of a Greek exit from the European Union, and about a 40 percent drop in oil prices, economic uncertainty led to a slowing economy. GDP annual growth slowed in the fourth quarter to 2.6 percent – down from 4.5 percent in the previous quarter.

Consumers led the increase in GDP, with a 4.3 percent increase in spending – the largest since the first quarter of 2006. Lower gas prices and new hiring no doubt contributed to this increased consumption. The University of Michigan consumer sentiment increased to its highest level since 2004. The consumer sentiment increase was as high for those with incomes of less than $75,000 per year as those with more than $75,000 per year.

Other factors contributing to the decline in GDP were a build in inventories, which could signal a drag on future growth, and a huge drop in defense spending, although that may just be a timing factor. However, more troubling was continued ambivalence toward capital spending, which declining oil prices will not help, and a slowdown in foreign demand, which a stronger dollar will not help. All things considered, GDP growth may not exceed 3 percent in 2015.

The U.S. was the standout performer in equities for the year and the quarter, with most other parts of the world underperforming. Even so, for January the S&P was down 3.12 percent, the Dow down 3.7 percent, and the NASDAQ down 2.1 percent. The price of a barrel of crude oil dropped 9.4 percent in December. As investors sought security, Treasury yields dropped 35 basis points in the third quarter, despite the Federal Reserve's apparent intention to raise rates in 2015.

The U.S. equity markets began 2015 with a swoon, and then a recovery, and then a sharp drop again as lower oil prices and a strong dollar weighed on the market. Volatility ruled the day. Oil was a drag because profits in the oil patch were dropping, leading to cutbacks in capital spending and employment.

The strong dollar depressed the market, because it was feared that dollar strength would undermine exports and therefore the economic recovery. The Fed appeared to vacillate on its plans to raise rates, while the futures market indicated the rate increases will come later in the year rather than in the summer.

In its January 28 policy statement, fhe Fed reaffirmed its intention to be "patient" in the timing of the rate increase. Fed Chairwoman Janet Yellen has defined patient as being two meetings, but it is not

certain when the count begins. Did the clock just restart? The Fed said the economy was expanding at a "solid pace" as opposed to December's "moderate pace," with job gains "strong" as opposed to last month's "solid" gains.

However, the Fed noted that inflation was headed lower due to falling energy prices. It still believes its 2 percent inflation target will be achieved, but described expectations as having "fallen somewhat further."

The Fed added the word "international" to its statement, saying it was now monitoring international developments. We can conclude that overseas growth, disinflation, dollar movement, foreign central bank activities, as well as the fate of the EU are all being closely followed. Foreign central banks all seemed bent on cheapening their currencies, and the European Central Bank launched its own version of quantitative easing, pledging to buy more than $1 trillion in European bonds.

The overall take on the Fed comments is that the Fed is leaning more dovish than it has been, and therefore may extend low interest rates longer than expected. This was also the first unanimous vote since 2009.

We can look forward to a period of increased volatility as the market adjusts to weaker oil prices and a stronger dollar. However, lower prices for oil and imported goods will be good for consumers, who provide 70 percent of domestic spending. Lower oil prices and lower import prices should restrain inflation and give the Fed more latitude for low interest rates.

With earning season upon us, we see about 70 percent of companies reporting beating earnings estimates. With earnings believed to increase about 8 percent this year, we could anticipate an increase of about 8 percent in the market averages. Stay invested in a diversified portfolio.

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