

Weekly Market Commentary December 22, 2014

The Markets

Geopolitics and monetary policy and deflation! Oh my!

It was a wild, wild week. First, the Russian central bank announced a massive rate hike and the country's main deposit rate rose from 10.5 percent to 17 percent. The move was the largest single increase in Russian rates "since 1998, when Russian rates soared past 100 percent and the government defaulted on debt," according to *Bloomberg.com*.¹

The central bank was desperately trying to shore up the ruble which was suffering from lower oil prices and Western sanctions imposed after Russian annexed Crimea. The rate hike wasn't immediately effective and the ruble sank to a record low. The currency has lost 52 percent of its value during 2014 to date, and the outlook for the future of the country's economy isn't bright.² If oil averages \$60 a barrel, Russia's gross domestic product – the value of all goods and services produced in the country – might fall by 4.5 percent to 4.7 percent in 2015.³

Events in Russia put investors in a selling mood, and stock markets around the world moved lower early in the week. *Barron's* commented, "From all appearances, investors were selling stocks while they were doing their holiday shopping."⁴

The investor stampede was headed off by a bit of whooping and hollering from the Federal Reserve. After the Federal Open Market Committee meeting, the Fed announced its policies remained unchanged:⁵

"...Based on its current assessment, the Committee judges that it can be patient in beginning to normalize the stance of monetary policy. The Committee sees this guidance as consistent with its previous statement that it likely will be appropriate to maintain the 0 to 1/4 percent target range for the federal funds rate for a considerable time following the end of its asset purchase program in October, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal, and provided that longer-term inflation expectations remain well anchored."

The Fed's decision was enough to calm markets, many of which showed attractive gains by week's end.

Data as of 12/19/14	1-Week	Y-T-D	1-Year	3-Year	5-Year	10-Year
Standard & Poor's 500 (Domestic Stocks)	3.4%	12.0%	14.4%	19.8%	13.2%	5.7%
10-year Treasury Note (Yield Only)	2.2	NA	2.9	1.8	3.7	4.2
Gold (per ounce)	-1.8	-0.5	0.0	-9.2	1.6	10.5
Bloomberg Commodity Index	-2.0	-13.7	-14.4	-7.5	-4.3	-3.1
DJ Equity All REIT Total Return Index	1.5	28.0	29.2	18.2	16.8	8.4

S&P 500, Gold, Bloomberg Commodity Index returns exclude reinvested dividends (gold does not pay a dividend) and the three-, five-, and 10-year returns are annualized; the DJ Equity All REIT Total Return Index does include reinvested dividends and the three-, five-, and 10-year returns are annualized; and the 10-year Treasury Note is simply the yield at the close of the day on each of the historical time periods.

Sources: Yahoo! Finance, Barron's, djindexes.com, London Bullion Market Association.
Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly. N/A means not applicable.

AS PEOPLE GET RICHER, DO INVESTMENT RETURNS GET BETTER? No, they don't. Research shows there is a negative correlation between gross domestic product (GDP) per capita – a measure of how wealthy people in a country are becoming – and investment returns.⁶

In other words, the countries with the fastest growing economies don't always produce the highest investment returns and vice versa. For example, between 1900 and 2013, South Africa rewarded investors with long-term stock market returns of about 7.4 percent while its per capita GDP growth was 1.1 percent. At the opposite end of the spectrum was Ireland, where markets returned 2.8 percent while per capita GDP growth was 4.1 percent.⁶ *The Economist* described the research findings:⁷

“The quintile of countries with the highest growth rate over the previous five years produced average returns over the following year of 6 percent; those in the slowest-growing quintile produced returns of 12 percent... Why might this be? One likely explanation is that growth countries are like growth stocks; their potential is recognized and the price of their equities is bid up to stratospheric levels. The second is that a stock market does not precisely represent a country's economy – it excludes unquoted companies and includes the foreign subsidiaries of domestic businesses. The third factor may be that growth is siphoned off by insiders – executives and the like – at the expense of shareholders.”

Here is another interesting economic tidbit. While past economic growth does not predict future equity market performance, changes in stock prices do correlate to future economic growth.⁶ That's because expectations play an important role in markets. The expectation of poor future economic performance may cause a country's share values to fall, and vice versa. A research report from *Schroders* said, “If expectations are key, a poor economic outlook will already be priced in, and investors' returns will depend instead upon whether market expectations are overly optimistic or pessimistic with regards to future GDP growth.”⁸

Weekly Focus – Think About It

"Not everything that can be counted counts, and not everything that counts can be counted."

--Albert Einstein, *Theoretical physicist*⁹

Best regards,

Jim

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* The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.

* The Dow Jones Industrial Average is a price-weighted index of 30 actively traded blue-chip stocks.

* The NASDAQ Composite Index is an unmanaged, market-weighted index of all over-the-counter common stocks traded on the National Association of Securities Dealers Automated Quotation System.

* Yahoo! Finance is the source for any reference to the performance of an index between two specific periods.

* Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.

* Consult your financial professional before making any investment decision.

* You cannot invest directly in an index.

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¹ <http://www.bloomberg.com/news/2014-12-15/russia-increases-key-interest-rate-to-17-to-stem-ruble-decline.html>

² <http://www.bloomberg.com/news/2014-12-16/ruble-snaps-six-day-loss-on-surprise-rate-increase-to-17-percent.html>

³ <http://www.bloomberg.com/news/2014-12-16/russia-stocks-sink-most-in-world-as-ruble-crisis-pummels-banks.html>

⁴ http://online.barrons.com/articles/barrons-up-down-wall-street-the-oily-slope-1419046381?mod=BOL_hp_we_columns (*or go to* http://peakclassic.peakadvisoralliance.com/app/webroot/custom/editor/12-22-14_Barrons-The_Oily_Slope-Footer_4.pdf)

⁵ <http://www.federalreserve.gov/newsevents/press/monetary/20141217a.htm>

⁶ <http://www.businessinsider.com/equity-returns-and-gdp-per-capita-2014-2>

⁷ http://www.economist.com/blogs/buttonwood/2009/08/the_growth_illusion (*or go to* http://peakclassic.peakadvisoralliance.com/app/webroot/custom/editor/12-22-14_TheEconomist_The_Growth_Illusion-Footer_7.pdf)

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<http://www.schroders.com/staticfiles/Schroders/Sites/Americas/US%20Institutional%202011/pdfs/Equity-Returns-and-GDP.pdf>

⁹ <http://www.brainyquote.com/quotes/quotes/a/alberteins100201.html>