

December 19, 2015

“Good investors gather information, put that information into current and historical context, then make sound decisions.”

In last month’s Commentary it was noted that since 1950 the month of December has had the best monthly performance with the S&P 500 and the DJIA. Well, it’s not looking very good so far for 2015. In December we have had six positive days, including a very nice day when the Federal Reserve announced that they were finally going to start letting short-term interest rates work their way higher. But we have also had eight negative days, including a very rough day yesterday, that occurred with very heavy volume. So what’s wrong with this ‘good news, bad news’ scenario?

People generally want the bad news first, so here we go. Since the August correction, equity markets have been unable to decisively break out to new highs. Large cap equities have been pulling the wagon all by themselves for most of the year, with concentration from technology, healthcare, and consumer discretionary sectors. Since there are a total of ten primary equity sectors, having only three in the harnesses represents a lack of breadth, which can be problematic. The roughest sector, performance-wise, in 2015 has been energy. Low prices at the pump are nice, but industrial energy consumption has been declining globally, which many perceive as being problematic. On a short-term basis, the very large drop in equity markets on the Friday before Christmas, with very heavy volume, was disconcerting. We normally see light volume heading into the Holidays, accompanied by a light volume Santa Claus Rally. Friday’s action was a big lump of coal. Does this mean that we are going to have a skinny Santa this year?

As for the good news, the fact that our very cautious (a.k.a. dovish) Federal Reserve elected to increase, ever so slightly, short-term interest rates for the first time in nine years is a reflection that they are confident that the U.S. economy is on safe ground. Also on the good news side, historically, domestic equities have performed quite well when interest rates have started to rise. This is consistent with the underlying premise that better economic times can handle higher interest rates, price increases, higher corporate profits and higher share prices. So those dominoes are falling in favor of higher equity prices.

We are also in a historically favorable time of the calendar year, although December looks like it is going to have to lean on January to make this sequence work one more time. There also exists the very real possibility that these sideways equity markets are still the prelude to a breakout to the upside as we continue this well-established long term Bull Market.

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Which brings us to the bond markets, the long-suffering alter-egos of equity markets. One would think that with all of the equity market angst in 2015, bond markets must have been having a field day (a very good time, for the youngsters among you.) Quite to the contrary, despite an eight-month, sideways equity market, and despite a very sharp and deep correction late in the year, and despite a correction recovery that failed to break out to new highs, the bond market languishes. The Federal Reserve’s impending interest rate rise accounts for some of the hesitation, but as the year progressed those threats were minimalized. The best rationalization for the lack of flood of capital into bond markets has to be that institutional investors are not done with equity markets yet, which bodes well for all equity market investors. The best may be yet to come.

If that ‘best’ fails to materialize soon, equity prices may once again become vulnerable. We remain optimistic for the intermediate and long-term, albeit very cautious over the near term. January may very well tell the tale of the next chapter. We continue to hold domestic equities, with emphasis on the large cap sector and avoidance of small caps. We also continue to avoid international and energy equities.

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