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# *OBSERVATIONS ON THE MARKET*

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Thank you oil, at least I think it was oil. Today the Dow hit 18,000. It's a nice big round number, but by itself means nothing. The fourth quarter experienced a rough start, then gained momentum on the downside as oil went into a freefall, hitting $53 a barrel at its low. Lower oil prices seemed like a positive for the economy, however, the market thought otherwise. Fear is a powerful motivator, and the fear of large scale defaults in the oil sector took hold. Most independent producers (80%) are less than investment grade debt issuers, so it becomes easy to draw a line to bank problems and the threat of contagion, a scary word especially after the recession of 2008. Then, something changed. Maybe it was the Fed implying that interest rates may stay low for longer than thought due to lower oil prices. In a matter of days all fear turned to celebration.

Fear really expressed itself in the oil market and energy stocks. Several days before hitting the current low of $53, the sector experienced declines of 1% or more daily. It was clearly a liquidation market. Companies tied to oil drilling or exploration and who also carried debt, fell by over 50% from just a few months earlier. Fear then turned to opportunity, and the hint that oil may have found a bottom lead the sector to rally by 20% or more in only a few days. For the moment, $2.25 gasoline seems to be a good thing.

Dow 18,000 is a good reason to reflect on what is next. With companies like MMM, Procter & Gamble, PepsiCo, and UPS trading at 20 times next years' earnings estimates, it begs the question; how much better can it get? With the economy growing at 5% in the fourth quarter, oil holding down inflation and interest rates, and earnings expected to grow by 11% next year, it can get 11% better. The market goes up for only two reasons given enough time. 1) Earnings growth - If a company doubles its earnings over time and everything else remains the same, the stock price should also double. 2) The market's multiple expands - Currently, with interest rates so low, investors are willing to pay more for earnings because the dividend of a company is more attractive compared to other investments. Historically, the market reverts to the mean and tracks the growth of earnings. The graphs of both look identical over decades. What gets us in trouble is all the noise.

The economist Rudiger Dornbusch said: "In economics things take longer to happen than you think they will, and then happen faster than you thought they could." Oil is the current bargain, it is economics 101. There are several reasons why the price has fallen. Too much supply and demand is down - especially in the emerging markets. Fracking is perceived to give us all the oil we need for decades to come, however, nobody drills for it if they don't make money. The drilling budgets are getting cut by virtually everyone, it just takes time for the supply to come down. One interesting point is that this cycle may be different than past oil cycles. In fracking, the oil production from a new well declines faster at the beginning of production than a normal well without the pressure stimulation. Supply may adjust downward faster than the past. Saudi Arabia appears committed to seeing production getting cut. They know that their oil is worth more over time if they let economics 101 have its way.

Does the idea of buying gasoline well into the future at $2.25 appeal to you? Just buy Chevron. However, you will now own one of the worst performing Dow stocks for the year, one that didn't contribute to Dow 18,000. However, as the infamous 1920's stock speculator Jesse Livermore once said, "Don't give me timing, give me time."