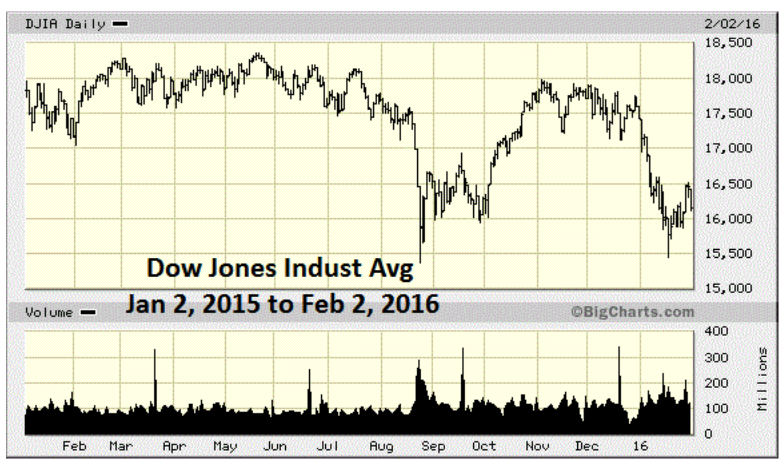
American Heritage Financial

February Update **February 3, 2016**

A Question of Demand or Supply?

- Frightening volatility has disheartened investors (once again!)
- Oil continues to provide a dramatic lesson in Economics 101
- The economy and world central banks give mixed signals
- Earnings have been…actually positive!
- Markets have responded to the hyperbole (similar to the electorate)
- The Fear/Greed pendulum is swinging to extreme fear
- Stocks prices have disconnected from valuations
- "Risk Off" is evident in the decline in Treasury bond rates

Would it be an understatement to say that the first month of 2016 was a disaster for the financial markets? The critical driver has been oil, so we start there with the ugly statistics for January: crude collapsed another 26% in the first three weeks of the year and rebounded to end the month down about 18%. Stocks swung wildly from day to day and a huge 2.5% gain on the final day of January left the S&P 500 negative by 5.1% for the month. The Dow Transportation Index—considered a "leading indicator"—slumped by 8.0% while the "safe haven" Dow Utility Index gained 5.8%. These demoralizing trends continue in the early days of February. We will look more in depth at January's performance, the causes and what to expect going forward in the rest of this month's comments.



The price of oil has been declining since mid-2014. After a period of relatively steady prices around $90 a barrel, oil declined by 33% to $60 by the close of 2014. Price held for the first six months of 2015 but the decline accelerated into the end of 2015, finishing the year at $38. January brought a true collapse, hitting $24 before bouncing back to the $30 area.

While it appears oil might be bottoming around the current $30 area, it is impossible to be certain. Oil is a commodity so the price is dependent on supply and demand. Normally, when commodity prices drop to "cost," producers stop producing to avoid losing money, bringing supply and demand back in balance and supporting a new rise in price. We hate to say these words but, ***"this time is different."*** That is because this oil glut is (mostly) due to excess production (supply) motivated by the desire to punish other producers. The main over-producer is Saudi Arabia, who would like to see the booming U.S. shale industry destroyed. Continued high production from cash strapped countries like Russia and Brazil and renewed supply from Iran also add to the oversupply. Where all of this ends is unpredictable but it will eventually end because producers are losing money on every barrel of oil drilled. It is impossible to say when someone will call "uncle".

There are other issues contributing to the decline in commodity and financial markets. The rapid slowdown in China, the appreciating U.S. dollar, the Fed tightening interest rates and generally weak global economies are all concerns but oil is the single over-riding issue. An optimistic view to the resolution of the market's problems is to understand that oil will get back to at least the cost of production, or about $60 per barrel. The pessimistic view of this situation is to dwell on the damage low oil prices are having on global economies and corporate earnings.

Investors, at this point, are definitely focusing on the pessimistic view. Even those of us who see this as simply another economic cycle, understand that the damage to profits and balance sheets is more severe than expected. It was obvious that earnings of oil companies would be hurt. Then any company remotely involved with the energy industry started feeling the pain.

Now, there is even concern that our recently recapitalized financial system (the banks) may take a hit.

Investors have looked at the problems, and with the pain of the last financial crisis still lingering, they are selling indiscriminately. They have no appetite (demand) for stocks and it results in an oversupply of stocks that is as distorted as the oversupply of oil. Earnings are not the problem: even with the negative impact of oil on earnings, reported numbers for the current quarter are coming in similar—or slightly better than—normal patterns. Stock prices have disconnected with the long-term reality when great growth companies like JP Morgan, Apple and United Technologies are trading at less than ten times earnings—AND have growing dividends of 2% to 3%. The fact that the yield on the Ten-Year Treasury bond dropped from 2.3% to 1.8% in the past month is a testament to the level of fear and risk avoidance which has overtaken the financial markets.

When markets go to extremes — on the upside or downside — It is a time of great opportunity for the long-term, value oriented investor. While we do not want to catch a falling knife or even try to anticipate the bottom, we believe oil prices will recover, the U.S. economy will remain resilient and strong and that we are near a great buying opportunity. We hope you will consider these thoughts and maintain a positive, confident approach to long-term investing. It is a time for patience and calm while constantly reassessing the risks and opportunities.

Don't hesitate to call or email if you have concerns or would like to discuss these ideas further.

Ted Ingraham

EGI Financial, Inc.
American Heritage Securities, Inc.

Questions or comments?
Email us at: ahs@egifinancial.com or call 330-535-0881. Visit us at www.EGIFinancial.com