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The captivating 2001 movie "A Beautiful Mind" was about John Nash, the brilliant mathematician who won the Nobel Prize in 1994 for his contributions to game theory. Game theory essentially states that competing parties will act in their own self-interest, even if it is to the detriment of the collective group. In the U.S. today, we have a real-life situation of game theory: if the country's oil producers cut production, the collective group will benefit from higher oil prices, but instead, each of them is waiting for a rival to cut. "Fracking,"a well-stimulation technique in which rock is fractured by a hydraulically pressurized liquid, has played a major role in U.S. oil production. Production has increased dramatically, rising from roughly 5 million barrels of oil a day in 2008 to about 9 million barrels a day at present. Some say the recent decline in oil prices, from over $100 during the summer to under $55 by year-end, is largely the fault of the U.S. Still, while low oil prices have hurt the stock prices of energy companies and helped lower inflation to a level undesired by the Federal Reserve, it's not all bad news. In fact, Janet Yellen, chair of the Fed, has gone so far as to say that the oil price decline is a net positive for the U.S. economy, as it lowers costs for households and many companies. She stated "It's like a tax cut that boosts their spending power," referring to households saving more on energy and gas and thus having more money to spend elsewhere.

Aided by higher consumer spending in areas including gasoline and healthcare, third quarter U.S. GDP was revised upward at the end of December to 5%, an annual growth rate not seen since 2003. However, with a first quarter GDP growth rate of -2.9%, it is clear that quarterly data can fluctuate and therefore should not be viewed in isolation. As such, in looking at the next 4 quarters, estimates are for a 2015 growth rate of 3%, which is still shy of most post-recession growth rates of 4% or greater. 3% is still a respectable number, though, and other metrics are looking up. Unemployment is now at its lowest level since the recession began, with many market participants now forecasting wage growth as more jobs continue to be filled. Additionally, we have seen solid strength in retail sales, consumer confidence, and of course the U.S. dollar.

The economic data has also been adequate enough for the Fed to finally end its last bond-buying program. Despite this exit, and a growing consensus that the Fed will soon raise the federal funds rate, long-term interest rates ended the year solidly lower, making long-term Treasury bonds one of the highest returning asset classes of the year. We feel this is unlikely to repeat, though, because rates are at historic lows and a stronger U.S. economy is likely to cause an increase in rates. However, there are also forces keeping rates low. Yields on Japanese sovereign debt and the European sovereign debt of countries such as France, Spain, and Germany touched record lows in December. With these yields now at large discounts to U.S. Treasury yields, coupled with low foreign exchange risk due to a strong U.S. dollar, foreign investor flows will likely continue into U.S. government bonds, keeping yields low. In addition, the massive drop in energy prices, along with slow wage growth, has helped keep inflation low, also leading to lower interest rates.

The old saying "A rising tide lifts all boats" didn't hold true with this year's U.S. stock market. We reached numerous all-time highs throughout the year, helped by a fairly strong domestic economy, but the energy sector significantly underperformed the broad market due to the fall in oil prices. Similarly, although the U.S. stock market appreciated, economic problems loomed in Europe, Japan, Russia, and in many other countries, causing their stock markets to perform poorly. With such strong U.S. equity gains, domestic equities are now predominantly fairly priced, leaving energy as a rare area in the market where we are finding value. With oil prices pressured because of supply and demand issues, we view the situation as cyclical, and as long-term investors we are happy to hold and/or increase our energy exposure. Outside of energy, we think that with a strong economy, corporate profits should continue to increase, helping to justify higher valuations. As always, we will continue to manage your capital prudently by purchasing companies that have healthy balance sheets and good growth prospects.

From all of us at Gamble Jones, we wish you a happy new year.

Alison J. Gamble
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