April 2016

Oil – black gold, Texas tea, major contributor to stock market volatility. After an unusually long stretch of relative calm over the past few years, the stock market has been a bit jumpy in recent months. Large swings in the price of oil have certainly played a major role in this heightened market volatility. The market followed oil sharply lower in the first half of the quarter with each reaching its lows for the year on February 11th. As oil rallied off its lows, stocks too reversed course, leading the Dow Jones Industrial Average to its biggest comeback from a deficit during a quarter since 1933.

While oil and stock prices have not historically been highly correlated, they have certainly traded in tandem lately. Chief among the many reasons for this is that the price of oil has increasingly been looked upon in recent months as an indicator of economic health. There has been a growing concern among investors that the driving force behind oil's price plunge has been a reduction in demand that could be signaling a rapidly slowing global economy that could ultimately drag the U.S. into recession. Some have also feared that the collapse in oil could force so many of the weaker energy companies to default on their loans that it would overwhelm the banking industry and result in a financial contagion similar to the one which occurred in 2008. As oil has risen off its lows, these concerns have eased, and stocks have followed suit.

Our view is that the market has overreacted to the oil price swings. We continue to believe that the primary cause of the weakness in oil has been a supply glut resulting largely from the surge in U.S. shale production in recent years. The strengthening of the dollar over the past couple of years has also played a role in oil's decline as it has made the dollar-denominated commodity more expensive in other currencies. So while a softening in demand for oil has likely played a secondary role in oil's price drop, we don't think it is an indicator of a looming global recession. Though China's economy has cooled and global economic growth has slowed, we don't view the slowdown as being significant enough to derail the U.S. economy. With a strengthening labor market and a housing market that remains in solid shape, the U.S. economy should remain resilient, continuing to plug along at a moderate but steady pace as it has for the past few years.

We also think that the banking industry as a whole is well equipped to absorb the spike in energy loan defaults that is sure to come. Energy loans make up just a fraction of the dollar amount that

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residential mortgage loans did in 2007. In addition, U.S. banks are in far better shape than they were a decade ago, as they have been forced to build their capital cushions by the stringent regulations that have been put in place since the time of the financial crisis.

The 50% rally in the price of oil off of its 12-year low of $26 per barrel has certainly been impressive. And while we think there is a good chance that oil has put in a bottom, we do not expect it to continue to head straight up from here. Significant production cuts still need to be made to bring supply in balance with demand, and these cuts are likely to occur very gradually over the course of the next several months or longer as weaker U.S. shale companies are forced out of business. Much of the recent oil rally has been built on hopes that a mid-April meeting of OPEC members and other major oil producers such as Russia will result in an agreement to limit production that could help to jumpstart the process of reducing supply. However, reaching and enforcing such an agreement among rival oil exporters has historically proven to be a difficult task. Another reason for the jump in the price of oil has been the weakening of the dollar over the past couple of months following its extended run-up. However, the dollar could easily begin to strengthen again, particularly if it is anticipated that the Federal Reserve is moving closer to raising interest rates. As a result, our expectation is that the price of oil will continue to bounce around in the coming months and that the stock market could very well continue to follow its lead.

While the stock market has calmed down quite a bit over the past few weeks, it would come as no surprise if volatility were to pick up again in the coming months given all of the uncertainty surrounding the price of oil, the global economy, the timing of interest rate hikes, and the upcoming elections. And though we continue to find individual stocks that we believe are attractively valued, we think the market as a whole is trading at a pretty full valuation, which could also contribute to volatility. Though market volatility can understandably be unnerving for investors, it is important during such times to maintain a long-term perspective. Legendary investor Benjamin Graham once said, “In the short run, the market is a voting machine but in the long run, it is a weighing machine.” Once all the noise dies down, what truly matters is the substance of a company. Over the long run, a stock’s value will be determined by the underlying company’s actual business performance, not by the price swings resulting from the fickle nature of markets. For this reason, our focus remains centered on owning attractively valued, financially strong companies that are built to withstand the many different economic and market cycles that are sure to occur along the way. We stand prepared to take advantage of any such long-term investment opportunities created by the short-term effects of market volatility.

Sincerely,

Alison Gamble, President